

Corporate Shareholders' Limited Liability: Useful or Abusive?

*di George Khoukaz**

If you come to grief, and creditors are craving (for nothing planned by mortal head is certain in this Vale of Sorrow – saving that one's liability is limited), do you suppose that signifies perdition? If so, you're but a monetary dunce; you merely file a winding-up petition, and start another company at once!¹

1. Introduction

An effective institutional structure is critical to the well-functioning of a business entity in order to allow for the economic growth of such an entity.² A large-scale effective development of business entities will result in an economic boost in such a way that particular attention should be given to the business entity as an economic unit. In other words, society is likely to have an interest in effective and prosperous business entities because, in theory, such generated benefits will have favorable economic repercussions beyond the entity itself. Therefore, it is important to raise and address questions regarding «how to improve the operational performance of the [financial] system»³ in order to establish an enterprise system that is healthy and sustainable in the long term.

* B.A., University of Balamand, 2015; J.D., University of Missouri School of Law, 2018.

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² GILBERT, SULLIVAN, *Utopia Limited*, 1893.

³ RUI-NA LIU, «An Economic Analysis on System of Limited liability», in *Int'l Conf. Hum., Ed., and Soc. Science Report*, 2016.

³ *Ibid.*

A. Stating the Premises: The Role of Corporate Limited Liability

Corporations are usually seen as the building block of a capitalist society in such a way that the corporations' successes (or failures) are directly associated with the health of a country's economy.⁴ An obvious argument can be made stating that since the aggregate of the corporations' operations is an important factor to assess and study the economy, then it is worthwhile to delve into the details of corporate structure. The reasoning is that a close look at the individual corporate structure will allow the reader to assess the viability of certain concepts associated with corporations, and to determine the benefits of these concepts *vis-à-vis* other drawbacks inflicted on the larger society. One relevant doctrine associated with corporate structure is that of limited liability. In fact, there is an agreement that the concept of limited liability is the *sine qua non* of the corporate form.⁵ For example, Hugh Sowards asserts that «the hallmark of the corporation is limited liability»⁶ and that it is «usually the central reason for incorporation».⁷ In other words, limited liability plays such a central role in a corporation's life that it is critical to get a better grasp of it, especially when there is a consensus that the whole area of limited liability is among the most confusing in corporate law.⁸

One's curiosity regarding limited liability is further increased and emphasized when learning about financial disasters and market failures. The financial crisis of 2007 and 2008 generated heated debates as to its causes and origins.⁹ A recurring theme dominated the discussion – despite ideological divides – and pointed to moral hazard as the prime source of the crisis.¹⁰ Moral hazard is, briefly, defined as the «opportunity for organizational and individual actors to reap rewards of risky behavior without bearing associated costs».¹¹ In other words, the concept of moral

⁴ H. G., «Complexity Matters: A New Atlas Reveals the Building Block of Economic Growth», *The Economist*, Oct. 27, 2011, available at: <https://www.economist.com/blogs/freeexchange/2011/10/building-blocks-economic-growth>.

⁵ K. F. FORBES, «Limited Liability and the Development of the Business Corporation», in *J.L. Econ. & Org.*, n. 2, 1986, p. 163

⁶ *Ibid.*, citing R. E. MEINERS, «Piercing the Veil of Limited Liability», in *Del. J. Corp. L.*, n. 4, 1979, p. 351.

⁷ *Ibid.*

⁸ P. BLUMBERG, «The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations», 1983, p. 8.

⁹ M. LOUNSBURY, P. M. HIRSCH, «Markets on Trial: The Economic Sociology of the U.S. Financial Crisis», 2011.

¹⁰ M.L. DJELIC, J. BOTHELLO, «Limited liability and its Moral Hazard Implications: The Systemic Inscription of Instability in Contemporary Capitalism», in *Theory and Society*, n. 42, 2013, p. 589

¹¹ *Ibid.*

hazard can be understood as a system that allows for risk to be shifted away from the risk creator to an independent and unrelated third-party. The abuse of the risk-shifting system results in a potential moral hazard as well as in a financial one. A number of scholars associate the so-called «moral hazard» to limited liability; in fact, it is argued that moral hazard is the direct result of corporate limited liability since it allows the shareholders to shift its damages to third-parties while hiding behind the shield of limited liability.¹² As will later be explained, the concept of moral hazard is usually seen as the result of allowing the externalization of costs.

B. Purpose and Outline

Based on all the premises mentioned above, it is natural to start thinking about the concept of limited liability while keeping in mind the financial importance of a successful corporate structure and its positive impacts on a nation's economy. Therefore, the purpose of this Comment is to address the question of when limited liability becomes abusive and disruptive to a society's development. In other words, we are interested in finding the sweet-spot which justifies risk-shifting – for the selfish purpose of corporate economic growth – while making sure that such a shift does not result in a destructive hazard on the larger society.

Section II will provide a historical background on the evolution of the concept of limited liability and will highlight how that concept evolved to its current state. The Section will go through a brief overview of 18th century French law in order to show the relationship between the economic environment at the time and how it came to impact the development of the concept of limited liability. It will also briefly describe the rise of the corporation as a separate legal entity. Such an overview should help the reader in better understanding the role of limited liability in today's society. Section III will delve into the purpose and theoretical rationale of the concept of limited liability. By doing so, we consider the justifications for limited liability and observe how the concept works in practice. This Section will also further introduce the reader to the idea of «burden-shifting» or «risk-shifting» and its application under limited liability. Section IV will address the benefits and drawbacks of limited liability. Laying out the pros and cons allows the reader to see the bigger picture and balance these competing interests. Section V will attempt to strike a balance by finding a middle ground where the benefits of corporate limited liability do not infringe on the growth of independent third-parties, while allowing for a corporate structure that enables growth.

¹² *Ibid.*

2. Limited Liability: From Feudal France To Today's Us Corporations

In 2007, Professor DeLong posted a list of top ten changes to US law over the past 225 years that were, in his opinion, judge-initiated legal changes without any congressional action or encouragement.¹³ Number four on his list was the following:¹⁴

The post-Civil War empowering of corporations with exorbitant privileges of citizenship and limited liability at the expense of government regulators and creditors.

This observation by Professor DeLong raises two points that need to be discussed from a historical perspective. The first is that of the recognition of corporations as a separate entity from its shareholders, therefore granting such institutions an independent status under the law. The second overlapping point is that of granting limited liability to these corporations. The ensuing discussion in this Section will cover these two points.

A. Corporation as an Independent Entity

The corporation stood the test of time and has been a remarkably resilient legal form, withstanding more than 200 years of industrialization and modernization largely because of its «capacity to adapt constantly to changing environments».¹⁵ The concept of a business entity created for the purpose of engaging in trade, manufacturing, or services is obviously not a new idea. There is ample evidence tracing the idea of such business entity – in its varying forms – to the Romans.¹⁶ The *societas*, for example, is «an association of persons that [is] established to pursue any goal, ranging from personal affairs to purely financial relationships».¹⁷ *Societates* were a critical factor in the Roman economy, and were the engine behind the em-

¹³ B. DELONG «All Ten of the Constitutions-in-Exile Order Their Respective Mojitos», *delong.typepad.com*, available at: http://delong.typepad.com/sdj/2007/02/all_ten_of_the_.html

¹⁴ *Ibid.*

¹⁵ K. PISTOR, «The Evolution of Corporate Law: A Cross-Country Comparison», in *U. Pa. J. Int'l Econ. L.*, n. 23, 2002, pp. 793-94.

¹⁶ S. HIRST, «Corporate Law Lessons from Ancient Rome», *Harvard Law School Forum on Corporate Governance and Financial Regulation*, (une 19, 2011, available at: <https://corpgov.law.harvard.edu/2011/06/19/corporate-law-lessons-from-ancient-rome/>)

¹⁷ *Ibid.*

pire's growth and expansion.¹⁸ Unlike today's US corporations, *societates* consisted mainly of wealthy individuals or families partnering together in certain endeavors or projects, such as maritime transportation or even slave trade.¹⁹ Interestingly but not surprisingly, these business entities were small in size and consisted of only few partners – usually no more than two.²⁰ Centuries later, these business entities were still forcefully present in 18th century feudal Europe in the form of «guilds»²¹ and «joint-stock companies».²² These entities were usually granted monopoly over different sectors of the economy, and were afforded special protection by the state.²³ These concepts were transferred into today's United States by the European colonization of the Americas throughout the years.

It was not until 1886 that the US Supreme Court, deciding a tax dispute, dismissively held that corporations ought to be deemed legal persons under the Constitution with all the rights and protections granted to humans by the Bill of Rights.²⁴ Remarkably, one of the most relevant corporate law doctrines in our era – the doctrine of corporate personhood – was created by a court opinion, lacking any reasoning or legal support for such a position.²⁵ Chief Justice Waite of the US Supreme Court, in his opening statement before the beginning of arguments, announced that:²⁶

The court does not wish to hear argument on the question whether the provision in the Fourteenth Amendment to the Constitution, which forbids a State to deny to any person within its jurisdiction the equal protection of the laws, applies to these corporations. We are all of opinion that it does.

Thus, it was that «two-sentence assertion by a single judge that elevated corporations to the status of persons under the law, prepared the way for the rise of global

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ Guilds are defined as «an association of people with similar interests or pursuits» often having considerable power; «especially: a medieval association of merchants or craftsmen», *Merriam-Webster*, available at: <https://www.merriam-webster.com/dictionary/guild>.

²² D PLESCH, S. BLANKENBURG, «Corporate Rights and Responsibilities: Restoring Legal Accountability», 2007, available at: https://eprints.soas.ac.uk/5707/1/RSA_Corporate_Rights-Plesch_and_Blankenburger.pdf.

²³ *Ibid.*

²⁴ *Ibid.*

²⁵ *Ratical.org*, available at: <https://www.ratical.org/corporations/SCvSPR1886.html>.

²⁶ *Santa Clara Cty. v. S. Pac. R. Co.*, 118 U.S. 394, 6 S. Ct. 1132, 30 L. Ed. 118 (1886).

corporate rule, and thereby changed the course of history».²⁷ The corporation as an independent legal entity, with the rights and protections to which it is entitled to under the US Constitution, was thus born. Limited liability was not automatically granted or associated with corporations at that time. The Santa Clara County case did not address such an issue at all.²⁸ The following subsection will address the rise of the concept of limited liability, and how it became associated with the corporate structure.

B. The Roots and Rise of Limited Liability

It is well-known that today's corporate structure indirectly results in a separation of ownership and management. A quick glance at publicly traded companies shows that the managers and officers are not necessarily majority shareholders (they most likely own a large number of the company's shares, but that does not in any way result in full or majority ownership of the company). This separation between management and ownership in today's US corporations is usually attributed to limited liability.²⁹ Limited liability encourages investors to invest their money by bearing a minimal risk – one that is limited to the amount of the investment in the company.³⁰ Such a system also allows investors to diversify their risks by investing in a variety of other corporations, thus spreading their wealth over a large number of corporations.³¹ Berle and Means argue that because investors have limited risks they lack the incentive (as well as the time and energy) to closely engage in and follow-up on the management of the business.³² Such a structure results in separation of management and ownership. This brief observation is relevant because, as we will discuss below, limited liability was not a relevant benefit of the present-day corporate structure's predecessor in 18th century France. In fact, limited liability was only the *de facto* result of the much-needed separation of ownership and management in feudal France.

To understand the rise of the *société en commandite simple*³³ – which is deemed to be the first business entity granting limited liability to its owners – in feudal

²⁷ *Ratical.org*, available at: <https://www.ratical.org/corporations/SCvSPR1886.html>

²⁸ *Santa Clara Cty. v. S. Pac. R. Co.*, 118 U.S. 394, 6 S. Ct. 1132, 30 L. Ed. 118 (1886) (the concept of limited liability was not mentioned in this opinion).

²⁹ A. BERLE, M. C. GARDINER, «The Modern Corporation and Private Property», 1932.

³⁰ *Ibid.*

³¹ *Ibid.*

³² *Ibid.*

³³ This is the French term for «limited partnership» which is distinguished from the general partnership, or *société générale*.

France,³⁴ it is necessary to take into account the broader social and cultural context.³⁵ As mentioned above, the traditional guild-based system of enterprise was prevalent in 18th century France.³⁶ Such a system was so closely tied to the State, that any efforts for self-enrichment, separate from the higher goal of serving the State, was condemned by the Catholic church.³⁷ However, the majority of the population – known as the group belonging to the third estate³⁸ – was not associated with the state-sponsored guild system, and was therefore solely concerned with «meeting their own self-interested material wants and needs».³⁹

Trade seemed to be the best method to pursue one's self-interested material wants and needs. The nobles could not participate in such an activity since they would risk condemnation by the Church, potentially resulting in *dérogation* – the loss of their social noble rank.⁴⁰ The problem, however, lays in the fact that wealth was concentrated in the hands of the noble class which, nevertheless, could not publicly invest it in state-unrelated activities such as cross-Atlantic trade. The lower-ranked part of the population (those belonging to the third-estate) possessed the will and ability to engage in such activities but lacked the capital to do so. It was in this context that the *société en commandite simple*, a form of business enterprise that later served as the model for the American limited partnership (encapsulating

³⁴ It is important to note that the *société en commandite simple* was a form of a partnership. The concept later evolved under US law and was adopted for corporations.

³⁵A.D. Kessler, «Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership», in *J.L. Studies*, n. 32, 2003, p. 516.

³⁶ S. Pollard, *Peaceful Conquest: The Industrialization of Europe, 1760–1970*, 63-78 (1981).

³⁷ Foremost among these inherited attitudes was a long-standing disdain for commercial activity, which was rooted in a Christian theological tradition that equated the pursuit of profit with sin. This tradition depicted commerce as an emanation of man's love for his own selfish, personal interests—a self-love that necessarily detracted from man's ability to love God above all others and, thus, lay at the root of all evil. As the Catholic Church continued to exercise significant influence throughout the eighteenth century, such theological disdain for commerce resulted in very real-world consequences. See A.D. Kessler, «Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership», in *J.L. Studies*, n. 32, 2003, pp.516-17.

³⁸ The French *Old Regime* social order was conceived as a kind of pyramid, with the spiritual and godly predominating over the material and earthbound. Therefore, of the three estates constituting the social order, the clergy was at the very top of the pyramid, which was committed to serving God. The second was the nobility, which was devoted to promoting ends greater than themselves (serving the State). The third estate included the majority of the population, who were looking for their own, self-oriented interests. See Sewell, *Work And Revolution in France: The Language of Labor from The Old Regime to 1848*, 21-25 (1980).

³⁹ A.D. Kessler, «Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership», in *J.L. Studies*, n. 32, 2003, p. 517.

⁴⁰ *Ibid.*

the concept of limited liability which was later adopted by corporate law), grew to prominence in French commercial life.⁴¹

According to Jena Toubeau, arguably the leading French commercial jurist of the early 18th century, the *société en commandite simple* came to life as a business structure allowing for a contract «between two or several people, in which one [...] does nothing other than contribute with his money, and the other gives his name, his money, and his industry, or his name and his industry only».⁴² Later on, the Commercial Ordinance of 1673 – named *Pour le Commerce* – was adopted⁴³ and stated that partners who do not give their names to the *société en commandite simple* have limited liability.⁴⁴ The concept of limited liability was thus born and associated to a form of business entity; however, Toubeau regarded limited liability as only one – and perhaps a secondary – feature of a form of organization that primarily was used to enable the noble class to participate in self-interested transactions while remaining hidden from the eyes of the Catholic church.⁴⁵ This new business structure made financial sense, and was therefore widely used.⁴⁶

C. Corporate Shareholders' Limited Liability

The American limited partnership is a direct import from France, mainly through Louisiana's long tradition of employing French legal concepts.⁴⁷ New York

⁴¹ *Id.*, p. 518.

⁴² J. TOUBEAU, *Les institutes du droit consulaire ou les elemens de la jurisprudence des marchands, d'un tres-grand secours au palais, utiles à tous marchands et négociants, et necessaires aux juges et consuls*, 1700, p. 73.

⁴³ Translated to «For the Commerce». S. E. HOWARD, «Business Partnerships in France Before 1807», in *Acc. Rev.*, n. 7, 1932, p. 242.

⁴⁴ Title IV, article VIII, of the Commercial Ordinance of 1673 provided that «[l]imited partners will be obligated only up to the limit of their share». P. BORNIER, *Conferences des Ordonnances de Louis XIV, Roi de France et de Navarre, Avec les Anciennes Ordonnances du Royaume, le Droit Écrit et les Arrêts, Enrichies d'Annotations et de Décisions Importantes 1755*, p. 472.

⁴⁵ A.D. KESSLER, «Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership», in *J.L. Studies*, n. 32, 2003, p. 518.

⁴⁶ «These partnerships are extremely advantageous to the state and to the public, because by this means, commerce, which is its wealth, is greatly swollen, since without this means, a lot of money would remain in the coffers and would not move; because through such partnerships, the nobility and magistrates [*Gens de Robe*], in good conscience and without losing their title [*sans déroger*], can make the most of their money and enjoy all the advantages of commerce, without being saddled with efforts and hard work». J. TOUBEAU, *Les institutes du droit consulaire ou les éléments de la jurisprudence des marchands, d'un très-grand secours au palais, utiles à tous marchands et négociants, et necessaires aux juges et consuls*, 1700, p. 105.

⁴⁷ F. TROUBAT, *The Law of Commandatary and Limited Partnership in the United States*, 2013, pp. 25-26.

subsequently became the first common law state to statutorily allow limited partnerships, and therefore to grant limited liability to investors and business owners.⁴⁸ Interestingly, however, the limited partnership's initial popularity in the US was credited to its incorporation of limited liability. In other words, whereas the *société en commandite simple* proved desirable in Old Regime France primarily because it afforded a separation of ownership and management – a separation of which limited liability was deemed a necessary moral consequence – the limited partnership was of interest in early 19th century New York largely because it offered limited liability.⁴⁹ It is noteworthy to mention that limited liability was first introduced into the US legal system through partnerships in the late eighteenth and early nineteenth century, and was only then absorbed into corporations.⁵⁰

Following this historical background, the Section below will delve into the purpose and rationales of limited liability.

3. Rationales And Limitations: The Theoretical Rationale Behind Limited Liability And Its Application In Practice

Before delving into the theoretical rationales in this Section, it is helpful to recall what limited liability is. The liability of the corporation itself, as an institution, is not limited. The liability of the corporate shareholders, on the other hand, is limited to the amount of capital they initially invest in the corporation. In other words, limited liability is «no more than a name for a complex set of contracts among managers, workers, and contributors of capital. It has no existence independent of these relations».⁵¹ This understanding of limited liability leads to two subsequent questions, which are the following: (a) why are investors' liabilities limited only to the capital they invest?; and (b) since investors' liability is limited, the risk and burden of failure are going to be shifted somewhere else. Is such a system beneficial? What are the available remedies against unreasonable shifts of risks?

This Section will cover and address the two questions above.

⁴⁸ *Ibid.*

⁴⁹ A.D. KESSLER, «Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership», in *J.L. Studies*, n. 32, 2003, p. 538.

⁵⁰ *Ibid.*

⁵¹ F.H. EASTERBROOK, D. R. FISCHER, «Limited Liability and the Corporation», in *Univ. Chi. L. Rev.*, n. 52, 1986, p. 89.

A. The Rationale of Limited Liability and why it Makes Sense

Henry Manne once stated that the modern publicly held corporation that we know today would not have existed without limited liability.⁵² This is so because if investors were required to put their whole wealth behind every bit of stock they buy in a publicly held corporation, then wealthy investors would obviously be reluctant and unwilling to invest large (or even small) sums of money into a wide variety of corporations.⁵³ An investor, risking his whole wealth with each investment he makes, would rather reduce the amount of his investments in order to be able to closely manage and supervise the corporation in which he is risking his wealth, in order to prevent opening himself to full liability.⁵⁴

Another rationale in favor of limited liability is that it allows for an equal value of a share, across the board at a certain point in time, regardless of the buyer's wealth.⁵⁵ Assume, for example, that limited liability does not exist and that every investor would be risking his whole wealth with every share he buys. Assuming that two investors own the same exact number of shares in a particular corporation, the failure of that corporation is likely to cost one investor significantly more than the other. This is so, because, the greater a particular investor's wealth in relation to that of other investors in the same company, the higher the probability that the investor's personal wealth would be reached in the event of corporate default, and therefore, that investor, in theory, would have paid more than others for that share.⁵⁶ Since, in such a scenario, investors would attach different values to corporate shares – depending on each investor's wealth – it would be impossible to conduct an organized market.⁵⁷ In other words, limited liability is a must to establish an organized and well-regulated securities market where investors are put at an equal footing when buying shares of stock. These obvious rationales for limited liability enable the creation of a market system where investors are encouraged to invest in companies, and which therefore facilitates capital pooling.⁵⁸ Furthermore, investors, facing limited

⁵² H.G. MANNE, «Our Two Corporation Systems: Law and Economics», in *Va. L. Rev.*, n. 53, 1967, p. 259.

⁵³ *Ibid.*

⁵⁴ *Ibid.*

⁵⁵ P. HALPERN, «An Economic Analysis of Limited Liability in Corporation Law», in *U. Toronto L.J.*, n. 30, 1980, p. 117.

⁵⁶ F.H. EASTERBROOK, D. R. FISCHER, «Limited Liability and the Corporation», in *Univ. Chi. L. Rev.*, n. 52, 1986, p. 92.

⁵⁷ *Ibid.*

⁵⁸ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p.1312.

and recognizable risks, can reduce their risks by holding diversified portfolios – therefore increasing the amount of investments in corporations.⁵⁹

This brief⁶⁰ overview of why limited liability is useful and beneficial to our societies could be misleading if we do not clearly cover the functioning of the economic system created by limited liability. This subsection provided a utopian perspective of limited liability, one where all parties seem to benefit, and downside risks are forgotten. However, we do not live in a utopian society, and failure risks and consequences are very well present. The following part will address risk-shifting, which is the direct result of limited liability.

B. Who Bears the Burden of Risk and how to Counter That Risk?

«Limited liability does not eliminate the risk of business failure. Someone must bear that loss».⁶¹ An important question that causes lots of debate is whether it is better to allow losses to lie where they fall, or to shift those losses elsewhere. It seems that the market's answer, through the adoption of limited liability, is «partial» risk-shifting.⁶² That is so because equity investors bear the first burden of failure *vis-à-vis* creditors, yet their losses are capped to the amount of their investments.

Since limited liability, in theory, increases the possibility that fewer assets will be available in case of corporate failure, it could result in corporate shareholders' reaping all the benefits while leaving creditors and the general public to bear the costs of that failure.⁶³ This incentive to transfer the costs of failures to creditors is known as the «moral hazard» of limited liability, and is a big source of concern for the critics who argue that limited liability is more destructive rather than beneficial.⁶⁴ We will address the validity of such arguments later on in this Comment. The point to keep in mind is that limited liability results in a burden-shifting where a third party has to bear the costs of corporate failure. In other words, the externalization of costs could impose significant social costs, and therefore could be undesirable.

⁵⁹ H.G. MANNE, «Our Two Corporation Systems: Law and Economics», in *VA. L. REV.*, n. 53, 1967, pp. 262–65.

⁶⁰ For more details about the benefits and drawbacks of limited liability, please refer to Section IV.

⁶¹ F.H. EASTERBROOK, D. R. FISCHER, «Limited Liability and the Corporation», in *Univ. Chi. L. Rev.*, n. 52, 1986, p. 98.

⁶² *Id.*, p. 103.

⁶³ *Id.*, p. 104.

⁶⁴ J.M. LANDERS, «A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy», in *U. Chi. L. Rev.*, n. 42, 1975, p. 589; C.D. STONE, «The Place of Enterprise Liability in the Control of Corporate Conduct», *Yale L.J.*, n. 90, 1980, pp. 65–76.

The question that naturally follows from the discussion above is to look at the current state of our laws, and to understand the protections that they afford in case of an unreasonable, malicious, and purposeful externalization of risks. The most common remedy that our laws provide against an abusive externalization of costs is the corporate structure veil-piercing. The Section below will provide a practical overview of the concept of veil-piercing and how it applies in practice.

C. Limited Liability and Veil Piercing: Policing Abusive Risk-Shifting

Corporate veil piercing is a doctrine that allows a court to counterbalance the benefits of limited liability.⁶⁵ However, it is important to note, that limited liability is the rule while veil piercing is the exception.⁶⁶ In that sense, the doctrine of veil piercing is reluctantly and rarely applied.⁶⁷ This makes sense since the law aims to encourage businesses, and an extensive use of the piercing doctrine would defeat the purpose of limited liability. The law assumes that when a corporation contracts debt or commits a tort, it is the corporation itself, as an entity, that commits these acts – and not its shareholders.⁶⁸ Therefore, the corporation shall be distinguished from its shareholders, and shall be held liable in case of failure. The doctrine of piercing the corporate veil usually comes into play whenever the shareholders treat the corporation as their «alter-ego».⁶⁹ This means that if the shareholders exploit the corporation as a tool to exclusively advance their own personal interests, common sense holds that they should not be entitled to the protection of limited liability since the separation between a corporation and its shareholders is non-existent. For example, in a 1976 case, the Fourth Circuit noted that:

[I]n applying the «instrumentality» or «alter ego» doctrine, the courts are concerned with reality and not form, with how the corporation operated and the individual defendant's relationship to that operation.⁷⁰

Looking at veil-piercing through such a scope allows the reader to develop a feeling of when limited liability ought to be pierced. Whenever it seems that a shareholder is not abiding by the required separation between himself and the

⁶⁵ F.H. EASTERBROOK, D. R. FISCHER, «Limited Liability and the Corporation», in *Univ. Chi. L. Rev.*, n. 52, 1986, p. 109.

⁶⁶ S.M. BAINBRIDGE, *Corporate Law (Concept and Insight Series, 3rd ed.)*, 2015, p. 54.

⁶⁷ *Ibid.*

⁶⁸ *Id.*, pp. 55-57.

⁶⁹ *Ibid.*

⁷⁰ *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 684–87 (4th Cir. 1976).

corporation, one would be inclined to rule in favor of veil-piercing. However, since mere feelings do not provide any sense of conformity, courts have developed a list of factors to assess when veil piercing ought to be applied.⁷¹

Veil-piercing cases are very fact-specific and usually differ in degree but not in kind.⁷² Throughout the years, the courts created what became known as the «laundry list» of factors to assess whether a corporate veil should be pierced or not. This was an attempt to rationalize the piercing situations, yet one still finds a dismal morass of repetitive rhetoric masking conclusory evaluation.⁷³ Despite the presence of this list, there is barely sufficient information regarding how the factors are to be weighed against each other, or which ones are sufficient or necessary by themselves to pierce the veil.⁷⁴ For example, the Fourth Circuit in the *DeWitt Truck Brokers* case mentioned above, after reciting the laundry list factors, held that:

The conclusion to disregard the corporate entity may not, however, rest on a single factor, whether undercapitalization, disregard of corporation's formalities, or what-not, but must involve a number of such factors; in addition, it must present an element of injustice or fundamental unfairness.⁷⁵

Among the various factors included in the laundry list, the following are deemed to be the most relevant:

- i. **Control** is an essential and common pre-requisite for holding a shareholder (usually a majority shareholder, not a minority one) unlimitedly liable. Control, by itself, is nevertheless not sufficient.⁷⁶ Adopting the instrumentality test, the court in *Olson* held that a plaintiff needs to prove that (a) control of the corporation by the defendant that is so complete that it amounts to total domination of finances, policy, and business practices in such a way that the controlled corporation has no separate will or existence; (b) such control is used to commit fraud, wrong or other violation of the plaintiff's rights; and (c) the control and breach of duty owed to Plaintiff was a proximate cause of the injury.⁷⁷

⁷¹ S.M. BAINBRIDGE, *Corporate Law (Concept and Insight Series, 3rd ed.)*, 2015, p. 61-71.

⁷² *Id.*, p. 57.

⁷³ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p. 1327.

⁷⁴ According to Professor Presser, the unweighted laundry list approach owes a substantial debt to a treatise, published in 1931, on the liability of parent corporations for the debts of their subsidiaries. See STEPHEN. Presser, *Piercing the Corporate Veil* § 1.01 N.7 (2003).

⁷⁵ *DeWitt Truck Brokers, Inc.*, 540 F.2d, p. 684-87.

⁷⁶ BAINBRIDGE, *op. cit.*, pp. 57-59.

⁷⁷ *Zaist v. Olson*, 227 A.2d 552, 558 (Conn. 1967).

- ii. **The nature of the defendant.** Stemming from the control factor above, courts take into account the type of defendant in question when making a decision. Passive shareholders of a close corporation and (minority) shareholders of a large public corporation are usually more immune from personal liability.⁷⁸
- iii. **Nature of the claim.** Courts are usually much less likely to pierce the corporate veil in contract claims versus in tort claims. That is so because it is (correctly) assumed that contract creditors are able and ought to protect their interests *ex ante*, by contracting with limited liability corporations.⁷⁹ If contract creditors negligently fail to protect themselves, there is no reason for the law to do so.⁸⁰ Such a distinction has received mixed reception from courts.⁸¹
- iv. **Under-capitalization** is best understood in either two senses: (a) the funds invested into the corporation at the outset were insufficient to satisfy existing contractual and likely tort obligations; or (b) all profits are drained out of the firm in the form of dividends paid to shareholders, leaving it with insufficient reserves to meet its foreseeable obligations.⁸² Generally, courts refused to treat undercapitalization, by itself, as a sufficient factor to pierce the veil.⁸³

Unfortunately, as mentioned above, this list is not always helpful. Judge Easterbrook's assessment in the opinion is apt:

Such an approach, requiring courts to balance many imponderables, all important but none dispositive and frequently lacking in a common metric to boot, is quite difficult to apply because it avoids formulating a real rule of decision. This keeps people in the dark about the legal consequences of their acts [...].⁸⁴

Those who enjoy tidy doctrines that can easily and clearly be adopted will not find comfort in the treatment of veil piercing by the various courts. «Judicial opinions in this area tend to open with vague generalities and close with conclusory statements, with little or no concrete analysis in between».⁸⁵

⁷⁸ BAINBRIDGE, *op. cit.*, p. 63. *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (Keating, J., dissenting).

⁷⁹ MILLON, *op. cit.*, p. 1324.

⁸⁰ *See, e.g.*, Perpetual Real Estate Services, Inc. v. Michaelson Properties, Inc., 974 F.2d 545 (4th Cir. 1992); Brunswick Corp. v. Waxman, 459 F. Supp. 1222 (E.D.N.Y. 1978), *aff'd*, 599 F.2d 34 (2d Cir. 1979).

⁸¹ *See, e.g.*, Secon Serv. System, Inc. v. St. Joseph Bank and Trust Co., 855 F.2d 406, 415-16 (7th Cir. 1988); U.S. v. Jon-T Chemicals, Inc., 768 F.2d 686, 693 (5th Cir. 1985); Laya v. Erin Homes, Inc., 352 S.E.2d 93, 100 (W. Va. 1986). *Compare with* Labadie Coal Co. v. Black, 672 F.2d 92, 100 (D.C. Cir. 1982).

⁸² Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (Keating, J., dissenting).

⁸³ S.M. BAINBRIDGE, *Corporate Law (Concept and Insight Series, 3rd ed.)*, 2015, p. 68.

⁸⁴ Second Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406, 414 (7th Cir. 1988).

⁸⁵ S.M. BAINBRIDGE, *Corporate Law (Concept and Insight Series, 3rd ed.)*, 2015, p. 70.

4. Understanding Limited Liability: Its Benefits And Drawbacks

Limited liability obviously has a number of benefits – it otherwise would not have been so widely used by business entities. Section III above, by addressing the rationales of limited liability, has indirectly covered some of the benefits associated with the doctrine. This Section will therefore briefly go over some of these benefits but will also focus on the drawbacks. In particular, we will address moral hazard, which is seen as the direct result of limited liability.

A. Numerous Benefits Associated with Limited Liability

As mentioned above, limited liability encourages additional investments by the average citizen.⁸⁶ In fact, nowadays, lack of limited liability is not only hazardous to investors but is also incompatible with generally accepted views of fairness.⁸⁷ Since the amount of exposure cannot be determined *ex ante*, an investor would be much less willing to invest his whole wealth into a particular venture; therefore, the lack of limited liability is a deterrent to investment and economic development.⁸⁸

The increased participation of investors – including middle-class individuals who aspire to accumulate further savings for their retirements – allows for enormous capital contributions that are necessary to large enterprises' activities.⁸⁹ Lack of limited liability would significantly reduce the amount of these investments, thus distancing savings from corporations.⁹⁰ Furthermore, the reduced need to monitor a business' activities by the shareholders allows investors to diversify their investments across the board resulting in an acknowledged efficient pattern for investments.⁹¹ Finally, limited liability reduces agency costs.⁹² It is argued that by limiting an investor's liability to the capital he invests in a corporation, that particular investor will have lower incentives to monitor the actions and business decisions

⁸⁶ J. HICKS, «Limited Liability: The Pros and the Cons», in *Limited Liability and the Corporation*, 1982, p. 12.

⁸⁷ *Ibid.*

⁸⁸ P. BLUMBERG, «Limited Liability and Corporate Groups», in *J. Corp. L.*, n. 11, 1986, p. 612.

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

⁹¹ J. HICKS, «Limited Liability: The Pros and the Cons», in *Limited Liability and the Corporation*, 1982, pp. 16-17; F.H. EASTERBROOK, D. R. FISCHER, «Limited Liability and the Corporation», in *Univ. Chi. L. Rev.*, n. 52, 1986, p. 96.

⁹² M. JENSEN, W.H. MECKLING, «The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure», in *J. Fin. Econ.*, n. 3, 1976, p. 331.

of the corporation's managers – compared to an investor who has his whole health subject to potential liability.⁹³

To better understand this point, we ought to further explain the relationship between an agent and his principal, as well as the agency costs associated with such a relationship. An agency relationship, from a legal perspective, results «when one person (the principal) manifests consent that another (the agent) acts on his behalf and subject to his control, and that other person (the agent) consents to do so».⁹⁴ Based on such a definition, it is understood that the agent will be acting on behalf of the principal in such a way that the former will be managing the resources of the latter.⁹⁵ This *de facto* separation of ownership and control – resulting from the agency relationship – results in agency costs.⁹⁶ A principal, entrusting the agent with all of his wealth, will obviously feel the need to monitor such agent's actions to make sure that wealth is managed in a lawful and productive manner. Such monitoring efforts result in agency costs—and therefore are deemed as «welfare losses».⁹⁷ The point here is that the elimination of limited liability will result in substantially higher agency costs simply because the principal will be opening himself to unlimited liability, and will therefore have a higher interest in putting more efforts in monitoring his agent.⁹⁸

B. Moral Hazard and Externalization of Costs

An understanding of the moral hazard concept is key for this Section. Moral hazard is associated with the idea of externalization of costs in such a way where a corporation would divert the resulting costs to the «exterior» of the corporation itself. Moral hazard is defined as «the tendency of insurance protection to alter an individual's motive to prevent loss».⁹⁹ In other words, the presence of insurance (or of a situation where a third-party will bear the costs) creates a disincentive to exercise caution with person and property, while increasing the tendency to engage in incautious or risk-seeking behavior.¹⁰⁰ Any invention will result in winners and

⁹³ *Ibid.*

⁹⁴ T.A. LAMBERT, *How to Regulate: A Guide for Policymakers*, 2017, p. 94.

⁹⁵ *Ibid.*

⁹⁶ Professor Lambert defines «agency costs» as «the welfare losses that result from agency (and similar) relationships». *Id.*, pp. 94-95.

⁹⁷ *Ibid.*

⁹⁸ P. BLUMBERG, «Limited Liability and Corporate Groups», in *J. Corp. L.*, n. 11, 1986, p. 614.

⁹⁹ S. SHAVELL, «On Moral Hazard and Insurance», in *The Quarterly J. Econ.*, n. 93, 2013, p. 592.

¹⁰⁰ L. DJELIC, J. BOTHELLO, «Limited liability and its Moral Hazard Implications: The Systemic Inscription of Instability in Contemporary Capitalism», in *Theory and Society*, n. 42, 2013, p. 592.

losers, and this rule is no different in the case of limited liability.¹⁰¹ In the case of externalizing costs, the corporation wins while the one bearing the costs will obviously be on the losing side. The problem is that the costs suffered by third-parties are not internalized by the people who make, and benefit from, these decisions.¹⁰² When managers of a corporation evaluate different business decisions, they only have to worry about the marginal costs and benefits associated with the investments that they will be required to internalize.¹⁰³ All costs that are diverged toward third-parties will not be a concern to the corporate managers, and such managers will not take such costs into account during their decision-making process.

The problem with such a system is that it allows investors to pursue extremely risky projects and to profit from the pursuit of a heads-I-win-tails-you-lose strategy of project finance.¹⁰⁴ Such a scenario allows corporate shareholders to share the benefits of successful ventures, while diverging the costs of failing projects toward creditors and tort victims. The economic theory suggests that limited liability may raise the level of risk-taking.¹⁰⁵ The result could be that unrelated parties should have to bear the costs of failing ventures. Two groups, in particular, will take the hit: contracted creditors and tort victims.

i. Tort Victims Versus Contract Creditors

Tort victims are obviously in a worse position in respect to contract creditors when it comes to corporate limited liability. Tort creditors, unlike contracted creditors, do not have an opportunity to bargain *ex ante* for personal guarantees against corporate failure.¹⁰⁶ This difference between tort victims and creditors usually results in sympathy for tort victims and in critiques for the doctrine of limited liability.

Limited liability is supposed to allow shareholders to externalize some costs that they would otherwise have to bear themselves. Such an idea makes sense and seems fair when voluntary creditors, fully aware that they are dealing with a limited liability

¹⁰¹ J.R. MACEY, «The Limited Liability Company: Lessons for Corporate Law», in *Wash. U.L.*, n. 73, 1995, p. 438.

¹⁰² *Id.*, p. 448.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ Such an argument is based on the assumption that by shielding decision-makers from liability, they are more likely to take on risky projects so that, in case of failure, the costs of such ventures could still be diverted elsewhere. The reasoning is that a decision-maker who is personally liable for any failure is less likely to take on such risky projects.

¹⁰⁶ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p. 1315.

entity, are able to factor such considerations into their decision of extending credit to the corporation.¹⁰⁷ For example, creditors can negotiate *ex ante* for «personal guarantees, security interests in particular assets, or contractual provisions that limit the corporation's freedom to engage in conduct that would increase the risk of default on their claims».¹⁰⁸ Such protections allow creditors to somehow guarantee a favorable outcome for themselves; they have the power and ability to do so even before engaging in a transaction with the corporation. In other words, bargained-for outcomes between creditors and corporations may be the same regardless of whether limited liability is the default rule.

Involuntary tort victims are clearly in a different situation. The pedestrian hit by a taxi cab or who is the victim of a toxic waste spill did not willingly assume the risk of corporate failure nor did he agree to the shareholders' limited liability. Furthermore, the tort creditor did not contract *ex ante* with the corporation in such a way where he could protect his interests and guarantee a favorable outcome for himself. Under such a scenario, shareholders and managers of a corporation are in the position to «shift some of the social costs from business activity to members of the public who have not agreed to bear those costs».¹⁰⁹ Limited liability, therefore, encourages shareholders to undertake risky activities without regard for the magnitude of possible social costs, which may by far exceed the benefits to the owners themselves.¹¹⁰ Therefore, in this respect, limited liability creates moral hazard in tort claims, and results in an unfair and inefficient allocation of resources.

The benefits associated with cost-externalisation may encourage corporations to carry out potentially harmful activities that they would otherwise be reluctant to pursue in the absence of the limited liability shield. Corporate limited liability gives the shareholders of financially weak corporations an incentive to gamble with a potential detriment to the welfare of the general public.¹¹¹ The abuse of the protection granted by limited liability may result in unsound economic and societal consequences that we must guard against.

¹⁰⁷ F.H. EASTERBROOK, D. R. FISCHER, *The economic structure of corporate law*, 1991, p. 51.

¹⁰⁸ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p. 1316.

¹⁰⁹ *Ibid.*

¹¹⁰ N.A. MENDELSON, «A Control-Based Approach to Shareholder Liability for Corporate Torts», in *Colum. L. Rev.*, n. 102, 2002, pp. 1233–35.

¹¹¹ T.H. NOE, S.D. SMITH, «The Bucks Stops Where? The Role of Limited Liability in Economics», in *82 Econ. Rev.*, 1997, p. 50.

C. When Limited Liability Becomes Destructive: Excessive Risk-Taking by Corporate Managers

Excessive risk-taking has been widely regarded to be a major cause of the financial crisis of 2008-09.¹¹² There has been significant frustration with the Obama administration for not seeking criminal charges against individuals responsible for such actions.¹¹³ Much of the prosecutorial attention has been focused on the institutions themselves, rather than their managers or shareholders.¹¹⁴ For example, professor Coffee claimed that the «SEC is settling cheaply with entities and ignoring individuals – a policy of parking tickets for securities fraud».¹¹⁵ It can be argued that a better form of deterrence against excessive risk-taking would be more useful. A failing deterrence system would «sow the seed [...] for future systemic meltdowns».¹¹⁶ The problem, however, is that limited liability shields corporate shareholders from any liability – so long as they abide by minimum required procedural standards. It is this protection – granted by the doctrine of limited liability – in times of excessive risk-taking, that rightly draws most of the critic against the doctrine.

The issue lies in the fact that corporate risk-taking is not, and most likely should not be, criminalized or penalized under the law.¹¹⁷ Despite the significant repercussions caused by it, excessive risk-taking could be defined as «greed, poor decisions, or bad judgment» but not as a criminal action bearing criminal intents.¹¹⁸ Any unsophisticated attempts to regulate or limit excessive risk-taking might result in value destruction – an outcome that obviously defeats the purpose of

¹¹² See, e.g., FIN. CRISIS INQUIRY COMM'N, *The Financial Crisis Inquiry Report: Final Report of The National Commission on The Causes of The Financial and Economic Crisis in The United States* xviii–xix (2011) (identifying excessive risk-taking as a primary cause of the financial crisis).

¹¹³ See, e.g., *Interview by Frontline with Ted Kaufman, Del. Senator* (Nov. 20, 2012), available at <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/ted-kaufman-wall-street-prosecutions-never-made-a-priority>.

¹¹⁴ D. DEBUCQUOY-DODLEY, «No 'Viable Basis' to Prosecute Goldman, Justice Department Says», CNN, 10 August 2012, available at: <http://www.cnn.com/2012/08/09/business/goldman-justice-department/>

¹¹⁵ J.C. COFFEE, JR., A.A. BERLE, Columbia Univ. Law Sch., «Regulation and Enforcement Institute Program: Securities Enforcement: What Has Happened? Why Are Folks Upset? What Can Be Done?», presentation at the New York City Bar, 11 December 2012, available at <http://slideplayer.com/slide/2541449/>.

¹¹⁶ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 536.

¹¹⁷ P.J. HENNING, «Making Misconduct a Crime», *N.Y. Times*, 24 June 2013, available at: <http://dealbook.nytimes.com/2013/06/24/making-mismanagement-a-crime/>

¹¹⁸ C. HURT, «The Duty to Manage Risk», in *J. Corp. L.*, n. 39, 2014, pp. 256–57.

incorporation.¹¹⁹ Therefore, the goal is to be able to distinguish between excessive risk-taking and adequate risk-taking.¹²⁰ Such a distinction would allow legislators to track excessive risk-takings, and to efficiently curtail them. Up until the financial crisis of 2008-09, observers wrongly assumed that a firm's failure would negatively impact its own shareholders, and no one else.¹²¹ Accordingly, «corporate risk-taking was assessed – and therefore “excessive” risk-taking was implicitly defined – by its potential impact on [its] investors».¹²² Today, however, it is well-known that a corporation's actions could have repercussions far beyond itself.

Systemic risk-taking – «the risk that a financial firm's failure will impact other financial firms or markets, resulting in a domino-type collapse that ultimately harms the real economy»¹²³ – is, therefore, adding a whole layer of complication in assessing corporate risk-taking and curtailing the excessive nature of it while encouraging its rational undertaking. As mentioned above, the current state of law does not hold a corporation accountable for any systemic risk it causes. In other words, the law does not require a corporation to internalize the costs associated with its reckless actions.¹²⁴ Such costs, therefore, must be externalized and the public at large has to bear such burdens – a result that encourages corporations to engage in shareholders-beneficial transactions at the expense of the public good. The following Section will attempt to find a middle-ground where corporations would be required to internalize some of the costs, or at least, to restrict them from purposely engaging in excessive risk-taking ventures without accounting to the subsequent damages.

¹¹⁹ E. PORTER, «Recession's True Cost Is Still Being Tallied», *N.Y. Times*, 21 January 2014, available at: <http://www.nytimes.com/2014/01/22/business/economy/the-cost-of-the-financial-crisis-is-still-being-tallied.html>

¹²⁰ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 540.

¹²¹ C. HURT, «The Duty to Manage Risk», in *J. Corp. L.*, n. 39, 2014, p. 290. («If excessive risk-taking harms anyone, it is the shareholder»).

¹²² S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 540.

¹²³ S.L. SCHWARCZ, «Systemic Risk», in *Geo. L.J.*, n. 97, 2008, p. 204.

¹²⁴ V. ACHARYA, «How to Measure and Regulate Systemic Risk», *NYU Leonard N. Stern Sch. Bus.*, available at: http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/measuring_and_regulating_systemic_risk-1.pdf

5. The Middle Ground: Finding The Balance

As explained above, it is important to distinguish between excessive and reasonable risk-taking. In fact, it is reasonable to impose different standards where corporate shareholders will be held accountable differently depending on the type of risk they take – assuming that the type of risk can be determined *ex ante*.

A. Imposing Corporate Governance Liability

One idea that was suggested to curtail managers' reckless risk-taking – on behalf of their shareholders – is to require them to act not only as agents of the corporate shareholders, but also as agents of the public at large.¹²⁵ In that sense, corporate managers' duties will not be restricted to the interests of the shareholders, but will be expanded in such a way where managers are required to take into account the interests of the larger community. Such a standard means that corporate managers will be prohibited from engaging in risky activities with potential adverse effects on the society. Furthermore, managers who breach their «public governance duty»¹²⁶ will be personally held liable for their breach of the agent-principal relationship – just as managers who breach their private governance duties to their investors. It «makes sense to penalize [managers] for causing their firm to engage in»¹²⁷ unreasonably risky behavior for the interest of their shareholders and at the expense of the larger public.

Such a suggestion raises the following question: how should managers assess the potential impact on the public caused by corporate risk-taking? It is significantly difficult to assess, *ex ante*, an *ex post* consequence, let alone consequences that will impact a scope larger than the corporation itself.¹²⁸ Traditionally, the business judgment rule governs the managers' decision-making. The business judgment rule asserts that managers should not be personally held liable for harm caused by decisions made in good faith and without conflict of interests – so long as there is

¹²⁵ R.T. MILLER, «Oversight Liability for Risk-Management Failures at Financial Firms», 84 *S. CAL. L. REV.*, n. 84, 2010, pp. 117-18) (observing that, in order to internalize systemic externalities, «it can be entirely proper – indeed economically efficient – for governments to regulate [...] activities [causing such externalities], perhaps even to prohibit them»).

¹²⁶ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 560.

¹²⁷ R.T. MILLER, «Oversight Liability for Risk-Management Failures at Financial Firms», 84 *S. CAL. L. REV.*, n. 84, 2010, p. 119.

¹²⁸ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 562.

no gross negligence.¹²⁹ If we enlarge the scope of the managers' duties – by having them account for the larger public's interests – should we also modify the business judgment rule in such a way that we allow for more (or less) flexibility to the managers' freedom of action?

A number of scholars advocate against lowering the threshold under which managers could be held liable.¹³⁰ The reasoning for such a position is that investors, through their investments, will punish managers for their reckless behavior. Such a reasoning, however, fails to apply in the context of the larger public. The public at large cannot, for obvious reasons, hold managers accountable by turning their investments away from these corporations. For example, members of the public cannot mitigate their risks by voting managers out.¹³¹ Therefore, some new standards for the business judgment rule would need to be developed in such a scenario.

B. Imposing Post Facto Liability

Another approach for preventing excessive risk-taking involves imposing after-the-fact personal liability. Although *ex post facto* criminal liability is unconstitutional in the United States, *ex post facto* civil liability is not.¹³²

By adopting such an approach, we would be heavily drawing upon tort law's method of internalizing costs. For example, when addressing the standard of «reasonably prudent person» tort law is requiring jury members to determine a reasonable standard of action and apply that standard, after the facts, to a particular case.¹³³ «Because the jury is effectively defining the community norm at the trial stage and not necessarily at the time of the alleged tort, civil liability is sometimes imposed based on *ex post* norms».¹³⁴

The jury, by relying on its own community sense of what the norm ought to be in that particular instance, will be defining continuously evolving legal standard. The upshot of such an approach, however, is that it will put corporate managers in a hard position: they would not know, at the time they are engaging in their decisions,

¹²⁹ Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

¹³⁰ C. HURT, «The Duty to Manage Risk», in *J. CORP. L.*, n. 39, 2014, pp. 259-60.; R.T. MILLER, «Oversight Liability for Risk-Management Failures at Financial Firms», 84 *S. CAL. L. REV.*, n. 84, 2010, pp. 120-23.

¹³¹ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 562.

¹³² S.L. SCHWARCZ, L. CHANG, «The Custom-to-Failure Cycle», in *Duke L.J.*, n. 62, 2012, p. 792.

¹³³ *Id.*, p. 793.

¹³⁴ *Id.*, pp. 793-94.

whether such actions will result in liability in the future.¹³⁵ Stuck in such a position, corporate managers will be forced to engage in low-risk activities, therefore creating less profits for their shareholders—an outcome that is counter-productive to the economy's health.

C. Narrowing Limited Liability

The last approach suggested by various scholars is to narrow limited liability in such a way that corporate managers could be held personally liable depending on the type of business activities they agree to execute. As mentioned above, limited liability is designed to function as a risk-allocation device. The policy question is the extent of this risk-allocation: to what extent do we want to externalize costs to the benefit of the corporation? This question begs another one: to what extent do we want to allow managers and corporate shareholders to «act opportunistically, and thus deliberately and recklessly impose losses on unwilling third parties»?¹³⁶

Surely, limited liability is a reasonable device to reward shareholders acting in good faith to develop their business. It is not, however, that reasonable, to provide shareholders acting in malicious and opportunistic manners with the same protections as the good faith shareholders. In such a case, the law would be allowing opportunistic shareholders to intentionally impose risks on creditors or recklessly subjecting members of the public to costs and injuries that they did not willingly agree to bear.¹³⁷ Lawmakers should be able to provide shareholders with the protections they need to conduct their businesses without the fear of personal liability, without extending the limited liability shield to losses resulting from opportunism.¹³⁸

Such a reasoning finds strong support in fairness and efficiency considerations. Opportunistic shareholders attempt to extract additional value from others without having the claimants agree to bear such costs.¹³⁹ The law does not allow, let alone encourage, such behavior in most contexts.¹⁴⁰ An example of such a situation with tort victims would be, for example, when a company purposely does not take sufficient safety precautions for its workers, or the public, in a construction venture.

¹³⁵ S.L. SCHWARCZ, «Excessive Corporate Risk-Taking and The Decline of Personal Blame», in *Emory L.J.*, n. 65, 2015, p. 572.

¹³⁶ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p. 1347.

¹³⁷ *Ibid.*

¹³⁸ *Ibid.*

¹³⁹ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, pp. 1348-49.

¹⁴⁰ *Id.*, p. 1349.

The managers of such a company would be risking the safety of their own employees (or the contractor's employees) in exchange for lower expenses and therefore higher profits. Employment law (as well as tort law) reasonably do not allow for such a diversion of risks (it would make the company liable for the damages caused to the workers) – so why should limited liability provide these managers with immunity from liability? Some scholars argue that such behavior should be allowed in the corporate setting because it allows for more business investments and development.¹⁴¹

This argument goes too far and provides a very lenient understanding of limited liability in favor of corporate managers and shareholders. Allowing such an opportunistic understanding of limited liability will result in efficiency repercussions: it encourages expenditure of resources to achieve security and is likely to result in abandonment of productive activities.¹⁴²

Furthermore, granting limited liability protection to opportunistic managers acting in bad faith with current and future creditors will only lead to negative results.¹⁴³ For example, creditors will have to factor the risk of opportunism into all their lending decisions, which will drive prices despite the fact that not all borrowers will be acting opportunistically. In that sense, creditors will have to factor intentional bad-faith into their calculation in addition to the usual risk of business failure. Adding the factor above into the creditors' considerations will make it harder for the reasonable corporate actor to borrow money at a fair price. If limited liability did not provide protection to opportunistic shareholders, then creditors need not necessarily consider such a factor since they can rest assured knowing that the courts will pierce the corporate veil and hold the individual shareholders liable. Since it is impossible for a creditor to know *ex ante* whether a particular shareholder will act in good faith or not, the creditor will have to insist on «an interest rate that reflects the aggregate risk presented by the overall pool of good and bad borrowers».¹⁴⁴ Good borrowers will end up having to pay more for credit than if the interest rate were tailored to them; bad borrowers pay less.¹⁴⁵

For these reasons, the protection provided by limited liability ought to be tailored based on a corporate shareholder's intention which would only be revealed

¹⁴¹ *Ibid.*

¹⁴² R.A. POSNER, *Economic Analysis of Law*, 6th ed., 2003, p. 36.

¹⁴³ D.K. MILLON, «Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability», in *Emory L.J.*, n. 56, 2007, p. 1349.

¹⁴⁴ *Id.*, p. 1350.

¹⁴⁵ In game theory parlance, this is known as a «pooling equilibrium». D.G. BAIRD, *Game Theory and the Law*, 1994, p.130. If lenders were able to distinguish the good borrowers from the bad, the result could be two different interest rates (assuming only two categories of borrowers). This is referred to as a «separating equilibrium».

after the facts. Doing so would benefit tort and contracted creditors as well as good-faith acting corporate shareholders. Tailored limited liability would provide creditors with the assurances of knowing that they can recover their money in case of opportunistic behavior by shareholders. On the other hand, tailored limited liability affords business owners the incentive to engage in business endeavors while protecting their personal assets. The overall result will be a reduction in the corporate borrowing costs and a corresponding increase in the shareholder returns.

6. Conclusion

This Comment covered a number of issues, providing the reader with a broader understanding of the doctrine of corporate shareholders' limited liability, which allows for a better discussion regarding the policy behind the current state of that doctrine and how to curtail its sometimes-harmful application. Section II provided a historical understanding of how the doctrine of limited liability evolved into what it is today, as well as the evolution of the policy rationales behind the doctrine. Having this historical data in the background allows for a larger scope of reasoning when addressing the doctrine today. Section III highlighted theoretical explanations and arguments as to why the doctrine of limited liability is beneficial and useful in today's society, and how our current state of laws limit the application of the doctrine through corporate veil-piercing. Section IV discussed the benefits and drawbacks associated with limited liability. In particular, the Section aimed to compare the benefits with the drawbacks of the doctrine, which puts the reader in a better position to find a balance between the two sides. Section V, ultimately, discusses the equilibrium where limited liability can be applied while protecting the larger society from opportunistic, bad-faith acting corporate shareholders.

Among the various solutions discussed, only one of them, in the author's opinion, seems to be practical enough to be further developed by the legislators and the courts. The imposition of corporate governance liability is a fairly impractical solution because it is hard for the managers to act in such a way that benefits all parties. Diverting the managers' focus away from the interests of the shareholders defeats the purpose of having investors invest their money into a corporation, hoping to get paid dividends. Imposing two contradicting duties of care – to both the shareholders and the public at large – would put the managers of a corporation in a weak position and will likely open them up to potential violations of their duties. On the other hand, imposing *post facto* liability is a reasonable solution. However, the strong presence of the current state of the limited liability shadows the possibility of applying any of the concepts addressed above regarding *post facto* liability. That

is so because this method addresses how to assess the blame rather than whether internalizing the costs is allowed or not. In other words, regardless how rational *post facto* liability is the theory will not kick until there is a consensus to put a limit on the externalization of costs. This brings us to the third and last approach: narrowing limited liability. This method is the most promising because it both encourages further business endeavors by providing the needed legal protections to the shareholders – through the managers’ actions, while at the same time holding accountable those shareholders who abuse the protections provided to them. It also provides a case-by-case analysis, based on the facts, to assess whether one acted in good faith or not. The drawbacks of such an approach, however, is that it will result in a significant increase in litigation in order to assess whether the disputed facts amount to an abuse of the protections afforded by limited liability, or not.

Despite the various options and their related benefits and drawbacks, it is likely that the legal and business community will need to keep addressing the scope of limited liability, and therefore the debate will keep moving forward.