Vanderbilt Law Review

Volume 47
Issue 1 *Issue 1 - January 1994*

Article 1

1-1994

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VANDERBILT LAW REVIEW

VOLUME 47 JANUARY 1994 NUMBER 1

Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise

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I. INTRODUCTION

The corporate form limits the liability of shareholders and other participants arising from the enterprise.[1] This broad insulation shields corporate participants not only from vicarious liability for the acts of others, but even from liability for some of their own acts taken in the corporate name. The liability that is avoided does not disappear into a black hole; it falls onto another person. If the liability is shifted to a tort victim, the use of the corporate form seems particularly troublesome, permitting the enterprise to externalize part of the cost of doing business. This limitation seems inconsistent with the increased use of strict liability and other modern tort doctrines to extend liability to the enterprise.[2] Indeed, some believe that corporate law undercuts tort law and represents a nineteenth-century relic that should be swept away in the face of current tort learning.[3]

Evaluating this possible conflict requires consideration of both corporate and tort law concepts. The impact of corporate law begins with its language. The corporate form separatos individual participants into shareholders, officers, and directors. This division reflects

1. Shareholders' limited liability generally is specified in a state corporations statute. See Model Business Corp. Act § 6.22 (ABA, 1985). Liability of officers is defined by agency law; officers as agents ordinarily are not liable for acts of their principal. See Part II.

2. See generally Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 Cal. L. Rev. 1345 (1982); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 Yale L. J. 1231 (1984).

3. Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 Vand. L. Rev. 1387, 1440 (1992) (stating, "Oddly, however, these themes [favoring industry and dating from the 19th century] have substantially eroded in tort and contract law, yet they centinue to be enshrined in corporate law."); Henry Hansmann and Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L. J. 1879, 1920 (1991) (noting that, for involuntary crediters, limited liability prevents tort law from fulfilling the function of allocating costs among acters). See also Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 Harv. L. Rev. 387, 391 (1992) (stating that "[l]imited liability . . . threatens the animating principles of tort law").

the separation of function and specialization of effort, which are core corporate characteristics.[4] Shareholders provide the equity capital for the enterprise but do not participate in management, other than by voting for directors or on fundamental corporate changes.[5] Officers and directors manage the enterprise, but do not by virtue of their positions have a claim to any residual gain from the enterprise.[6]

In turn, this division shapes the discussion of individual liability. Limited liability for shareholders, officers, and directors is the norm in corporate law, but there are two major exceptions that break down along the functional division just described. First, some statutes hold managers personally liable for specified violations by their firms, without reference to whether the managers also are shareholders.[7] Second, the judicial doctrine of piercing the corporate veil, a frequent means by which courts extend liability beyond the enterprise, focuses on the liability of shareholders, thereby suggesting a concern with participants who have the potential for economic gain even if they do not have the ability to exercise control.[8]

Traditional tort concerns reinforce these functional exceptions te limited liability. Tort law seeks to create incentives for an enterprise to control risks and to spread costs to more efficient risk-bearers.[9] Liability aimed at managers suggests that the incentive to control corporate actions is the principal focus of extending liability, since corporate managers control an enterprise but may not be efficient risk-bearers.[10] Liability directed toward shareholders, particularly in publicly held corporations in which investers are numerous and dis-

4. Corporate statutes identify separate roles for shareholders, officers, and directors that are combined in one group in a partnership or proprietorship. This specialization permits the enterprise te adapt to changed circumstances, a prized characteristic of the corporate form. See Charles R. O'Kelley, Jr. and Robert B. Thompson, *Corporations and Other Business Associations, Cases and Materials* 149-50 (Little, Brown, 1992).

5. See, for example, Model Business Corp. Act §§ 8.01, 7.28, 11.01 (cited in note 1).

6. See id. § 8.01(b) (stating that "[a]ll corporate powers shall be exercised by . . . its board of directors"). See also id. § 8.40.

7. See, for example, Part IV.

8. See generally Stephen B. Presser, *Piercing the Corporate Veil* (Clark Boardman Callaghan, 1991).

9. Hansmann and Kraakman, 100 Yale L. J. at 1916 (cited in note 3) (stating that "shareholder liability should be seen as a standard problem of tort law. . . . [W]hen are a corporation's shareholders cheaper cost avoiders and/or cheaper insurers than the persons who may be injured by the corporation's activities?").

10. Managers typically have invested their human capital in one firm and cannot by diversification protect themselves against risks specific te that firm; this lack of diversification may cause them to be overly cautious in making decisions. See note 85 and accompanying text.

persed, suggests an emphasis on distributive concerns such as the ability to bear risk.[11]

In the real world, of course, legal categories do not overlap perfectly with economic principles. Shareholders who have the claim to the residual gain from the enterprise may lack a diversified portfolio and thus not be particularly good risk-bearers. Liability placed on such participants may be based on unjust enrichment or some sense of fairness, or may simply reflect a political judgment that shareholders should bear the loss.[12] Alternatively, since real world participants are not limited to one corporate category, some participants will possess both the control attributes of managers and the gain-sharing attributes of shareholders. In a closely held corporation, the same individuals often serve as shareholders, officers, and directors.[13] Parent-subsidiary corporations within corporate groups provide a somewhat more complicated example. The corporate parent receives the residual gain from the enterprise and can exercise control through individual employees who serve as officers of the subsidiary.[14]

Applying tort principles to these contexts, a stronger case can be made to hold such participants liable for the acts of others as compared to situations in which the individual is only a shareholder without control or a manager without claim to any residual gain. Indeed, these overlapping contexts encompass most modern examples of situations in which courts have extended liability beyond the enterprise by piercing the corporate veil.[15] Yet owners of closely held businesses or parent corporations within corporate groups regularly escape liability for torts of the enterprise.[16] This result has been a recurring concern of academic writers[17] and has provoked a variety of proposals,

11. See Hansmann and Kraakman, 100 Yale L. J. at 1919 (cited in note 3) (arguing that "if tort law is to have any role in shifting risks to low-cost insurers, then using it to shift risks to the equity market makes sense").

12. See notes 129-35 and accompanying text.

13. See, for example, F. Hodge O'Neal and Robert B. Thompson, 1 *O'Neal's Close Corp.* § 1.08 at 32 (Clark Boardman Callaghan, 3d ed. 1992) (footnote omitted) (noting that close corporations often unite the decision-making function and the risk-bearing function in one group, the shareholder-managers).

14. See generally Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 Del. J. Corp. L. 283 (1990) (advocating use of enterprise theory instead of entity theory to determine liability questions within corporate groups).

15. See generally Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991) (analyzing 1600 piercing-the-veil cases and finding no piercing to reach shareholders in public corporations; use of the doctrine was limited to close corporations and corporate groups).

16. See the results described in note 102 and accompanying text.

17. See Blumberg, 15 Del. J. Corp. L. at 328 (cited in note 14) (discussing the "fundamental inadequacy" of entity law); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 Colum. L. Rev. 1565, 1587 (1991) (footnote omitted) (stating that "we have [been] moving back [from negligence toward] strict liability in tort, and arguably we should move away from limited

including a call to hold even passive shareholders liable for the acts of an enterprise.[18]

This Article addresses the question of when corporate participants should be liable for the acts of others. Part II's introductory presentation of limited liability first examines the liability of managers who have control but no claim to the residual gain and then examines the liability of shareholders who share in the economic gain of the enterprise but have little opportunity to control it. Part III presents an overview of the theoretical underpinnings of limited liability and again focuses on how the various arguments affect managers and shareholders. Tort principles as applied in these contexts suggest a limit on liability based only on status as an officer and nothing else or on status as a shareholder and nothing else. Thus, Part IV disputes the efficiency of the recent proposal by Professors Henry Hansmann and Reinier Kraakman to reverse the current default rule in corporate law and make shareholders liable for the torts of the enterprise.[19] Neither ability to control nor distributive concerns of tort law supports liability for passive shareholders. Similarly, there is reason to question whether recent statutes that place additional liability on managers in environmental and other areas, particularly for conduct not involving their personal participation, will overdeter managers, who are not the most efficient risk-bearers.

These statutes and case law by their language appear to impose vicarious liability on shareholders or managers, when in fact liability usually is limited to managers who participated directly in the wrongful activity or combined control and profit-sharing. When these holdings are expressed in the language of corporate law, with its emphasis on the separate functions of shareholders and managers, the results appear broader than intended. The overlap of invester and manager functions permitted in the corporate form requires an unpacking of the basis for tort liability.

Even with this clarification of language, there remains a perplexing judicial reluctance to hold a corporate parent liable for the obligations of its subsidiaries when the parent possesses both the opportunity to control and the potential to share in residual earnings of a subsidiary.[20] Even this result would not be inconsistent with tort law to the extent that nonlegal alternatives provide sufficient

liability with respect to tort claimants as well"); Arden Doss, Jr., Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 Yale L. J. 1190, 1191 (1967) (contending that limited liability thwarts the objective of modern tort law).

18. See, for example, Hansmann and Kraakman, 100 Yale L. J. at 1896-99 (cited in note 3).

19. Id. at 1879.

20. See note 102 and accompanying text.

incentives for the enterprise to take care. This Article discusses two of these constraints: contract creditors' monitoring and managers' causing the enterprise to purchase sufficient insurance. Together these constraints may encourage an appropriate level of caution and support a continued use of limited liability even for corporate groups.[21]

II. HOW LIMITED LIABILITY WORKS: INSULATION FROM DIRECT AND VICARIOUS LIABILITY

A. *Corporate Norms*

The creation of a corporation establishes a new entity, legally recognized as separate from its participants. This separation offers many advantages, such as facilitating the ownership and transfer of collective property, but its most powerful effect is its insulation of participants from financial responsibility for debts of the enterprise. Indeed, limited liability may be the attribute most often associated with the corporate form. However, limited liability is not absolute. The limits of that concept can best be understeod in the context of another corporate characteristic, a norm which presumes the separation of corporate functions between investors and managers. All corporations statutes assume that a corporation will have shareholders, directors, and officers. Each of these groups possesses limited liability, but the result for each group rests on somewhat different bases and the reach of limited liability is not coterminous for each group.

B. *Limited Liability of Managers*

Officers are agents of the corporation who act for the entity in a variety of day-to-day matters. Their existence and their duties usually are specified by corporations statutes, but any individual liability for enterprise obligations derives primarily from the common law.[22]

21. See notes 156-64 and accompanying text.

22. Compare Model Business Corp. Act § 8.42, which was added in 1984 and thereafter adopted in many states: "An officer is not liable for any action taken as an officer, or any failure to take action if he performed the duties of his office in compliance with this section." Model Business Corp. Act § 8.42(d) (cited in note 1). The duty specified in the section refers to "discretionary authority" and must be "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation." Id. § 8.42(a). This section does not appear to have had any impact on the liability discussed in this Article.

These principles, as reflected in the Restatement (Second) of Agency, usually insulate the officer.[23] An individual who signs a contract on behalf of the corporation is cloaked in the mantle of the enterprise and is not personally liable for action taken in the corporate name.[24] If the enterprise defaults on an obligation under the contract, the creditor normally cannot proceed against the individual.

However, the same individual who acts for the same corporation in the same capacity in taking action deemed tortious loses the corporate cloak and is held individually liable along with the enterprise.[25] Similarly, an officer, director, or shareholder who commits a criminal act cannot avoid personal liability by claiming to act on behalf of the enterprise.[26] As the regulatory state has grown, legislatures have extended these principles in various regulatory acts, so that a person who, as a corporate official, violates a specific federal or state regulation is not shielded by the corporate entity.[27]

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23. See Restatement (Second) of Agency §§ 354-357 (1958) (discussing liability for officers who act without authority or who fail te disclose that they are contracting for a cerporate principal).

24. There are limits, of course, when individuals so intertwine personal and corporate dealing that courts will pierce the veil or will consider the corporation as an agent for individuals. Absent such unusual cenduct, the individuals escape liability for their direct actions, which they cannot do in tert.

25. See Restatement (Second) of Agency § 343 (stating, "An agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal, except where he is exercising a privilege of the principal, or a privilege held by him for the protection of the principal's intorests or where the principal owes no duty or less than the normal duty of care to the person harmed."). See generally Henry Winthrop Ballantine, *Ballantine on Corporations* 275 (Callaghan, rev. ed. 1946) (stating, "[A]n officer or directer is, in general, personally liable for all torts which he authorizes or directs or in which he participatos, notwithstanding that he acted as agent of the corporation and not on his own behalf."). See, for example, *Alexie, Inc. v. Old South Bottle Shop Corp.*, 179 Ga. App. 190, 345 S.E.2d 875, 879 (1986) (stating, "In Georgia, where a cerporate tort is committed, an officer who takes part in its cemmission or who specifically directs the particular act to be done or who participatos or cooperates therein is personally liable for the commission of the tort.").

26. See, for example, *Parish v. State*, 178 Ga. App. 177, 342 S.E.2d 360 (1986) (holding that a corporato officer could be held criminally liable for issuing a bad check, even though the check was issued by the corporation on its cerporato account, rather than by the officor as an individual). See also Cal. Penal Code § 387 (West Supp. 1993) (imposing liability on managers for failing to disclose a corporation's hazards).

27. This has long been true of tax liability. The Intornal Revenue Code has imposed direct liability on the official responsible for collecting and forwarding to the government tax funds withheld from employees' pay. See 26 U.S.C. § 6672 (1988 & Supp. 1992). See, for example, *Thomsen v. United States*, 887 F.2d 12 (1st Cir. 1989) (holding the treasurer and vice-president of a family-owned corporation liable as a "responsible person" for purposes of 26 U.S.C. § 6672, which penalizes the failure to collect and pay over withheld income taxes, even though the treasurer owned no stock and delegated responsibility for financial matters, payment of creditors, and payment of withholding taxes to another vico-president).

Additional liability is imposed under the securities laws on those who control, are controlled by, or are under common control with the regulated entity. See the Securities Act of 1933, 15 U.S.C. § 77o (1988). The extension of liability in environmental and pension areas is discussed below.

Thus, as to direct participation, the corporate shield really only works for contracts,[28] a narrowness of protection that may surprise many entrepreneurs who intend to use corporations to avoid liability.[29] Note, however, that the corporate form does insulate corporate participants in a tort (or contract) setting against vicarious liability, a point that remains central for later discussion in this Article.

Directors, unlike officers, are not agents of a corporation. State corporations codes provide that a collective act of the board of directors is the act of the corporation, but directers as individuals are separate from the enterprise.[30] Corporations statutes typically impose some specific duties on boards of directers, such as a duty not te declare dividends when the enterprise lacks available funds; however, absent similar statutes, the individual directors are not liable for corporate obligations.[31] Directors also have broad fiduciary duties to the corporation and to the shareholders, but these duties usually do not render the directors liable for obligations of the enterprise.[32]

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28. One possible exception to this assertion that the corporate insulation works only in centracts with direct participants may be the fiduciary shield doctrine found at the intersection of procodure, constitutional, and conflicts law. See, for example, *Marine-Midland Bank, N.A. v. Miller*, 664 F.2d 899 (2d Cir. 1981). Some courts have found that when a defendant's only presence in the forum has been as a corporate official, the "fiduciary shield" of corporate office prevents the assertion of personal jurisdiction. See id. at 902. Such an application would be consistent with the substantive law if limited to actions taken pursuant to contracts, but has sometimes been extended to tortious or regulatory violations. See, for example, *R.F. Barron Corp. v. Nuclear Fields (Australia) Pty., Ltd.*, 1992 U.S. Dist. LEXIS 19857 (N.D. Ill. 1992) (holding that the fiduciary shield protects a defendant in a fraud charge arising out of termination of employment); *Ryan v. Chayes Virginia, Inc.*, 553 N.E.2d 1237 (Ind. App. Ct. 1990) (using the fiduciary shield to dismiss a claim against the chairman (and sole shareholder) and the president for wrongful termination). More commonly, courts refuse to apply the fiduciary shield in a tert setting, thus subjecting the corporate officer te suit for tortious action taken in the corporate name. See, for example, *Kreutter v. McFadden Oil Co.*, 71 N.Y.2d 460, 522 N.E.2d 40, 527 N.Y.S.2d 195 (1988).

29. But see Leebron, 91 Colum. L. Rev. at 1626-27 (cited in note 17) (distinguishing liability based on participation from liability based on ownership; the law permits limiting liability only based on ownership).

This surprise about the narrowness of protection for individual participants from using the corporate form probably arises because piercing the corporate veil dominates the legal discussion of the limited liability issue. The language of piercing is language of shareholder liability. Against a background of corporate norms that assume a separation of function between shareholders who provide investment capital and officers and directors who manage the business, piercing's constant discussion of shareholders obscures liability based on personal participation. In close corporations in which the same participants serve as both managers and shareholders, a court's decision to pierco the veil usually results in liability being directly imposed on managers, although the language of the decision may suggest liability as shareholders. In that sense, the failure of piercing cases te unpack the passive and active participants means that piercing cases arising in tort may placo liability on managers while appearing to place liability on shareholders.

30. See generally Harry G. Henn and John R. Alexander, *Laws of Corporations* 582-85 (West, 3d ed. 1983).

31. See, for example, Model Business Corp. Act § 8.33 (1985).

32. See, for example, id. § 8.30. These fiduciary duties normally are enforced by shareholders and sometimes have been broadened to include creditors at or around the time of

C. Limited Liability of Shareholders

Corporations statutes typically specify that shareholders will not be liable for the obligations of the enterprise.[33] Although such limited liability was not found in many early American corporations, it has been the statutory standard in most American jurisdictions since the middle of the nineteenth century.[34] Although statutes do not specify exceptions to this insulation, courts regularly disregard the entity or pierce the veil of the enterprise to hold the shareholders liable.[35] Courts often portray this remedy as drastic, and the standard stated for piercing can best be described as open-ended. A typical holding is that a court will pierce the veil if the separate entity "is used to defeat public convenience, justify wrong, protect fraud or defend crime. . . ."[36] While the legal test is phrased as imposing liability on shareholders, the activity required to pierce the veil goes well beyond the typical shareholder role as a passive provider of capital. Courts generally refuse to impose liability on shareholders unless they have control of the corporation and there has been misuse of the corporate form, such as fraud, undercapitalization, or intermingling of corporate and individual transactions.[37] My study of 1600 piercing-the-veil cases found no case in which shareholders in a public corporation were held liable and no civil case in which individual shareholders identified as passive in corporations of any size were held liable.[38] Most successful piercing cases in the study involved individuals who served as both shareholders and managers or corporate groups in which the parent corporation was the

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bankruptcy. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12,150 (Del. Ch., Dec. 30, 1991), reprinted in 17 Del. J. Corp. L. 1099 (1992).

33. See, for example, Model Business Corp. Act § 6.22(b) (1985) (stating, "unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct"). Compare id. § 8.42 (discussed in note 22) and Part IV (discussing statutes that address officer liability).

34. See Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. Corp. L. 573, 587-95 (1986) (describing early American laws providing for shareholder liability and the movement to limited liability).

35. See Thompson, 76 Cornell L. Rev. at 1041 (cited in note 15).

36. *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (C.C.E.D. Wis. 1905).

37. William M. Fletcher, 1 *Fletcher Cyclopedia of the Law of Private Corporations* § 43.10 at 758-59 (perm. ed. rev. vol., 1990), describes a three-part test used by many courts, which requires (1) control; (2) use of control by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other duty, or te commit dishonest and unjust acts; and (3) that the control and misuse proximately cause the plaintiff's injury.

38. Thompson, 76 Cornell L. Rev. at 1047 (cited in note 15).

shareholder and could name the individuals who managed the subsidiary.[39]

D. Summary of Limited Liability

Individuals who commit torts are personally liable even if they act in the name of the corporation. However, non-participating individuals are insulated from liability for tortious acts by others in the corporation, and no individual is liable for corporate obligations arising under contract, absent piercing of the corporate veil. Piercing the corporate veil requires more than mere shareholder status and the potential for gain from the enterprise; some affirmative misuse of the corporate entity usually must be present.

In close corporations in which the same individuals are shareholders as well as officers and directors, the result produced by direct liability for tort, crime, or regulatory actions is the same as piercing the veil to reach shareholders under traditional corporate law. When the shareholder behind the veil actively participatod in the act leading to liability, there is no need to use piercing and indeed there are relatively few cases involving torts within close corporations. Only 226 of 1600 piercing cases in the empirical study mentioned above arose in a tort setting, and most of those tort cases arose in corporate groups.[40] In only ten of the cases outside of corporate groups did a plaintiff seek to reach an individual defendant who directly participated in the tort, and in another fifteen the plaintiff sought to reach close corporation participants even though they were not directly involved in the tort.[41] In situations in which the corporate defendant is not insolvent, officers or directors are rarely sued indi-

39. In 637 cases involving corporate groups, courts pierced in 237 (37.21%). See Thompson, 76 Cornell L. Rev. at 1055 (citod in note 15). Of the 858 cases in which plaintiffs sought to reach individual defendants, the individuals were described as being both shareholder and manager in 302 cases; piercing occurred in 140 or 45.90%. The court identified the defendant in a single capacity as follows: shareholder in 489 cases (piercing in 205 or 41.34%); passive shareholder in 6 cases (piercing in 1 or 16.67%), see *Commonwealth v. Beneficial Finance Co.*, 275 N.E.2d 33 (Mass. 1971)); officer in 52 cases (piercing in 22 or 42.31%); director in 9 cases (piercing in 4 or 44.44%). The one case in which the court pierced the veil to an apparent passive shareholder was a criminal case involving a corporate group in which there was significant indication of the parent corporation's participation in the subsidiary.

40. See Thompson, 76 Cornell L. Rev. at 1058 (cited in noto 15).

41. See F. Hodge O'Neal and Robert B. Thompson, *O'Neal's Close Corporations: Law and Practice* § 111 n.2 (Clark Boardman Callaghan, 3d ed. 1992 rev.) (reporting that courts pierced in one-half of the cases seeking to reach direct participants and in one-third of the cases in which there was not direct participation). Of the 226 tort cases, 152 arose in corporato groups and 65 in individually owned close cerporations. Other than the 25 cases mentioned in the toxt, the close corporation cases involved fact situations not directly raising liability questions for individual shareholders.

vidually, which likely further reinforces lack of recognition about individual tort liability.[42]

Together, these doctrines give almost unbounded insulation for passive shareholders and substantial insulation for active participants so long as they do not directly participate in tortious or criminal acts. Two cases illustrate the breadth of this insulation. In the well-known taxi-cab case of *Walkovszky v. Carlton*,[43] an entrepreneur formed a series of corporations to engage in taxi service in New York City, each with minimal assets, in a business in which injuries to third parties might be expected. The New York Court of Appeals refused to hold the shareholder liable when one of the cabs injured a pedestrian. Judge Keating's dissent portrayed the corporate plan as an improper device that should not insulate the controlling shareholder:

> From their inception these corporations were intentionally undercapitalized for the purpose of avoiding responsibility for acts which were bound to arise as a result of the operation of a large taxi fleet having cars out on the street 24 hours a day and engaged in public transportation. And during the course of the corporations' existence all income was continually drained out of the corporations for the same purpose.[44]

A similar example is *Baatz v. Arrow Bar*,[45] in which the plaintiffs sought to recover from the shareholders of an incorporated bar whose employee had served the drunken driver who caused the plaintiffs' serious injuries. The South Dakota court found the corporation liable because of the court's earlier holding that it is negligence (for civil liability purposes) as a matter of law[46] when a person violates the state's criminal provision banning sales of liquor to intoxicated persons.[47] In *Baatz*, the corporate licensee lacked sufficient assets to pay the damages. The South Dakota Supreme Court upheld a summary judgment dismissing as parties the husband, wife, and daughter, who were the corporation's only shareholders. In depositions prior to the trial, the husband described the decision to incorporate as based "[u]pon advice of counsel, as a shield against individual liability."[48] The dissent described the court's message as, "Incorporate, mortgage

42. George W. Dent, Jr., *Limited Liability in Environmental Law*, 26 Wake Forest L. Rev. 151, 167 (1991) (noting that tort victims generally refuse to sue officers and directors).
43. 18 N.Y.2d 414, 223 N.E.2d 6 (1966).
44. Id. at 11 (Keating, J., dissenting).
45. 452 N.W.2d 138 (S.D. 1990).
46. S.D. Cod. Laws § 35-4-78 (1992).
47. See *Walz v. City of Hudson*, 327 N.W.2d 120 (S.D. 1982).
48. *Baatz*, 452 N.W.2d at 143 (Henderson, J., dissenting).

the assets of a liquor corporation to your friendly banker, and proceed with carefree entrepreneuring."[49]

Similar examples exist for corporate parents who regularly form corporate subsidiaries to avoid liability. In a recent federal appellate case, the Eighth Circuit held:

> 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, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, on the whole, is socially reasonable and useful. We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment.[50]

III. THE THEORETICAL BACKDROP FOR LIMITED AND UNLIMITED LIABILITY

A. In Bargain, Tort, and Enterprise Liability Settings

Limited liability for corporate participants is generally accepted in a bargain setting. The introduction of a corporation into a transaction necessarily shifts risks, as compared to the same transaction involving partners or other business participants not possessing limited liability.[51] By forming a corporation, shareholders ordinarily limit their liability to the amount they have invested. If that amount is insufficient te pay the obligations of the enterprise when they come due, some of the risks of the business will be borne by others (for example, trade crediters, employees, government, or tert victims). The reasons for non-shareholders carrying some of the risks of the enterprise are sufficiently strong that few question the shifting of these risks when creditors voluntarily deal with the limited liability enterprise.[52] In some situations, the non-shareholder may be a more

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49. Id.

50. *Radaszewski v. Telecom Corp.*, 981 F.2d 305, 311 (8th Cir. 1992).

51. See Uniform Partnership Act § 15 (West, 1969) (specifying liability for partners).

52. The deference accorded such bargaining varies substantially among scholars writing about limited liability. Compare Gabaldon, 45 Vand. L. Rev. at 1430 n.252 (cited in note 3) (cautioning against overreliance on the assumption of equal information and bargaining power to justify the "ostensible willingness of third parties" to accept risk) and Reger E. Meiners, James S. Mofsky, and Robert D. Tollison, *Piercing the Veil of Limited Liability*, 4 Del. J. Corp. L. 351, 366-67 (1979) (noting that involuntary creditors inadvertently or intentionally decide which risks to bear and which risks to cover with insurance; for example, a person may ride in an adequately in-

efficient monitor of a particular risk. Consider, for example, an owner who offers to sell a business to a buyer who is not confident that future growth can support the seller's suggested price. If the parties enter into a deferred payment contract, the seller may accept a newly created corporation as the obligor for future payments instead of lowering the price. The seller now assumes the risk of nonpayment rather than the buyer, which would make sense if the seller's past experience gives it more reliable information about future prospects.[53]

Alternatively, the creditors may possess a comparative advantage in monitoring managers. This result is more likely to occur in larger corporations, in which the shareholders are numerous, dispersed, passive investors and whose lenders are banks or other institutional investors with specific knowledge about a particular industry.[54] In addition, the shareholders may be more risk averse than creditors.[55] From a structural standpoint, mandatory periodic payments owed to creditors force a company to return to the credit market for capital, subjecting the enterprise to the discipline of recurring monitoring by outsiders.[56] In any event, so long as the parties can raise or lower prices or negotiate over additional security (including a personal guaranty or a security interest in assets), there is little need for the law to override the parties' bargain by placing the risks on one party or the other. Starting with limited liability saves transaction costs in many situations as compared to having the parties start from unlimited liability.[57]

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sured cab and pay the extra insurance cost in the form of a higher fare or ride in an uninsured cab and pay a lower fare).

53. An example is *RKO-Stanley Warner Theatres, Inc. v. Graziano*, 467 Pa. 220, 355 A.2d 830 (1976), in which the seller retaining a security interest in a theater expressly agreed to the formation of a corporation to replace the individual purchasers. In a decision based on the defective incorporation doctrine, the court held the individuals personally liable when the corporation was later formed but failed to close on the agreement. The seller, as a corporation experienced in the movie business, likely received a higher price since it was taking the risk of future nonperformance, but ended up with both the higher price and the individuals' personal liability.

54. See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 46 (Harvard U., 1991) (stating that banks or institutional investors may be good monitors of certain decisions such as whether to build a new plant, even though they are not residual claimants); Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 501-03 (1976) (indicating a bank as an example of a better risk appraiser than a shareholder of a public corporation).

55. For example, the creditor may be diversified and the shareholder not. See Posner, 43 U. Chi. L. Rev. at 502 n.8.

56. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 46 (cited in note 54).

57. See Sykes, 93 Yale L. J. at 1245 (cited in note 2) (stating that "[i]f transaction costs prevent efficient shifting of risk to the principal, then the principal must compensato the agent more generously than he would in an ideal world"). See also Larry E. Ribstein, *The Deregulation*

However, this consensus disappears when the context changes to tort. Limited liability in a tort setting raises the possibility that an enterprise will not bear all of its costs. Entrepreneurs contemplating the tort consequences of a limited liability business need not concern themselves with harm to others that would generate liabilities beyond the amount contributed to the enterprise.[58] Permitting an enterprise to avoid the full costs of its activities creates incentives for excessive risk-taking. For example, the enterprise may not sufficiently invest in safety or may overinvest in hazardous activities.[59] Given the direct liability for personal participation in tortious acts as discussed above, the real focus of dispute is the extent to which vicarious liability should be imposed for the acts of others in a corporation.

Imposing liability on participants for the tortious acts of others usually reflects one of two basic motivations: to provide a stimulus to the appropriate party to avoid the harm or to allocate the risk to the most efficient risk-bearer. The first factor, aimed at deterrence, will clearly have a greater effect in corporate settings if directed to officer liability or in close corporations where there is an overlap of the management and investment functions. Hansmann and Kraakman believe shareholder liability can play a similar role even in public corporations in which shareholders do not perform the management function. This indirect effect can occur to the extent that the share price would incorporate the possibility of additional shareholder liability. Management could be expected to respond to this signal as it might to any other cost that affects share price.[60] In addition, shareholders facing additional liability might be expected to seek more information about liabilities or the firm's insurance. Some of this information might come from sources outside the firm, providing

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of Limited Liability and the Death of Partnership, 70 Wash. U. L. Q. 417, 448 (1992) (arguing that "limited liability eliminates costs rather than simply transferring them to victims").

58. See Sykes, 93 Yale L. J. at 1241-42 (cited in note 2) (noting that liability limited to a potentially insolvent agent "increases the expected profits of the principal-agent enterprise by the value of the judgment less the agent's ability to pay, multiplied by the probability of the judgment").

Leebron illustrates this point by reference to the standard learning of financial economics that investers base value on risk and return, with risk being defined as the dispersion of all possible outcomes from the mean. Computing return requires determining all possible future outcomes of the investment and their probability. Leebron's example includes a 1% chance that the shares will be completely worthless (the other 99% are dispersed among various options up to a profit of more than $100). In an unlimited liability regime, that bottom 1% probability would be a negative number, if the investor would be required to pay additional funds. Under limited liability, that number cannot be negative, but only $0. Since value is a weighted average of all future returns, the value of an investment in a limited liability enterprise will be higher. See Leebron, 91 Colum. L. Rev. at 1570-72 (cited in note 17).

59. See Hansmann and Kraakman, 100 Yale L. J. at 1882-83 (cited in note 3).

60. See id. at 1907. See also id. at 1903 (stating that "the *purpose* of unlimited liability is to make share prices reflect tort costs") (emphasis in original).

additional information that otherwise might not have been part of management's decisions.[61]

The risk-distribution aspect of the argument would have the greatest impact when many shareholders hold diversified portfolios as compared to tort claimants who face large losses of health, life, or property. There are circumstances, however, in which shareholders would be comparatively inefficient risk-bearers. For example, if only a few shareholders exist or a joint and several unlimited liability rule is applied, and if the injuries to particular tort victims are generally not severe, the distributive justification for shareholder liability disappears.[62]

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.[63] 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.[64] However, the earlier enterprise liability scholarship tended to assume shareholders' limited liability[65] and therefore included little discussion of how the enterprise liability principles might apply to shareholder liability. One factor frequently cited to support enterprise liability is the transfer of risks to third parties that would otherwise occur when an agent lacks sufficient assets to satisfy a claim,[66] a concern that also fits a corporate-shareholder relationship in which the insufficient assets of the corporation can lead to incomplete internalization and too little care. However, other reasons for enterprise liability do not work as well. For example, enterprise liability can be justified as a response to the difficulty in determining the particular person in the

61. Id. at 1907.

62. Leebron, 91 Colum. L. Rev. at 1603 (cited in note 17) (noting that if insurance is available for tort victims, it is not clear that shareholders are better risk-bearers; if there are only a few shareholders and the tort injuries are not severe, if victim insurance is available but shareholder liability insurance is unavailable, or if diversification exists, shareholders will not be better risk-bearers).

63. See generally Kornhauser, 70 Cal. L. Rev. at 1345 (cited in note 2); Sykes, 93 Yale L. J. at 1231 (cited in note 2).

64. Hansmann and Kraakman, 100 Yale L. J. at 1919 (cited in note 3) (stating that "if tort law is to have any role in shifting risks to low-cost insurers, then using it to shift risks to the equity market makes seuse").

65. Compare Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale L. J. 857, 862 (1984) (setting aside the most basic issue of all—the ultimate wisdom of limited shareholder liability.) Professor Kraakman returned to the issue at length. See note 3.

66. See Kornhauser, 70 Cal. L. Rev. at 1362 (cited in note 2); Sykes, 93 Yale L. J. at 1241-42 (cited in note 2).

organization responsible for wrongful actions.[67] Enterprise liability removes an inducement to scapegoat a particular individual for decisions made elsewhere in the organization.[68] The enterprise likely will be better able than a court to sort out joint responsibility. As liability extends beyond the enterprise to shareholders, however, these arguments shrink, and the costs of enforcing such a system increase.[69]

Just as enterprise liability theory did not engage the liability of shareholders, traditional discussions of limited liability seldom addressed tort contexts. The story most often told for limited liability in corporations emphasizes its importance in facilitating large aggregations of funds to fuel the growth of industrial America.[70] Limited liability reassured investors otherwise unwilling to invest in activities beneficial to society[71] and facilitated the growth of a widespread public

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67. Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 Yale L. J. 1 (1980).

68. Kathleen F. Brickey, *Close Corporations and the Criminal Law: On "Mom and Pop" and a Curious Rule*, 71 Wash. U. L. Q. 189, 194 (1993) (citing individual misconduct as a response to subtle or overt institutional pressures and arguing that singling out low-level employees could well be regarded as choosing a convenient scapegoat).

69. See Sykes, 93 Yale L. J. at 1271 (cited in noto 2) (noting that litigation costs in some situations may suffice to render vicarious liability inefficient).

These arguments help explain why imposing extended liability on shareholders is different from the loss shareholders suffer when their corporation pays tort damages. Thus, providing limitod liability for shareholders does not necessarily lead to a finding that no corporate liability for torts should be imposed. But see Hansmann and Kraakman, 100 Yale L. J. at 1908 (cited in noto 3). Imposing liability on the corporation does not create the diversification problem that shareholder liability might entail. Compare Leebron, 91 Colum. L. Rev. at 1578 (citod in note 17) (arguing that vicarious unlimited liability is not fundamentally different from vicarious limitod liability) and 1612 n.143 (asking why, if limited liability currently penalizes individual shareholders for the benefit of tort victims up te the amount of the shareholders' investment, should the penalty be so limited? Possible reasons include the claim that excess liability is inefficient and the presence of comparative risk-taking.).

70. Professor James Willard Hurst qualifies the traditional story, concluding that other opportunities for "limitod commitment" investment provided by the corporate form (for example, the ability te invest in an entorprise with a defined purpose, defined shares, or one with assurance of limitod drafts upon invester time and energy) were as important to the growth of corporations as limited liability. James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780-1970* 28 (U. Press. of Va., 1970).

71. See Max Radin, *The Endless Problem of Corporate Personality*, 32 Colum. L. Rev. 643, 654 (1932) (stating, "[I]t was found in medieval Europe that men would often decline te adventure in business transactions unless they ceuld so limit their liability. And this was especially the case when those who were asked to join the enterprise had no direct control over its management."); William P. Hackney and Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. Pitt. L. Rev. 837, 840 (1982). See generally Phillip I. Blumberg, *The Law of Corporate Groups: Substantive Law* (Little, Brown, 1987).

Limitod liability existed both in the United States and elsewhere prior to its becoming a typical feature of corporations. See, for example, the in rem liability of the ship in maritime law. More recently, Stephen Presser has demonstrated that the introduction of limitod liability in the United States in the first half of the 19th century reflected in part a desire to encourage investment in the small firm or investment by entrepreneurs of modest means. Stophen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 Nw. U. L. Rev. 148, 163 (1992). See also Stephen B. Presser, *Piercing the Corporate Veil* § 1.03[1] market for shares.[72] Concern about shifting liability to tort victims did not play a large role in the discussion of limitod liability. Piercing the corporate veil, the principal legal vehicle used to restrict limited liability, has been described as concerned primarily with fraudulent conveyance law,[73] and the great majority of piercing cases arise in a bargain setting.[74]

B. Economics-Based Arguments to Extend Liability

In response to recent calls to eliminate limited liability, debate has moved from the traditional historical justification to two issues informed by economic theory. Each of these issues in turn raises questions regarding insurance as a possible explanation or solution.

1. The Finance Dimension: Will Unlimited Liability Adversely Affect Markets or the Firm's Capital Structure and Shareholder Diversification?

A dominant argument for extending liability to shareholders rests on the superior risk-bearing ability of dispersed shareholders of public corporations. A primary attraction of a developed securities market derives from its ability to permit individual shareholders te diversify cheaply against firm-specific risks. By holding a portfolio of stocks that do not move in direct relation to one another, an investor can anticipate that gains from one part of the portfolio will balance out losses from another part. Under limited liability, the possibility of one firm in the portfolio failing will not affect the other stocks held in the portfolio beyond the investor's initial investment.

Under an unlimited liability regime, one severe liability claim could wipe out the entire portfolio. Indeed, the more stocks that are in the portfolio, the greater the possibility of a catastrophic claim wiping

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(Clark Boardman Callaghan, 1991). Limited liability thus is tied to the desire to encourage investment by more than the wealthiest members of society, and perhaps even to the goal of dispersing wealth in order to preserve a republican form of government. Id. at 155, 163.

72. See Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 259, 262 (1967) (noting that limited liability likely is an essential aspect of a corporato system with widespread public participation); Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 J. Institutional & Theoretical Economics 601, 604-05 (1985); William O. Douglas and Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 Yale L. J. 193 (1929) (observing that the corporato devico has lent itself particularly well to the public marketing of securities).

73. Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv. L. Rev. 505, 542 n.98 (1977) (noting that the most frequent problems in the piercing area are fraudulent transfer and similar contract-related claims).

74. Thompson, 76 Cornell L. Rev. at 1071 (cited in note 15) (concluding that piercing the corporate veil usually occurs in a bargain setting).

out the entire portfolio. Hansmann and Kraakman suggest that diversification is possible so long as liability is pro rata, rather than joint and several.[75] Professor David Leebron would not go as far, advising that diversification would be practical only by investing in a portfolio that does not contain equity securities.[76]

Unlimited liability also can affect the market indirectly to the extent that it impacts on the amount of monitoring. Under joint and several unlimited liability, a shareholder's ultimate exposure may turn on whether she is the richest or poorest investor and how likely she is to be the target of plaintiffs; shareholders may seek to monitor each other's wealth both at the time of purchase and as the identity and wealth of the other shareholders change.[77] Nor would this monitoring function be spread equally; only larger, richer shareholders might undertake it. Such disparity would mean that the stock would have a different value for each shareholder, breaking down the liquidity of the public markets that has been one of the primary advantages of modern public corporations as an investment vehicle.

Proportionate liability instead of joint and several liability may respond to this problem.[78] While this variation may be necessary to preserve a public market and to reduce unnecessary monitoring, it undercuts the compensatory effect of the liability rule. When combined with the transaction costs described below, even a proportionate liability rule may have the deleterious effect of leading to the decline of mutual funds. Such funds would remain as an inviting target of opportunity to any plaintiff and thus may have rates of return less than those available through direct individual investments.

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75. If the liability were joint and several, any one investor could be sued for the corporation's entire debt; it is likely, however, that different investors would face different risks of being sued because of their wealth or easy amenability to suit. In contrast, if the liability were pro rata, each investor would be liable only for the proportion of the claim corresponding to the shareholder's ownership interest in the business. See Hansmann and Kraakman, 100 Yale L. J. at 1892-93 (cited in note 3).

76. See Leebron, 91 Colum. L. Rev. at 1600 (cited in note 17) (stating that "unlimited 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").

77. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 45 (cited in note 54).

78. See Blumberg, 11 J. Corp. L. at 627 (cited in note 34); Hansmann and Kraakman, 100 Yale L. J. at 1892-94 (cited in noto 3); Leebron, 91 Colum. L. Rev. at 1578-84 (cited in note 17). But see Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 Yale L. J. 387, 411-12 (1992) (contending that liquid, actively traded equity means proportionate liability cannot work; if, as Hansmann and Kraakman suggest, the "constructive equity" doctrine is used to respond to potential increases in the use of derivative securities te avoid unlimited liability, the potontial exposure of any one invester will turn on the size of the open interest in derivative securities, which is unknown; this situation recreates externalities to which limited liability responds, because liability turns on the behavior of other investors).

The connection between limited liability and public markets has been widely accepted, but there is very little concrete evidence concerning public markets without limited liability. Professor Phillip Blumberg cites the widespread trading of joint stock associations with many dispersed shareholders in England in the eighteenth century.[79] Professors Jonathan Macey and Geoffrey Miller have described the continuation of double liability for bank shareholders into the middle of the twentieth century; at least some of those banks seemed to have large numbers of shareholders.[80] As Professor Peter Grossman has described, American Express continued as a joint stock association with unlimited liability until 1965.[81] There appeared to be a liquid market for its shares even in the face of a financial debacle that raised the possibility of shareholder liability.[82] Indeed, Professor Joseph Grundfest has suggested something of a contrary argument, focusing not so much on the essentialness of limited liability to markets but arguing that markets will find ways to provide limited liability even if the legal rule seeks to decree otherwise.[83]

2. The Liability Dimension: What Effect Would Unlimited Liability Have on Incentives to Control Harm and the Amount Available for Recovery?

The initial focus of tort law when applied to limited liability is that corporations with limited liability will underinvest in safety and overinvest in hazardous activities.[84] Yet the reverse is also possible when liability is imposed on managers or shareholders. Shareholders in close corporations or managers in public corporations who have firm-specific human capital invested in the corporation may cause the corporation te overinvest in safety for fear of losing their own investment. This tendency is exacerbated if the managers do not have an

79. See Blumberg, 11 J. Corp. L. at 581-82 (cited in note 34).

80. Jonathan R. Macey and Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 Wake Forest L. Rev. 31, 50-51 (1992) (describing the Carnegie Trust failure, which involved a suit against 225 shareholders; 19th century cases mainly involved a single shareholder, while cases in the early 20th century involved a larger number of shareholders).

81. Peter Grossman, *American Express: The Unofficial History of the People Who Built the Great Financial Empire* 329 (Crown, 1987).

82. In 1963 the "salad oil scandal" left an American Express subsidiary potentially liable for $150 million of claims. See id. at 319. Professor Grossman reports the company's net worth to be about $70 million. (Interview with Peter Grossman, Oct. 8, 1993). The price of American Express steck dropped by half, but a market continued in the steck. See generally Peter Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express* (Wash. U. Bus., Law & Econ. Center Working Paper 1994) (on file with the Author).

83. See Grundfest, 102 Yale L. J. at 389-90 (cited in note 78).

84. See Hansmann and Kraakman, 100 Yale L. J. at 1882-83 (cited in note 3).

ownership interest in the enterprise and thus do not share in any upside potential of a choice not to overinvest in safety.[85] In addition, unlimited liability might lead to an excessive amount of monitoring, as both creditors and shareholders duplicate monitoring.[86]

A rule other than limited liability imposes additional transaction costs that would affect both the distributive and deterrence goals of tort law. If additional liability causes a change in a firm's investment structure, both risk-bearing and control incentives will be affected. First, there would be substantial costs in making assessments on many dispersed shareholders. There is some limited historical information as to the feasibility of a collection system. Both the creditors' bill in the nineteenth century[87] and collections under bank double liability laws in the twentieth century[88] offer evidence of collection from a large group of shareholders (although not the size of today's publicly held corporations). Yet as Leebron recognizes, the costs would consume the benefit of collecting from many small shareholdings so that enforcement is likely only to be feasible for entities such as parent-subsidiary groups.[89]

A second transaction cost is the increase in evasion strategies, such as the transfer of assets to judgment-proof investors or managers who then carry out risky activities. Grundfest has described how the development of new derivative securities would permit investors in capital markets to adjust to unlimited liability and still preserve their own limited liability.[90] Professor Janet Cooper Alexander's extensive treatment of the jurisdictional difficulties of an extended liability rule exposes the complexity of new issues that will arise as the liability discussion shifts.[91] Without discussing all possible details of evasion, it seems fair to say that an unlimited liability regime would still permit a significant degree of evasion.

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85. See id. at 1929 (recognizing that managers facing excess liability risks will overinvest in loss prevention, resign, or become judgment-proof); Leebron, 91 Colum. L. Rev. at 1612 n.143 (cited in note 17) (arguing for the limitation of excess liability if the imposition of excess liability would be ineffective).

86. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 45 (cited in note 54).

87. See Blumberg, 11 J. Corp. L. at 603 (cited in note 34).

88. See Macey and Miller, 27 Wake Forest L. Rev. 31 (cited in note 80).

89. Leebron, 91 Colum. L. Rev. at 1612 (cited in note 17) (claiming that enforcement costs blunt pro rata as the optimal rule).

90. Grundfest, 102 Yale L. J. at 387 (cited in note 78).

91. Alexander, 106 Harv. L. Rev. at 387 (cited in note 3).

3. The Insurance Dimension

Discussion of expanded liability necessarily involves insurance as a possible substitute. If the focus is on protection for the tort victim, unlimited liability and mandatory insurance can be seen as alternative solutions. One can view unlimited liability as a method by which shareholders provide insurance to tort victims of the enterprise. Under this view, one would compare the alternative price of insurance versus the reduction in the price the shareholders would pay for the shares reflecting the fact that the shareholders are, in effect, issuing insurance.

As to the finance dimension, insurance has been offered to counter adverse effects on markets. Judge Frank Easterbrook and Professor Daniel Fischel have noted that limited liability was more important te the growth of publicly held corporations in the nineteenth century because insurance markets were less developed than the markets today.[92] Thus, current shareholder concerns about additional liability may dissipate to the extent that insurance is easily and cheaply available to them. Hansmann and Kraakman's proposal rests on an expanded role for insurance. They envision portfolio insurance sold to individual investors by insurers or brokerage houses just as life insurance currently is sold to airline passengers. In addition, they see the development of more esoteric forms of insurance, such as retroactive insurance, to permit continued trading of the steck of a firm that has suffered a tort-producing accident with damages not yet specified.

Insurance may seem like an attractive method to provide protection to tort victims without changing shareholder investment patterns, but such a status quo result seems unlikely. Even if an airline-type distribution system is available, loading costs will be high.[93] Insurance will not work to the extent that policy exclusions are imperfectly enforced. For example, in the environmental area, there has been extensive litigation as to the extent that insurance policy provisions exclude environmental claims. If courts broadly interpret policies after the fact to include ambiguous claims, such imperfect enforcement would require insurers to price this moral hazard, and the

92. Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 48 (cited in note 54).

93. Hansmann and Kraakman, 100 Yale L. J. at 1901 (cited in note 3), recognize that "loading costs on portfolio insurance, were it available, would be high," and they assume that large and diversified shareholders would avoid it. Elsewhere they note that loading costs constituted 27% of annual premiums paid in 1984. Id. at 1889 (citing Louis De Alessi, *Why Corporations Insure*, 25 Econ. Inquiry 429, 432 (1987)).

size of the premium required would lead most prospective insurance purchasers to self-insure.

In addition, portfolio insurance would insure not ouly against particular hazards; it also necessarily would insure against the risk of bankruptcy of the particular firm and to some extent the general business cycle. Such coverage also raises a moral hazard problem and might embolden management to take excessive risks,[94] affecting adversely the incentive of other investors to monitor managers.

Such risks are likely to affect adversely the availability of insurance. Some evidence exists that insurance is unavailable against environmental liabilities when extonded liability has been applied in a way parallel to proposals for shareholder liability.[95] In addition, large environmental claims imposed against investors in Lloyd's of London have rocked that venerable institution and illustrate an inhibition to the formation of large insurance groups that could follow from unlimited liability.[96] More generally, George Priest has argued that tort law curently extends well beyond what is necessary to provide sufficient insurance and that insurance features should be eliminated from modern tort law.[97]

Although the primary direction of this Part seeks to analyze how economic principles explain liability rules, these principles undoubtedly do not capture fully all reasons for the continuation of

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94. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 48-49 (cited in note 54).

95. Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 Colum. L. Rev. 942, 944 (1988) (observing, "In the past two years, for example, not only has the cost of the little environmental liability insurance that is still available skyrocketed; more importantly, for most businesses in the United States insurance against environmental liability is completely unavailable."). See also Geoffrey M. Dugan, *Liabilities of Corporate Individuals for Environmental Claims Under CERCLA: The Current State of the Law and Strategies for Coping*, 23 Envir. L. Rptr. 10074, 10079 (1993) (noting that "[u]ntil recently, commercial insurance markets could not be viewed as an effective means of reducing risks of environmental problems . . . . Recently, however, insurance companies have introduced various new products that, although largely untested, may offer some relief to businesses.").

96. See Grundfest, 102 Yale L. J. at 420 (cited in note 78) (observing that "Lloyd's of London, long the paradigmatic example of an institution that relied on unlimited liability, has recently announced plans te limit the liability" of its individual participants). One could expect to see shareholders withdraw in the face of extended liability in the same way that directors resign as liability increases.

97. See George L. Priest, *Satisfying the Multiple Goals of Tort Law*, 22 Valp. U. L. Rev. 643, 645 (1988) (stating that "[t]ort law, in fact, is a disastrous method of providing insurance for unpreventable losses[,] . . . provides benefit in wrong amounts, . . . diminishes the extent of bank insurance coverage" (and at higher administrative costs than first-party insurance)). See also George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 Yale L. J. 1521, 1525 (1987) (noting, "The expansion of liability since the mid-1960s has been chiefly motivated by the concern of our courts to provide insurance to victims who have suffered personal injury. . . . This insurance rationale suffuces our modern civil law and must be acknowledged as one of the great humanitarian expressions of our time. The paradox exposed by my theory is that the expansion of tort liability has had exactly the opposite effect.").

limited liability. It may be that these economic models fail to capture fully the entire benefit of limited liability diffused over the entire society that benefits from an increased amount of economic activity. To that extent the continued judicial preference for limited liability in corporate groups, discussed later in this Article, may reflect a society-wide judgment that the benefits of limited liability exceed its costs. It may be that the continued preference for limited liability, for example, by courts refusing to pierce the veil, is a judicial counterweight to broad extensions of liability, as in products liability cases.[98] The justification that limited liability should be preserved as a check on runaway tort damages may have some attraction to those desirous of tort reforms, recently a popular political topic.[99] Nevertheless, Hansmann and Kraakman are correct in their characterization of limited liability as an extremely crude check on such expansive liability if it exists.[100]

While probing deeper for the appropriate responses to this tort damage issue, one should not underestimate the collective weight of individual judicial decisions addressing limited liability. 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. One of the most startling results of the empirical study of 1600 piercing-the-veil cases was that courts pierce less often in tort than in contract cases,[101] even though economic analysis suggests the opposite result. Most of the tort cases arose within corporate groups in which tort concerns of ability to control and diversification would make limited liability *less* preferred. Yet the percentage of courts piercing the veil in tort cases within corporate groups (26.32 percent) is even less than in all tort cases (30.97 percent) or all cases involving corporate groups (37.21 percent).[102] It may be too broad a characterization to see these results as a response to the tort liability

98. See generally W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. Legal Stud. 147 (1991) (indicating doctrinal changes as leading to products liability). Compare James Henderson and Theodore Eisenberg, *The Quiet Revolution in Products Liability: An Empirical Study of Legal Change*, 37 U.C.L.A. L. Rev. 479 (1990) (noting that courts since the mid-1980s have not been expanding liability as they did prior to that time).

99. See Ribstein, 70 Wash. U. L. Q. at 447 (cited in note 57) (claiming that an inefficient tort system may provide a remedy that "would exceed appropriate loss prevention and loss distribution").

100. Hansmann and Kraakman, 100 Yale L. J. at 1918 (cited in note 3) (arguing that firms should not be invited "to opt out of the tort system by exploiting limited liability").

101. Thompson, 76 Cornell L. Rev. at 1058, 1068 (cited in note 15). Courts pierced the veil in 30.97% of cases arising in tort settings (70 of 226) and in 41.98% of cases arising in contract settings (327 of 779). Id. at 1058.

102. Of the 226 tort cases, 152 included corporate groups. Within this subset, courts pierced in only 40 (26.32%) of the cases. The other results are from Thompson, 76 Cornell L. Rev. at 1055, 1058 (cited in note 15).

explosion, but these results should provoke a more systematic analysis of why courts continue to see the virtue of limited liability in these cases.

IV. VICARIOUS LIABILITY IN THE NEW REGULATORY STATE

Recent regulatory laws, such as those in the environmental and pensions areas, illustrate the need to unpack the bases for vicarious liability at the intersection of corporate law and tort law. Federal environmental statutes such as CERCLA[103] evidence a desire to help clean the environment by making a number of participants responsible for pollution sites, including present and past owners, operators, and transporters.[104] The law does not specify whether the corporate veil may be pierced when defining who is an owner or operator. Some have argued that managers or shareholders generally are liable under CERCLA only when they could have been liable under traditional corporate law doctrine.[105] Others assert that the statutory purpose evidences a federal policy to override the limited liability rules of stato law and to hold managers or shareholders liable for the acts of their corporation.[106] This issue is a variation of the perceived conflict between corporate law and tort law that began this Article.

Similarly, in recent years, many suits have raised the issue of whether plaintiffs may recover from officers or shareholders for a corporation's failure to make contributions to employee pension funds as required by law or contract. A federal purpose derived from the Employee Retirement Income Security Act (ERISA) to protect employee pensions parallels the purpose found in the environmental laws to prevent companies from escaping their clean-up obligations.[107]

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103. The Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9601-9675 (1991). See Hansmann and Kraakman, 100 Yale L. J. at 1928 (cited in note 3) (suggesting that CERCLA liability for customers, lenders, corporate parents, and other affiliated actors serves as a "diluted form of de facto unlimited liability" and that judicial application uses principles similar to those advocated by the authors).

104. CERCLA may do more than require internalization of costs. See, for example, Dent, 26 Wake Forest L. Rev. at 171 (cited in note 42) (noting that risk-spreading goes beyond inducing cautious behavior; government may be a better risk-spreader than the largest firm).

105. See generally Lynda J. Oswald and Cindy A. Schipani, *CERCLA and the "Erosion" of Traditional Corporate Law Doctrine*, 86 Nw. U. L. Rev. 259 (1992).

106. See Kathryn R. Heidt, *Liability of Shareholders Under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA)*, 52 Ohio St. L. J. 133 (1991) (observing that a federal rule specific to CERCLA is developing, which focuses on "pervasive control").

107. See *Connors v. Incoal, Inc.*, 1993 WL 186019 (D.C. Cir. June 4, 1993) (holding a farm partnership of the family members who owned a coal mining corporation liable for the corporation's liability after withdrawal from a multi-employer pension plan; no economic nexus

This Part separately considers these liability questions from the standpoint of holding either managers or shareholders liable, assuming that those named parties perform the functions usually assigned te them by corporate doctrine. If a defendant fits into only one group, there are reasons to limit the extent of liability, as discussed in the prior Part. Although the language of recent cases suggests broad liability for each group, courts usually impose liability in most cases only when there is direct participation by the defendant or, for vicarious liability, if there is an overlap of the management and shareholder functions.

A. *Liability of Managers*

Recent statutes and judicial decisions have extended direct liability further in the direction of vicarious liability by imposing on managers a duty to supervise or monitor. Examples of such liability can be found in a torts context where an officer with a duty te supervise has been held liable for a corporation's copyright infringement even though the officer was without direct knowledge,[108] in criminal law where an individual officer has been found liable for a corporation's safety violation,[109] and in tax law where officers are held liable for a corporation's failure to forward to the government tax funds withheld from employees' paychecks.[110] These results demonstrate some parallel te the responsible corporate officer doctrine in criminal law under which a corporate agent vested with responsibility to devise compliance measures can be convicted upon the corporation's failure to comply with a statute.[111]

Such a duty to supervise or monitor already exists in corporate law, but as part of a director's duty to shareholders, not as part of a

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between the entities was required for liability under 29 U.S.C. § 1301(b) (1) (1988)). See generally the cases in notes 125 and 126.

108. See, for example, *Feder v. Videotrip Corp.*, 697 F. Supp. 1165 (D. Colo. 1988).

109. See, for example, *People ex. rel. Volberg v. Durch*, 140 Misc. 2d 353, 530 N.Y.S.2d 956 (1988) (holding the corporation's president criminally liable for violations of safety regulations and procedures applicable to elevaters in commercial premises).

110. See 26 U.S.C. § 6672 (1988 & Supp. 1992). See also, for example, *Bowen v. United States*, 836 F.2d 965 (5th Cir. 1988) (finding the failure of the corporation's president and vice-president to remit taxes withheld from employees' pay willful and subjecting the president and vice-president to a penalty equal to the tetal amount of the tax). In contrast to the federal statuto that imposes liability on officors, statutes in New York and Wisconsin impose liability on the largost shareholders for the corporation's failure to pay wage claims. See N.Y. Bus. Corp. Law § 630 (McKinney 1986); Wisc. Stat. § 180.40(6) (1992).

111. See, for example, *United States v. Park*, 421 U.S. 658 (1975). See also *United States v. Johnson & Towers, Inc.*, 741 F.2d 662 (3d Cir. 1984) (recognizing that an employee could be held liable for knowing endangerment if he teok affirmative steps to shield himself from actual knowledge).

director's or officer's duty to creditors or "outsiders." In *Graham v. Allis-Chalmers Manufacturing Co.,*[112] the plaintiff filed a derivative suit seeking to recover from directors for their failure to take action designed to learn of and prevent antitrust violations by corporate employees. The court denied liability based on the size of the enterprise—a large, publicly held corporation with 30,000 employees spread over a large geographic area. The court permitted the board members to confine themselves to large policy decisions absent cavalier performance or inattention to obvious danger signs of employee wrongdoing. The court held that the directors had no duty "to install and operate a corporate system . . . to ferret out wrongdoing which they have no reason to suspect exists."[113]

Subsequent statements of corporate duty suggest a somewhat broader, less passive duty. The *Corporate Director's Guidebook* states that "[t]he corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations, both foreign and domestic, that it circulates (as appropriato) policy statements to this effect to its employees, and that it maintains procedures for monitoring such compliance."[114] The official comment to the American Law Institute's *Principles of Corporate Governance* section on a director's duty of care states that "an ordinarily prudent person serving as the director of a corporation of any significant scale or complexity should recognize the need to be reasonably concerned with the existence and effectiveness of procedures, programs and other techniques to assist the board in its oversight role."[115]

The *Corporate Director's Guidebook* was intended to provide corporate practice recommendations rather than rules of law; the ALI project explicitly emphasizes that its duty of care standard is "not intended to create new third party rights (e.g. for tort claimants or government agencies) against directors or officers. The standards . . . apply only to relationships among directors, officers, shareholders, and their corporations."[116] Despite such apparent limitations, existiug law permits these current standards to be used for the benefit of those outside the group of directors, officers, and shareholders. In *Francis v.*

112. 41 Del. Ch. 78, 188 A.2d 125 (Del. Sup. Ct. 1963).

113. Id. at 130-31.

114. American Bar Association, Section of Corporation, Banking, and Business Law, Committee on Corporate Laws, *Corporate Director's Guidebook*, 33 Bus. Law. 1591, 1610 (1978). See also The Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083, 2101 (1978) (listing compliance with law as a "core function" of the board).

115. See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 4.01(a) (1)-(a) (2), cmt. c at 217 (Proposed Final Draft 1992).

116. Id. § 4.01, cmt. f at 187.

United Jersey Bank,[117] in which an action was brought by the trustee in bankruptcy of a reinsurance broker, the court found a breach of a director's fiduciary duty to the corporation by a director who had inheritod forty-eight percent of the corporation's stock from her husband, the founder of the business. The widow was held liable for the diversion of $10,000,000 from the corporation by her two sons who served as the other two directors and actively controlled the company's business.

Recent case law and statutes suggest a stronger duty to monitor, at least in tort or regulatory contexts, when the party to be protected is the government, consumers, or tort victims.[118] For example, liability imposed because the defendant could have prevented or significantly abated the disposal of hazardous waste blurs the distinction with vicarious liability.[119] One should not, however, overestimate the reach of these cases in applying vicarious liability. The language of the opinion in *Francis* suggests that liability was based on director status, but the actual liability fell on the estate of the director who had a strong economic investment in the business. Many of the new regulatory cases appear to impose broad liability on "operators" as under some environmental laws, but the cases seem to require either direct involvement or an overlap of economic gain and the ability to control the actions of the wrongdoer. Courts should be careful to separato vicarious liability placed on officers alone from either liability imposed on officers for their direct participation or liability imposed on a control person who also reaps the economic benefits of the enterprise. When there is an overlap of management and shareholding, there exists the greatest chance that decisions are being made to externalize costs. When an extended duty to monitor is tied te officers who have the ability to control but who may not be efficient risk-bearers, overdeterrence may result. Analyzing the extent to which these recent applications of duty to monitor extend liability requires unpacking the arguments. A particular focus should be whether the liability is direct or vicarious and whether it is based on control or risk-sharing.

For example, liability is often imposed on individuals who participate directly in waste disposal.[120] As discussed in Part II above,

117. 87 N.J. 15, 432 A.2d 814 (1981).

118. See notes 103-06 and accompanying text.

119. See Dent, 26 Wake Forest L. Rev. at 161 (cited in note 42).

120. See Heidt, 52 Ohio St. L. J. at 144-45 (cited in note 106) (noting that "[o]f the twenty or more reported cases concorning shareholder liability for CERCLA claims, only five have considered the question of veil piercing"; veil piercing often is unnecessary for liability in CERCLA because facts often support direct liability).

there is no conflict between tort and corporate principles in this context; performing those wrongful acts in the guise of a corporate office does not insulate a person from liability.[121] What some see as a new law unique to CERCLA is simply a recognition that an individual who acts for a corporation in ways that violate regulatory rules is not cloaked in corporateness.[122] Yet some of the CERCLA cases do evidence an expanded duty to monitor;[123] to that extent, the CERCLA limited liability cases do not mirror the historical pattern of piercing cases. The CERCLA cases fit within the theory discussed here to the extent that they are based on seeking to control an officer's conduct without leading to overdeterrence. Alternatively, expanded liability may be appropriate for an individual who both controls the enterprise and reaps economic gains.

Certain pension cases seeking to hold individuals liable appear to reflect this emphasis on direct participation. Courts have found individuals liable when, for example, the president conspired to defraud a benefits fund[124] or was personally responsible for the decision not to make the required contributions,[125] but generally have not held shareholders liable in the absence of traditional piercing characteris-

121. See, for example, *United States (EPA) v. Environmental Waste Control, Inc.*, 710 F. Supp. 1172 (N.D. Ind. 1989), aff'd, 917 F.2d 327 (7th Cir. 1990) (stating that a corporate officer would be held liable as operater of a hazardous waste disposal site under the Resource Conservation and Recovery Act given the officor's involvement in the site's operation and finances). See also *United States v. Nicolet, Inc.*, 712 F. Supp. 1193 (E.D. Pa. 1989) (holding a parent corporation liable for a subsidiary's waste site when it actively participated in the subsidiary's management while asbestos was being disposed of at the site); *United States v. Mottolo*, 695 F. Supp. 615 (D.N.H. 1988) (holding the sole owner of a corporation liable under traditional piercing factors when the corporation was the altor ego of a prior sole proprietorship that operated a hazardous waste facility).

122. See generally Oswald and Schipani, 86 Nw. U. L. Rev. at 259 (cited in note 105). See also Cindy A. Schipani, *Integrating Corporate Law Principles with CERCLA Liability for Environmental Hazards*, 18 Del. J. Corp. L. 1, 5 (1993) (stating that "direct involvement in the actual environmental violations appears te be a significant prerequisite te the imposition of individual liability").

123. *Attorney General, Director of Dep't of Natural Resources v. Acme Disposal Co.*, 189 Mich. App. 722, 473 N.W.2d 824 (1991) (holding a shareholder in a position of authority personally liable for a nuisance created or maintained by the corporation when he should have known, through the exercise of ordinary diligence, of the corporation's tertious activities). See also *Kelly v. Thomas Solvent Co.*, 725 F. Supp. 1446 (W.D. Mich. 1988) (recognizing that liability can be imposed on an owner-operater in a close corporation if that individual could have preventod or significantly abated the hazardous waste discharge).

124. *Leddy v. Standard Drywall, Ine.*, 875 F.2d 383 (2d Cir. 1989).

125. *Serembus v. Comfort Lines, Ine.*, 689 F. Supp. 1496 (N.D. Ill. 1988). See also *Dardaganis v. Grace Capital Inc.*, 889 F.2d 1237 (2d Cir. 1989) (imposing personal liability on the investment manager's chief executive officer for the company's fiduciary breach under ERISA in exceeding the management agreement's equity limit, when the officer by his own admission exercised discretion over how the plan's portfolio was invested); *Lowen v. Tower Asset Management, Inc.*, 653 F. Supp. 1542 (S.D.N.Y. 1987) (holding an individual officer and shareholders of the corporation liable for the corporation's breach of ERISA duties).

tics.[126] A pension context may present a somewhat less compelling case for piercing to the extent that many cases arise out of a collective bargaining situation and there would have been some theoretical chance to bargain for individual liability or that of the parent corporation.

B. Liability of Shareholders

The most far-reaching of the recent proposals to reform limited liability law would make all shareholders liable for torts of the enterprise.[127] The most significant departure from existing law would be the increased liability imposed on passive shareholders. Under traditional piercing cases, the judicial focus has not been on passive shareholders, but rather on active investors masquerading as passive investors to gain the protection of limited liability. Piercing cases reflect a judicial search to unmask efforts by participants who combine both the ability to control and the opportunity for gain and use the separate corporate form to the disadvantage of outsiders. Recent commentary seeks to extond the legal concern beyond this group to passive shareholders and remove what has, in effect, been a per se rule against finding passive shareholders liable.[128]

This argument for shareholder liability often is phrased in terms of the benefit shareholders receive when their corporations externalize costs.[129] Benefit alone may support liability based on the

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126. *Plumbers' Pension Fund, Local 130 v. Niedrich*, 891 F.2d 1297 (7th Cir. 1989) (finding the president and secretary not liable); *Rockney v. Blohorn*, 877 F.2d 637 (8th Cir. 1989) (refusing to hold an officer liable); *Scarbrough v. Perez*, 870 F.2d 1079 (6th Cir. 1989) (finding the sole shareholder-chief executive officer of a parent corporation not liable for a subsidiary's unpaid contributions); *International Bhd. of Painters and Allied Trades Union v. George A. Kracher, Inc.*, 856 F.2d 1546 (D.C. Cir. 1988) (refusing to impose liability on the chief officor and principal shareholder for delinquent pension contributions); *DeBreceni v. Graf Bros. Leasing, Inc.*, 828 F.2d 877 (1st Cir. 1987) (refusing to find the corporation's sole shareholder liable for the corporation's ERISA withdrawal liability).

127. See, for example, Hansmann and Kraakman, 100 Yale L. J. at 1880 (cited in note 3) (arguing that "there may be *no* persuasive reasons to prefer limited liability over a regime of unlimited pro rata shareholder liability for corporate torts") (emphasis in original).

128. See id. at 1932. Their proposal would leave room for a court to find, in particular circumstances, that costs should be imposed on the tort victim. Id. at 1917. They suggest that courts should consider corporate structure in determining corporate liability and tomper damages te individual shareholders because of transaction costs of unlimited liability. Their advocacy of judicial development of "constructive equity" rules to police investments that should be exposed to extended liability would leave substantial room for continued judicial involvement similar te current piercing cases. Their proposal is different, however, in that as a matter of principle, liability of passive shareholders would not be foreclosed.

129. Id. (arguing that even those who benefit from residual equity ownership should be liable for cerporate acts); Alexander, 106 Harv. L. Rev. at 396-97 (cited in note 3) (noting that economic benefits derived by shareholders provide the principal argument in favor of shareholder liability).

venerable law of unjust enrichment[130] or may support a broader argument based on shareholders' personal responsibility.[131] The reasoning of some CERCLA cases would seem to extend to passive shareholders based on benefit. For example, in *United States v. Monsanto Co.*,[132] the Fourth Circuit permitted imposition of joint and several liability without a showing of causation on defendants whose waste disposal methods may have been technically legal prior to CERCLA's enactment. The court noted that the defendants *profited* from inexpensive disposal methods, citing an earlier Supreme Court decision upholding retroactive liability for "Black Lung" benefits.[133] The Supreme Court's language quoted in *Monsanto* upheld the Black Lung law as "a rational measure to spread the costs of the employees' disabilities to those who have *profited* from the fruits of their labor."[134] Hansmann and Kraakman similarly view the shareholders' profit as justifying their liability for corporato torts.[135]

The most developed arguments for expanded liability link benefit with two traditional tort-based concerns: the efficiency of an extended liability rule in changing the behavior of corporate managers and the belief that shareholders are better risk-bearers than are tort victims. Nevertheless, neither argument is consistent with the prevailing law in the corporate area, nor are the arguments likely to better serve tort purposes.

The effort to translate shareholder liability into increased discipline over management activity reflects two distinctive strains of

130. See George Palmer, 1 *The Law of Restitution* § 1.7 at 41 (Little, Brown, 1978) (stating, "There are times when a court gives relief on a finding no more precise than . . . that the enrichment is unjust, but the usual approach is to search for some particularized reason or ground for finding that the retention of the enrichment would be unjust.").

131. See Gabaldon, 45 Vand. L. Rev. at 1436 (cited in note 3) (claiming that depriving a shareholder of limited liability is necessary te jolt shareholders out of apathy concerning possible misuses of funds).

132. 858 F.2d 160 (4th Cir. 1988).

133. Id. at 174 (citing *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1 (1976)).

134. *Usery*, 428 U.S. at 18 (emphasis added).

135. Hansmann and Kraakman, 100 Yale L. J. at 1917 (cited in note 3) (contending that "[s]hareholders who *benefit*, for example, from intentional dumping of texic wastes, from marketing hazardous products without warnings, or from exposing employees without their knowledge and consent te working conditions known by the firm te pose substantial health risks, should not be able to avoid the resulting costs simply by limiting the capitalization of their firm") (emphasis added). The *Monsanto* and *Usery* cases use the benefit-profit language to uphold the retroactive application of CERCLA and the Black Lung law. Hansmann and Kraakman stop short of a retroactive application of unlimited liability. See Henry Hansmann and Reinier Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 Harv. L. Rev. 446, 455 (1992).

Profit does not necessarily equate with being the best risk-bearer. See note 104. It may be that the government would rather the industry bear costs than the public treasury, even if shareholders are not the best risk-bearers.

recent corporate scholarship, one that builds on the efficient-market hypothesis that was a dominant concept during the 1980s and another that relies on shareholder activism by institutional investors, currently the hottest tepic in corporate law. With regard te the market argument, if liability imposed on shareholders increases, a reduction in the market price of the company's stock indirectly might cause management to change its policies.[136] Joseph Grundfest's recent article foresees creation of equity-type instruments that are not subject to extended liability, including futures, options, and other newly creatod intorests that would be practically unreachable. In such a scenario, the unlimited liability equity would be held by either remote investers who are judgment-proof or foreign shareholders from whom it would be difficult to collect judgments. Use of derivative securities with limited liability thus may negato any price effect of an extended liability rule so that the market will not translato the potential shareholder liability into increased discipline of management activity.[137]

The likelihood of dispersed passive shareholders forcing such action directly is slim given experience in other governance issues. Even the new-found hope among academics that the increasingly large ownership by institutional investors will lead to more active monitoring[138] does not play out in a world without limited liability. Even the least intrnsive form of extonded liability, pro rata liability of shareholders for torts of their corporations, 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.

In partuership 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.[139] Corporate law, in contrast, holds shareholders, who are presumed te be passive and unlikely to influence corporate man-

136. Hansmann and Kraakman, 106 Harv. L. Rev. at 455 (cited in note 135) (stating, "In short, all shareholders participate importantly in corporate control through the market."). See also Leebron, 91 Colum. L. Rev. at 1587 (cited in note 17) (assuming for purposes of the article that shareholder liability will cause managers to act efficiently in taking potential losses into account and asking if costs outweigh benefits). But see Ribstein, 70 Wash. U. L. Q. at 445 (cited in note 57) (raising the concern that unlimitod liability deflects risk away from managers who are effectively disciplined onto remote owners who are not, thus reducing incentives for care).

137. Grundfest, 102 Yale L. J. at 392, 395, 399 (cited in note 78).

138. See generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rov. 10 (1991).

139. See Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 Md. L. Rev. 80, 104 (1991).

agement, not responsible for the liability created by others.[140] Hansmann and Kraakman recognize that the primary incentive effects of their proposal will fall on shareholders, not managers,[141] an admission that undercuts the effectiveness of the deterrence purpose of their proposal in light of the smaller impact that passive shareholders are likely to have on corporate management. Professor Theresa Gabaldon's recent article developing how limited liability does not fit easily within a feminist view of society also illustrates ambiguity in whether to focus on shareholder or management activity. She notes that the detachment permitted to passive investors by limited liability is inconsistent with values of caring and connectedness.[142] Yet her proposed solution abandons shareholders' liability to focus on managers' duty to insure.[143]

The remote impact that expanding shareholder liability will have on corporate behavior increases the importance of the alternative argument that liability should be imposed on shareholders because they are better risk-bearers. The argument that shareholders are better risk-bearers, however, faces considerable challenge for a number of reasons. First, extended liability will have a significant negative effect on the ability of shareholders to diversify, which in turn removes their risk-bearing advantage and more generally will remove the standardized pricing of shares that has contributed significantly to the growth and development of liquid financial markets for shares.[144] Second, large transaction costs are likely to be incurred in a move to extended liability; these costs include excessive monitoring and eva-

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140. See Arden Doss, Jr., Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 Yale L. J. 1190, 1197 (1967) (stating, "Since these 'passive owners' [shareholders of publicly held corporations] lack the personal responsibility that close corporation shareholders have for corporate operations, and since they are unable to affect corporate funding policies, the equities justifying personal liability are correspondingly less substantial."); Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. Corp. L. 573, 612 (1986) (noting that "[s]uch liability is not only hazardous for investors, but also is incompatible with generally accepted views of fairness").

141. Hansmann and Kraakman, 100 Yale L. J. at 1909 (cited in note 3).

142. Gabaldon, 45 Vand. L. Rev. at 1432 (cited in note 3) (arguing that liability limitations artificially distance individuals from the real-life effects of entorprises in which they invest, thus decreasing their acknowledged personal responsibility).

143. Id. at 1448 (concluding that a feminist generally would disapprove of the concept of limited liability, but, in the face of political reality, suggesting a requirement of adequate insurance with sanctions against management if insurance did not comply with periodic recommendations of a panel of community voluntoers). See also Leebron, 91 Colum. L. Rev. at 1633 (cited in note 17) (suggesting liability for officers and possibly directors in close corporations for negligent infliction of economic loss if reasonably priced insurance is available but management opted for self-insuranco through limited liability; distinguishing similar liability for officors in public corporations who receive little benefit from failure te insure).

144. See Leebron, 91 Colum. L. Rev. at 1600 (cited in note 17); Hansmann and Kraakman, 100 Yale L. J. at 1903 (cited in note 3).

sion strategies exceeding what now occurs. The expectation of insurance markets expanding to fill in this increased shareholder risk is unlikely and in any event would pose large transaction costs.[145] Finally, in close corporations in which participants cannot diversify their financial or human capital, shareholders often will not be better risk-bearers and overdeterrence becomes a substantial possibility.

Recent case law in the environmental area generally does not apply the broad liability principles for shareholder liability discussed above. The expansive environmental liability rulings have been based on participation in the prohibited activity, not on a desire to distribute cost te passive shareholders as better risk-bearers.[146] The Environmental Protection Agency's interpretation of the lender exemption under CERCLA illustrates this distinction.[147] In *United States v. Fleet Factors Corp.*,[148] the Eleventh Circuit took a broad view of when a secured lender could be an operator under CERCLA. That court focused on the lender's authority to affect hazardous waste disposal decisions rather than the lender's actions exercising that authority. In response to industry concern about such potentially broad liability, the EPA promulgated rules in 1992 that emphasized actual participation.[149] The preamble to those rules states, "Participation in the management of a facility means . . . actual participation in the management or operational affairs of the vessel or

145. See the discussion at notes 87-100 and accompanying text. See also Hansmann and Kraakman, 100 Yale L. J. at 1899, 1901 (cited in note 3). They foresee new types of insurance developing: (1) a market in retroactive insurance for shareholders who, at the time tert liability attaches, desire te insure against the contingency that a tert judgment might ultimately exceed the net value of the firm; (2) portfolio insurance for individual investors that the authors anticipate would have high loading costs, but which they believe might be available even without limit by insiders or brokerage houses; and (3) additional liability insurance purchased by the firm to cover foreseeable tort losses.

146. See notos 120-23 and accompanying text. See generally *United States v. Kayser-Roth Corp., Inc.*, 910 F.2d 24, 27 (1st Cir. 1990) (holding that parent liability as operator at a minimum requires active involvement in the activities of the subsidiary); *City of New York v. Exxon Corp.*, 112 Bankr. 540 (S.D.N.Y. 1990) (finding mere capacity to influence not sufficient). But see *Donahey v. Bogle*, 987 F.2d 1250, 1254 (6th Cir. 1993) (finding authority te prevent contamination sufficient for individual liability).

147. CERCLA exempts from the definition of owner or operator "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily te protect his security interest in the vessel or facility." 42 U.S.C. § 9601(20)(A).

148. 901 F.2d 1550 (11th Cir. 1990).

149. See 40 C.F.R. § 300.1100 (1992). The more limited approach te lender liability was driven in part by the recognition that the federal government would pay a large share of such lender liability because of the savings and loan insurance program. See Jackson B. Battle and Maxine I. Lipeles, *Hazardous Waste* 304 (Anderson, 2d ed. 1993) (noting that "spurred somewhat by the lending community's horrified reaction to the *Fleet Factors* tost, and more significantly by the savings and loan industry failure, which had resulted in federal agencies holding large real estate loan portfolios, the EPA construed the lender exemption to enable a lender to conduct a wide range of activities without incurring CERCLA liability").

facility by the holder, and does not include the mere capacity to influence, ability to influence, or the unexercised right to control facility operations."[150]

In other contexts, courts have been reluctant to impose liability on large groups of passive shareholders. One example is the question of shareholder liability for failed leveraged buyouts in bankruptcy law. In leveraged buyouts, entrepreneurs get a bank loan, pledging the corporation's assets as security. They then use the cash proceeds of the loan to purchase the interests of the existing shareholders at a premium over the prior market price. When the deal goes bad, as many of them have done in the last five years, creditors might seek to recover from several potential defendants: the managers who put the deal together while ignoring the high possibility of failure, the banks who provided the money to shift the financial structure of the business from equity to secured debt, or the shareholders who walked away with a large sum of money. Courts have been unwilling to go after the shareholders.[151] The parallel to limited liability is strong. Although courts have not provided extensive theoretical discussions in their decisions, the same willingness to let passive shareholders escape liability appears to underlie these results.

Apart from the particular context of leveraged buyouts, a more fundamental question is why shareholders should face expansive liability that other corporate providers of capital do not. A common refrain of many economic-based analyses of corporate law has been to de-emphasize the centrality of shareholder ownership of corporations in favor of a nexus of contracts among various contributors of capital and other assets that the corporation needs. The widespread adoption of other constituencies statutes in the 1980s emphasizes a related issue by requiring directors to consider not just shareholders but a variety of other constituencies. Why should shareholders bear the liability and responsibility for the acts of others that other groups do not? Shareholders do receive the residual gain from the operation of the enterprise while the return of lenders, employees, or other creditors is usually fixed, but that distinction should not be determinative. In fact, many creditors will be better able than dispersed shareholders to influence management; in some situations, creditors may be better risk-bearers. There are reasons why imposing liability on these groups would not lead to the appropriate amount of precautionary

150. 40 C.F.R. § 300.1100(c)(1) (1992).

151. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Weiboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488 (N.D. Ill. 1988).

behavior, but many of those same arguments can also apply to shareholders.

C. Limited Liability in Corporate Groups

When a shareholder is a collective incorporated entity, application of the liability rules discussed in this Article becomes more difficult. Direct liability is still possible for individuals who commit tortious acts on behalf of the subsidiary, but the likelihood increases that the subsidiary's liability resulted from the acts of an employee who received direction from someone else in the corporate hierarchy. The different layers of corporato structure make finding the person who took the action more difficult. Dispersed power may make it practically impossible to impose liability on anyone other than the subsidiary or parent corporation.

A parent corporation is like the shareholders in *Walkovszky* or *Baatz* who control the enterprise and also receive the residual economic gain but may not have participated directly in the wrongful activity. Should corporate parents be treated as passive shareholders or as active participants subject to a broader duty to monitor or supervise? Analyzing the parent-subsidiary cases under the economic factors discussed earlier in this Article, the case for limited liability, is, if anything, less persuasive.[152] When the parent owns all or most of the shares of the subsidiary, no transaction costs will be incurred in pursuing the shareholder's liability. There is no public market for the subsidiary corporation's shares, so there can be no adverse effect on the market for shares. Since the piercing is done to another corporation, there is unlikely to be any effect on an individual investor's ability to diversify (thereby distinguishing a typical parent piercing case from a typical piercing case in closely held corporations when piercing could adversely affect an individual's ability to diversify).[153]

Yet, despite this less persuasive case for limited liability, courts clearly are reluctant to embrace the commentators' call for extended liability. Even in the CERCLA cases in which an argument can be made that the statuto supports extended liability beyond the corpora-

152. This discussion proceeds without distinguishing wholly owned subsidiaries from those that are not wholly owned. The argument would change for the minority shareholders, but the focus here is cn the controlling shareholders.

153. Leebron, 91 Colum. L. Rev. at 1616 (cited in note 17) (positing inefficiency for extended liability in corporate groups ouly when there are efficiencies from the integration of the businesses carried on by two entities, but those efficiencies do not otherwise increase liability costs; because it is difficult te identify these situations, he would abolish limited liability for wholly owned subsidiaries).

tion, courts have hesitated to reach passive parent shareholders.[154] If the parent is not actively controlling its subsidiary, many courts continue to treat the parent as a passive investor just like dispersed passive investors in large, publicly traded corporations. In the words of one court, specific to the CERCLA context, "a corporation which wants to put a waste site or past generation site to productive use can do so by creating a well capitalized, non-fraudulent, separate corporate subsidiary. . . . 'There is nothing fraudulent or against public policy in limiting ones liability by the appropriate use of corporate insulation.'"[155]

The parent-subsidiary context presents a greater concern if the collective, intangible nature of the corporate shareholder is used to confuse those dealing with the corporation and thereby portray as passive what is really a well-planned insulation of liability and externalization of foreseen costs. Piercing-the-veil cases relating te parent-subsidiary groups reflect this concern. Courts are much more willing to find corporate shareholders liable when there is no substantive separation, or when the court finds that the parent is the subsidiary's alter ego. A finding of common directors, officers, or owners alone is less likely to lead to a judicial finding of liability.[156] The differentiation between mere overlap and active control is consistent with the premise that liability should be based on direct participation or a duty to monitor or supervise. In the absence of parental domination, the subsidiary may be subject to the discipline imposed by the credit markets. That discipline coupled with the existing incentives of managers to insure can be expected to provide a sufficient check such that additional legal regulation is not required.[157] To impose liability in that instance would produce no increase in efficient precautions being taken while disrupting some beneficial investment.

Voluntary creditors seeking to be paid back on the assets advanced to the corporation will evaluate the possibility of hazardous activity and charge a rate of interest commensurate with the risky

154. See generally notes 103-06 and accompanying text.

155. *In re Acushnet River & New Bedford Harbor Proceedings*, 675 F. Supp. 22, 32, 34 (D. Mass. 1987) (quoting *Miller v. Honda Motor Co.*, 779 F.2d 769, 773 (1st Cir. 1985)).

156. Thompson, 76 Cornell L. Rev. at 1063 (cited in note 15). Examining only tort cases, courts pierce the veil in 85.71% of cases in which no substantive separation is shown (12 of 14), 100% of alter ego cases (16 of 16), and 81.82% of cases finding instrumentality (10 of 11). Where the court identifies common officors, piercing occurs 47.22% of the time (17 of 36), 35.71% for common directors (10 of 28), and 38.46% for common owners (5 of 13).

157. The law has pulled back in similar situations before. For example, minimum capitalization requirements were common in corporations codes earlier in this contury. The abandonment of such rules says more about their relative effectiveness as a constraint than about the conclusion that the law was encouraging externalization.

activities of the enterprise. The equity owners, and their managers if the functions are separated within the corporation, have an incentive to creato or agree to policies that reduce the risk and thereby reduce the risk premium.[158] A firm will not undertake risky activity when the compensation that must be paid in this way exceeds the benefits. This protection for tort creditors from the existence of contract crediters 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 (for example, employees or some trade creditors).[159]

The participants' incentive to insure creates an altornative constraint on an enterprise externalizing costs. Managers with firm-specific human capital invested in a firm cannot diversify against the risk of business failure as can shareholders who may split their money capital among various unrelated entorprises. These investor-managers may prefer to have a limited liability firm insure against tort claims so as to protect their firm-specific human capital. To the extent that insurance is purchased, it creates a "contract creditor where none existed before," forcing the enterprise to pay higher premiums for the right to engage in risky activities.[160]

Taking these last two points together, externalization is more likely to occur in an enterprise in which the investor-managers have little firm-specific human capital invested and the firm does not need te enter the capital markets.[161] These two points help explain why courts regularly let some parent corporations form subsidiaries to insulate the parent from liability. Contract creditors and the desire to

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158. Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 51 (cited in note 54).

159. Some have argued that externalization is less common than often supposed. See, for example, Ribstein, 70 Wash. U. L. Q. at 442 (cited in note 57) (noting that crediters, including employees, will adjust prices te reflect increased risks); Meiners, Mofsky, and Tollison, 4 Del. J. Corp. L. at 367 (cited in note 52) (claiming that limited liability does not arbitrarily impose unwarranted costs on involuntary crediters).

Alternatively, other commentaters have noted that despite an opportunity te externalize, managers' sense of professionalism or their individual values and interests will lead to internalization of the harm. See Mark J. Ree, *Corporate Strategic Reaction to Mass Tort*, 72 Va. L. Rev. 1, 24 (1986) (observing that "[t]he psychology of professionalism does not lead solely te a blind effort te maximize shareholders' interests. Rather, it is likely to embody a desire to *operate* the enterprise well.") (emphasis in original); Leebron, 91 Colum. L. Rev. at 1602 n.115 (cited in note 17).

160. Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 54 (cited in note 54).

161. Many commentaters advocate direct regulation of a targeted group te address possible externalization by these firms. See Ribstein, 70 Wash. U. L. Q. at 443 (cited in note 57); Grundfest, 102 Yale L. J. 387 (cited in note 78).

insure influence firms to take an appropriate amount of care. Only when the parent corporation so controls the subsidiary as to leave these usual incentives ineffective does a need for a different legal rule as to limited liability arise.

The focus should be on the set of firms whose contracts do not cause them to internalize fully their tort costs and those corporations without firm-specific investment by management leading them to purchase a sufficient amount of insurance. Would a change in the legal rule reduce or eliminate the avoidance of liability by these firms? Given the transaction costs, there is reason to doubt substantial benefit in corporations generally, but there likely would be benefit in some particular situations.[162]

In parent-subsidiary contexts, it is much more difficult te determine if the credit markets or incentives from firm-specific human capital operate specifically on the subsidiary or whether their effect is felt on the corporate group as a whole. The extent te which creditors or managers actually separate the subsidiary from the larger group has spawned a vigorous debate among commentators.[163] Courts, avoiding the complexity of this debate, sometimes fall back te a structured analysis, asking if a corporate shareholder is acting as a mere shareholder in a traditional shareholder role limited to passive investment or rather has also undertaken the more active role of a manager.[164] Such an approach is consistent with the view expressed in this Article that passive shareholders should not be liable for the acts of others. However, this does not mean that a parent corporation should be judged only against the standard for manager liability described in Part II of this Article, in which individuals are held liable

162. Ribstein, 70 Wash. U. L. Q. at 431, 433 (cited in note 57) (arguing that the extra cushion provided by unlimited liability is small, net of collection costs; unlimited liability simply changes the nature of evasion rather than precluding it). See Dent, 26 Wake Forest L. Rev. at 174 (cited in note 42) (noting that the "argument that shareholder liability encourages prudence and spreads the costs of accidents assumes that shareholder liability does not alter the financial structure of firms. . . ." These assumptions are false.).

163. See, for example, the debate between Landers and Posner, relating to whether affiliated corporations will be managed differently from independent firms. Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. Chi. L. Rev. 589, 596-97 (1975) (stating that a subsidiary will be responsive to dictates of owners, who will be most interested in the overall return on their investments); Richard Posner, *Economic Analysis of Law*, 229 (Little, Brown, 2d ed. 1977) (stating that normally profits of the group will be maximized by maximizing the profits of each constituent corporation).

164. See *Lansford-Coaldale Joint Water Auth. v. Tonolli Corp.*, 4 F.3d 1209, 1222 (3d Cir. 1993) (in determining operator liability under CERCLA for a parent corporation, a court examines whether the parent is a mere investor or is actually and substantially participating in the subsidiary's management); *CPC Int'l, Inc. v. Aerojet General Corp.*, 777 F. Supp. 549, 573 (W.D. Mich. 1991) (distinguishing "mere oversight of a subsidiary's business in a manner appropriato and consistent with the investment relationship" from "actual participation and control over a subsidiary's functions and decision-making").

for their direct participation in the tortious activity. Parent corporations who are active in their control of a subsidiary are not the same as individual officers, whose only connection to the enterprise is their management job; parent corporations combine control and economic gain. In addition, the corporate form provides the parent hierarchy and specialization that permits it to diffuse control in a way that makes a corporation seem more passive than an individual in the same position. The threshold for when corporations should be vicariously liable for the acts of others should not be as high as the standard for individuals who serve only as corporate managers, and the liability standard should reflect the specific context.

For example, recent federal legislation extends liability for deficiencies in pension plans insured by the Pension Benefit Guaranty Corporation (PBGC) beyond the plan sponsor to include the plan sponsor's "controlled group."[165] This broader rule borrows from tax law in determining "controlled group" and generally includes all persons with at least an eighty percent ownership interest in the employer and all persons in which the employer owns at least an eighty percent interest.[166]

It may be that this broader rule is tied to the risk to the federal treasury from the unique nature of the obligations insured by the PBGC. Pension plans insured by the PBGC can create immediate obligations to employees based on past service credit of those employees, but the plan sponsor can then amortize over thirty years their contributions necessary to defray those benefits. If a plan sponsor were to decide after the first few years that the plan was simply too expensive, the tormination might leave the PBGC with liability for past service credit that had not been fully funded.[167] Extonded liability could be justified as based on this unfunded payment concern.

V. CONCLUSION

Applying the learning of recent economic analysis of limited liability issues te existing case law suggests several new insights. First, direct participation is an important explanation of liability in tert contexts. The language of piercing-the-veil cases has sometimes conflated shareholder liability with that of direct participants, but the latter basis of liability is now taking on increasing significance. The

165. See 29 U.S.C. § 1362(b), (c) (1988 & Supp. 1991).
166. 26 U.S.C. §§ 414(b), (c), (m), & (o) (1988); Treas. Reg. §§ 1.414(b)-1 through (c)-5.
167. This suggestion comes from Daniel Keating.

corporate form has never provided a shield for individuals to engage in tortious acts while clothed in a corporate capacity. In recent years, this lack of insulation has expanded to include individuals who should have monitored or supervised others in the enterprise who committod tortious acts. Similarly, there have been an increasing number of statutes and cases that remove limitod liability from those who violate regulatory requirements while acting in a corporato capacity.

Separated from the overlap with liability for direct participation, liability for shareholders based on distributional grounds is much weaker. Such liability would likely have negative effects on diversification of shareholders and the liquidity of shares and would engender large transaction costs while not preventing substantial evasion of liability. When combined with the inability of these potential liability bearers to affect the actions of the enterprise, the insulation of limited liability should remain undisturbed for passive shareholders.

The continuing puzzle is why courts remain so willing to provide limited liability to parent corporations in tort cases. The various arguments for limited liability do not have much impact in the parent-subsidiary situation. There do not appear to be large transaction costs to reach the parent corporation. There is no impact on the public market for shares of the subsidiary. No adverse diversification effects appear that would lead to overdeterrence or excessive monitoring. Yet externalization of some of the costs of the business clearly does occur. Even if piercing would be harsh to a passive parent corporation that did not participate in the wrongful action, it would seem to be outweighed by the harshness to those injured. It may be that these risks are viewed as remote, so that no extra preventive actions would be taken if liability were imposed,[168] or that other methods of covering the injury are more efficient,[169] combined with a desire to defer to the legislature to make such decisions.[170] To the extent that a parent corporation does not exercise dominance in the manner used traditionally to support piercing, a greater likelihood exists that the parent-subsidiary strncture remains responsive to the usual credit markets so that a sufficient amount of preventive care is taken and no additional corrective liability would be beneficial.

168. Alan Schwartz, *Products Liability, Corporate Structure and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. Legal Stud. 689 (1985).

169. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 259, 263 (1967) (observing that "[t]he solution to the industrial accident problem was simply shifted out of the corporate arena and its modern counterpart, the auto accident, seems to place no special pressure on the limited liability concept").

170. See, for example, the court's deference in *Walkovszky v. Carlton*, 223 N.E.2d 6, 9 (N.Y. Ct. App. 1966), and in *Radaszewski v. Telecom Corp.*, 981 F.2d 305, 311 (8th Cir. 1992).

Unpacking the contexts in which the limited liability question arises insures that the language of the corporate form, with its emphasis on the separate functions, does not confuse the application of tort principles. This unpacking both provides a means to address the problem and suggests the direction of the solution. Liability for passive shareholders is not supported on either risk-sharing or control grounds. Liability for managers can be extended if appropriate consideration is given to possible overdeterrence. Liability for those who combine both functions presents the easiest case for departing from limited liability, but even in this context, nonlegal constraints temper the application of the legal rule. In none of these applications, however, does corporate law thwart the application of tort principles.