Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil

Franklin A. Gevurtz
Pacific McGeorge School of Law

Follow this and additional works at: https://scholarlycommons.pacific.edu/facultyarticles
Part of the Business Organizations Law Commons

Recommended Citation

This Article is brought to you for free and open access by the McGeorge School of Law Faculty Scholarship at Scholarly Commons. It has been accepted for inclusion in McGeorge School of Law Scholarly Articles by an authorized administrator of Scholarly Commons. For more information, please contact mgibney@pacific.edu.
Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil

Limited liability means leaving creditors of failed corporations unpaid. A common response by such unpaid creditors is to sue one or more of the shareholders of the failed corporation, arguing that the court should extend liability beyond the corporate entity, or, in the more colorful phrasing, “pierce the corporate veil.” If the creditor is successful in this argument, the court will impose liability upon one or more of the corporation’s shareholders for the company’s debt to the creditor.¹

Given the high mortality rate among small businesses, it should not surprise one to learn that piercing claims constitute the single most litigated area in corporate law.² It is probably also the area of corporation law that the attorney seeking to avoid corporate practice is most likely to confront. It is therefore especially unfortunate that, despite hundreds of opportunities to get it right, judicial opinions in this area have made it one of the most befuddled. The following discussion attempts to “pierce” some of the “veil of confusion” surrounding this area of law.

¹ Occasionally, courts pierce to impose liability for a corporation’s debts upon parties who are not shareholders. This might include an individual controlling a corporation, but who never became a shareholder because the corporation never issued shares, or corporations under common control with the debtor corporation. Also, courts may disregard the separate entity status of a corporation for reasons other than to extend liabilities for the corporation’s unpaid debts. We shall address these possibilities later.

This discussion will proceed in seven parts. First, we will dissect three common foibles found in piercing decisions, which have created much of the confusion in this area of law. Having put these missteps to rest, the second part of this article looks at the distinction often urged in the literature on piercing between the appropriate treatment of contract creditors and tort plaintiffs. We shall see that the importance of this distinction is both more subtle and fundamental than generally recognized by previous commentators. Specifically, the distinction does not predict greater success for one type of claimant versus another; rather, it allows us to identify the underlying reasons why courts should pierce.

Having identified the underlying reasons for piercing, the next two parts of this Article compare the factors often mentioned in court opinions and commentary. Part III of this article examines the significance of the factors of “domination or control” and the failure to observe corporate formalities. We will see that the significance of the former factor is often misunderstood, while the latter factor is a red herring. Part IV looks at the three principal factors which can, in appropriate cases, justify piercing. We will find that most decisions to pierce find their real justification in wrongs committed by the defendant in his or her dealings with the plaintiff or abusive dealings by the defendant with the corporation’s assets. We close Part IV with an extended look at what has been the most discussed factor for piercing, inadequate capitalization. We shall not only consider whether so-called inadequate capitalization ought to be grounds for piercing, but we shall also see that much of the conventional wisdom on what constitutes inadequate capitalization has been misguided. Part V of this article looks at the added considerations created by the presence of multiple corporations. Part VI takes a look at which state’s law should govern a piercing decision and whether this decision is a question for the judge or a jury. Finally, Part VII takes a brief look at piercing in contexts other than creditors seeking to hold shareholders liable for the debts of a corporation.

I

Common Areas of Confusion in Piercing Decisions

Courts in piercing cases almost invariably begin at the same point of departure: Piercing is an equitable remedy the court can
impose in order to avoid injustice. Fair enough. The problem, of course, is to go beyond this broad generality and determine what specific facts establish such an injustice, and why. Unfortunately, three judicial foibles have made a mess of this area of the law.

To begin with, many writers have criticized the courts' tendency in this area to reason by pejorative. For example, courts often explain their decision to pierce by announcing that the corporation was a mere "sham" or "shell," or the defendant's "alter ego" or "instrumentality." At best, such terms are unhelpful. All too often, they confuse the issue.

Terms like "sham" and "shell" seem to convey a lack of substance to the corporation. To the extent this refers to inadequate capitalization, it would be clearer to state this and discuss whether inadequate capitalization should provide grounds to pierce in the situation at hand. Otherwise, it is easy for the court and litigants to start wandering off looking for additional ways in which a corporation can lack substance. For instance, this can lead to a focus on the non-observance of rituals or "corporate formalities," which, as discussed later, rarely has much to do with the equities of piercing in a given situation.

Worse, terms such as these sometimes lead to a search of the defendant's purpose for establishing the corporation. This, in turn, can convey the impression that creating a corporation for the purpose of enjoying the benefits of owning a business while, at the same time, avoiding personal liability, should be grounds to pierce. This cannot be correct. Most corporations exist for the purpose of achieving limited liability for their owners. It would be perverse to grant limited liability to anyone who did not care about it and deny it to everyone who sought it.

A relatively recent case, *Kinney Shoe Corp. v. Polan*, provides an illustration of this sort of confusion. The defendant estab-

---

3 E.g., DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976).
6 Thompson, supra note 2, at 1037.
7 The bulk of courts recognize there is nothing wrong with incorporating for the purpose of limiting liability. E.g., Walkovszky v. Carlton, 223 N.E.2d 6 (1966).
8 939 F.2d 209 (4th Cir. 1991).
lished two corporations to undertake his venture. One, a leasing corporation with no assets, leased premises from the plaintiff, and, in turn, subleased the premises to the second company, a manufacturing corporation. The defendant intended to use the manufacturing corporation to conduct a manufacturing operation on the site. In deciding to pierce, the court labeled the leasing corporation a “transparent shell.”

Sounds bad; but what exactly does this label mean and how does it justify piercing? The inadequate capitalization of the leasing company bothered the court. However, to rely solely on this fact in piercing the corporate veil would have forced the court to address the defendant’s argument that the plaintiff was a voluntary creditor who could have checked the leasing company’s financial status. Instead of coming to grips with this argument, the court pointed to the defendant’s failure to follow corporate formalities and his establishment of the leasing corporation apparently for the purpose of insulating the manufacturing corporation from liability on the lease.

So? The court never explains how the lack of formalities prejudiced the plaintiff nor how the use of the leasing corporation was unfair to a party that could have insisted on contracting with the manufacturing corporation.

A second foible is to follow what one might call a “template” approach. Under this approach, a court either quotes or constructs a list of facts, which, in prior cases, accompanied decisions to pierce the corporate veil. The court then compares the list with the facts in the situation at hand and pierces if enough of the facts present fit the list.

The court’s opinion in DeWitt Truck Brokers v. W. Ray Fleming Fruit Co. provides an example of this sort of reasoning. The defendant was the ninety percent shareholder of a corporation engaged in selling fruit on commission for growers. The company defaulted on obligations to pay the plaintiff for transportation services—despite having collected sums to cover those costs from the growers—and the plaintiff sought to pierce. The court set up its evaluation of the plaintiff’s claim by listing the following factors which prior cases used in deciding to pierce the corporate veil:

1) Undercapitalization

---

9 Id. at 210.
10 Id. at 212-13.
11 540 F.2d 681 (4th Cir. 1976).
2) Failure to observe corporate formalities
3) Non-payment of dividends
4) Insolvency of the corporation “at the time”\textsuperscript{12}
5) Siphoning of corporate funds by the dominant shareholder
6) Non-functioning of other officers and directors besides the
defendant
7) Absence of corporate records
8) Non-participation in corporate affairs by the shareholders
   other than the defendant.\textsuperscript{13}

The template approach is a godsend to students, litigants, and
courts who recognize the weakness of reasoning by pejorative,
but still wish to remain aloof from analysis based on policy. Unfor­
tunately, it leads to difficulties. To begin with, listing facts
from prior opinions without an evaluation of why these facts
should or should not lead to piercing inevitably introduces facts
into these sort of lists, which, upon reflection, seem of questiona­
ble significance. For example, the list in \textit{De Witt} included, as
many such lists do, the non-payment of dividends.\textsuperscript{14} It is hard to
understand why a creditor should complain about the non-pay­
ment of dividends, which, after all, are payments from the corpo­
ration to its shareholders and leave less money in the company
for its creditors. In fact, loan agreements and corporations stat­
utes commonly limit dividends for the protection of creditors.

A second difficulty with the template approach is that the rele­
vance of some facts in the list, even when present in a given case,
may depend upon the circumstances. Again, \textit{DeWitt} provides an
example. The court’s list included undercapitalization, and the
court dutifully matched this item to the existence of a lack of
capital in the case before it.\textsuperscript{15} Ignored in this is the question of
whether undercapitalization, which, as we shall see, should be of
significance in dealing with tort claimants, should be relevant to
the claim of a contract creditor, as in \textit{DeWitt}, who might have
checked the financial status of the corporation before dealing
with it.

Finally, this sort of multi-factor approach carries tremendous
indeterminacy. Must all factors on the list be present? Is the
presence of any one factor enough? If the answer to these two

\textsuperscript{12} What time, exactly, the court does not say. \textit{DeWitt}, 540 F.2d at 686.
\textsuperscript{13} \textit{Id.} at 688-89. There are longer lists. \textit{E.g.}, \textit{Laya v. Erin Homes, Inc.}, \textit{352 S.E.2d} 93, 98-99 (W. Va. 1986) (listing nineteen factors).
\textsuperscript{14} 540 F.2d at 686.
\textsuperscript{15} \textit{Id.} at 688.
questions is, as seems to be the rule from the opinions, no,\textsuperscript{16} then how many factors does one need and which factors are more important than the others? The opinions provide little guidance. Actually, there were ample grounds to hold the defendant liable in \textit{DeWitt} based upon his promise to personally pay the plaintiff if the corporation did not,\textsuperscript{17} as well as for the sort of abusive dealings with the corporation’s assets which we will discuss later. The invocation of multiple factors simply confused the situation and will confuse those who look to the case for precedent.

The third foible is to employ a character test. Consciously or subconsciously, many courts in piercing cases appear to engage in a sort of general review of the defendant’s business ethics. Is this an honest business person who simply suffered misfortune, or is this some sort of “sharp operator”? A stark illustration in a recent case is the court’s pointing to the defendant’s tax fraud as among the facts leading to piercing.\textsuperscript{18} The problem, of course, is that the defendant’s tax fraud in this case had absolutely nothing to do with the plaintiff’s (who was a private creditor) claim.\textsuperscript{19} We might all agree that tax or other fraud is wrong, but to allow recovery by parties who were not the victims creates a windfall.\textsuperscript{20}

\section*{II}

\textbf{THE CONTRACT CREDITOR—TORT PLAINTIFF}

\textbf{DISTINCTION AND THE POLICIES UNDERLYING PIERCING}

Innumerable writers over the years have argued that courts should draw a distinction between piercing claims asserted by voluntary (or contract) creditors of the corporation and involuntary (or tort) claimants against the corporation.\textsuperscript{21} The basic notion is that contract creditors deserve less sympathy from a court when asking it to pierce. After all, they chose to do business with

\textsuperscript{16} See, e.g., \textit{Secon Serv. Sys., Inc. v. St. Joseph Bank \\ & Trust Co.}, 855 F.2d 406, 414 (7th Cir. 1988) (the multi-factor approach requires the court “to balance many imponderables, all important but none dispositive”).

\textsuperscript{17} \textit{DeWitt}, 540 F.2d at 689.

\textsuperscript{18} \textit{Sea-Land Servs., Inc. v. Pepper Source}, 993 F.2d 1309 (7th Cir. 1993).

\textsuperscript{19} \textit{Id.} at 1312-13.

\textsuperscript{20} If courts are going to turn a piercing case into the corporate equivalent of standing before the pearly gates for the weighing of all one’s sins, perhaps the defendant similarly ought to able to point to unrelated business misdeeds by the plaintiff creditor.

an entity whose owners have, as a rule, limited liability. If the contract creditor wanted to look to the owner for repayment, it could have negotiated for a personal guarantee. Hence, piercing in favor of a contract creditor gives the creditor something more than it bargained for and thus is a windfall. By contrast, the tort victim generally did not choose to deal with a corporation and accept the consequences of limited liability.

This rationale, in turn, has led to a conventional wisdom often recited by students of corporate law. It has become common to state that courts are more likely to pierce in favor of a tort than a contract creditor of the corporation 22 In fact, this conventional wisdom is wrong. An important study conducted by Professor Robert Thompson surveyed every reported piercing decision through 1985 contained in the Westlaw database, totaling around 1600 decisions. 23 This study found that courts pierced about forty percent of the time in contract claims and only about thirty percent of the time when dealing with tort victims 24

Perhaps this result simply illustrates how badly the courts have been handling piercing cases. Indeed, long before Professor Thompson’s work, other writers had condemned the courts for not perceiving the need to distinguish between contract and tort claimants. 25 There is another explanation, however. The insight of various writers that there is a need to distinguish between contract and tort claimants in evaluating piercing claims is fundamentally correct. The notion that courts should treat tort plaintiffs more sympathetically than contract plaintiffs, however, is oversimplified. The question is not what sort of creditor more deserves piercing in the abstract. Rather, the question is what specific facts justify piercing in favor of either type of creditor. The utility of the torts versus contracts distinction is that the facts which should justify piercing may be different when dealing with the different types of claimants. The probability of the courts piercing then becomes a question not of who is a more sympathetic type of plaintiff, but whether the sort of conduct that justifies piercing for a contract creditor is more or less common than the conduct that justifies piercing for a tort victim.

23 Thompson, supra note 2, at 1044.
24 Id. at 1058.
25 E.g., Hamilton, supra note 21, at 985.
When dealing with a piercing claim by a contract creditor, it is important to start by asking why, in the absence of piercing, the corporation is liable and its shareholders are not. The answer is simple: This is what the parties agreed. By choosing to do business in the corporate form, the owners have in effect asked creditors to agree to limited liability. By doing business with the corporation and not demanding a personal guarantee, the creditors have in effect agreed to this request. The fundamental issue posed in a piercing case brought by a contract creditor, therefore, is what grounds can justify letting the contract creditor out of its agreement to look only to the corporation for recovery. To answer this question, we must ask what sort of grounds does contracts law provide for parties to get out of their agreements.

One common ground for voiding an agreement is fraud. Hence, as we will see, if the creditor can show that the defendant induced the creditor to do business with the corporation by making misrepresentations, this will be grounds to pierce. Another basis for relief from a contractual obligation is to show a material breach by the other side. Can this provide the underpinning for a piercing claim? Of course, the corporation has failed to perform its end of the contract or we would not have a contract creditor seeking to pierce. But this is not the nonperformance we are talking about, since insulation from such claims is the whole idea of limited liability. The question is can the creditor point to nonperformance by the defendant shareholder of some personal obligation which was a quid pro quo for the creditor’s agreement to limited liability.

A non-corporate example may help clarify the rationale. Suppose a bank agrees to make a non-recourse loan, which the borrower will use to purchase property that will serve as collateral for the loan. The agreement commonly will impose upon the borrower obligations to protect the collateral. If the borrower fails to perform those obligations and the collateral is destroyed, the borrower should hardly be in a position to default on the loan and claim the advantage of the contract’s non-recourse provision.26 Similarly, we might assert that the agreement to do business on a limited liability basis by contracting with a corporation carries with it certain implicit obligations for the controlling own-

26 Cf. Cornelison v. Kornbluth, 542 P.2d 981, 991 (Cal. 1975) (a mortgagor who, in bad faith, damages the property subject to the mortgage, is personally liable for the damage despite California’s anti-deficiency legislation).
ers of the corporation in how they deal with the "collateral," that is, the corporation's assets. What those obligations are we shall return to later.

By contrast, it makes little sense to talk about fraud (at least in the narrow sense of a misrepresentation), or the failure to perform implicit contractual obligations, when facing piercing claims by tort victims. Instead, we again need to go back and look at the underlying reasons for the corporation to be liable and, in the absence of piercing, its shareholders not to be. Corporate tort liability arises from the doctrines of vicarious liability (making the corporation liable for the torts of its employees committed in the scope of their employment) and products liability (making the corporation liable for defects in the products it produces). The modern justification for these doctrines lies in internalizing the cost of accidents so as to become part of the cost of the goods or services that created those accidents. In this manner, producers of goods or services have an incentive to adopt cost-justified accident prevention measures. Moreover, consumers called upon to pay a price reflecting the cost of accidents which it would not be cost-effective to avoid, will see the total resources (including accident losses) used in the production of the good or service in question. Allowing limited liability for tort claims inevitably undercuts this cost internalization. Presumably, certain societal benefits from limited liability justify this result. Even if this is true as a general proposition—a question on which there has been considerable debate—there may be specific cases in which the externalization of costs because of limited liability is particularly egregious, while the societal gains from limited liability are especially slight. These cases, examples of which we will discuss later, are appropriate for judicial piercing in favor of tort claimants.

III
MISUNDERSTOOD OR BOGUS FACTORS IN PIERCING DECISIONS

Having identified the different theoretical bases for piercing in favor of contract and tort claimants, we can now evaluate the various specific grounds often mentioned as the reasons for

---

piercing. We start with factors whose significance is either misunderstood or nil.

A. Control or Domination

One frequently mentioned factor in piercing cases is the defendant’s domination or control over the corporation. Courts commonly get into this factor by invoking one of two multi-part tests often said to provide the elements of a successful piercing claim. One is a three-part test. To pierce, under this formulation, there must be:

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

The alternate is a two-pronged test: First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and second, adherence to the corporate fiction under the circumstances would sanction a fraud or promote injustice.

The second element in both formulations—that there be some fraud, wrong or injustice—seems to be nothing more than a restatement of the basic starting point that piercing is an equitable remedy used to prevent injustice. The notion that there ought to be some causal relationship between the fraud or wrong of the defendant, and harm to the plaintiff, is sound, yet, as we have seen above, often forgotten by the courts in piercing cases. What does the first element, control or unity of interest, add?

28 Professor Thompson found this factor mentioned in 551 of the approximately 1600 piercing decisions surveyed in his study. Thompson, supra note 2, at 1063.
At first glance, this element seems to add very little. After all, the typical defendant in a piercing case is the majority, or even sole, shareholder of the corporate debtor. One would expect it to be quite rare for a majority (and especially a sole) shareholder of a corporation not to exercise control over the business. If this is grounds to pierce, few closely held corporations would provide limited liability.

Perhaps this would not be a bad result. A number of economics writers have argued that limited liability is generally inefficient for a closely held business because of incentives for excessive risk taking and the lack of offsetting gains from promoting securities markets. Indeed, historically, the notion that abstention from control was the quid pro quo for limited liability provided the basis for the enactment of limited partnership acts. Nevertheless, given well-established legislative and judicial permission for closely held and even single shareholder corporations, it is far too late in the day to make an ex post judicial change through piercing decisions. Indeed, the legislative trend is away from any rule that suggests liability must follow control. For example, statutory provisions sanctioning greater direct shareholder control over closely held corporations make little sense if shareholder control meant the loss of limited liability. Similarly, the Revised Uniform Limited Partnership Act dramatically watered down the prohibition on limited partners participating in control. Finally, we have the rapid spread of legislation creating new entities, the limited liability company and limited liability partnership, in which limited liability expressly can co-exist with direct owner control.

31 E.g., Paul Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L.J. 117 (1980); Easterbrook & Fischel, supra note 22, at 110.
35 Rev. Unif. Limited Partnership Act § 303 (amended 1985), 6A U.L.A. 144 (1995) (creating an extensive list of actions which limited partners can take without losing limited liability, and allowing limited partners to participate in control without losing limited liability except to a party transacting business with the limited partnership, who, because of the limited partner's exercising control, reasonably thought that the limited partner was, in fact, a general partner).
36 Limited liability company and limited liability partnership statutes allow owners of such entities to enjoy limited liability despite the fact that these statutes gener-
Given this, courts generally do not pierce simply because one or more shareholders exercise control over the corporation. Many courts attempt to arrive at this result doctrinally by explaining that the impermissible “control” referred to in the formulations for piercing goes beyond “mere” control, to “domination,” in which the corporation has “no separate mind of its own.” This distinction is silly. No corporation in the world has a mind of its own; they are fictitious entities. People control corporations. True, in a large corporation, decisionmaking may occur in differing levels of managers leading up to a chief executive officer and the board of directors. As there are fewer participants in the corporation, inevitably there are fewer decisionmakers, until, in the corporation with a majority or sole owner, normally that party will decide what the corporation is to do.

Implicitly recognizing this, many courts start throwing in other factors as part of the test for impermissible domination or control. For example, in Sea-Land Services, Inc. v. Pepper Source, the court examined four factors to determine if the case met the “shared control/unity of interest and ownership” element for piercing: (1) failure to maintain corporate records and comply with corporate formalities; (2) commingling of funds or assets; (3) undercapitalization; and (4) treating the assets of the corporation as the defendant’s own (albeit, this seems to be somewhat the same as commingling).

As we shall see, many of these factors can provide grounds to pierce. To evaluate them as a template for proving impermissible domination or control, however, simply creates confusion. The Sea-Land case itself provides an illustration. The appellate court upheld the finding of impermissible “control,” based largely upon the defendant’s misuse of corporate assets, such as paying personal expenses with corporate funds. Nevertheless, the court remanded the case for determination of the element of wrong or
injustice. This necessitated a trial and second appeal, the end result of which—other than to increase litigation costs—was to pierce based largely upon the defendant’s misuse of the corporation’s assets. How did the court get itself into ordering such a pointless exercise?

The formulation of the test for piercing speaks of “control” and “wrong” in the conjunctive. Hence, the Sea-Land court was correct that, under the formulation, a finding of control or “unity of interest” did not alone justify piercing. The problem resulted from trying to beef up the control test by adding factors picked because they suggest the court should pierce. If these factors are persuasive, however, it is because they are the sort of wrongs or injustices which the second element identifies as the reason for piercing. Hence, using them to distinguish “ordinary” control from impermissible domination and control does little but create a potentially confusing redundancy.

One alternative is to change the test into a disjunctive one: “control” or “wrong” leads to piercing. In fact, a few recent opinions state that meeting the impermissible domination and control element can, in itself, justify piercing. This avoids the Sea-Land result, but carries its own risks. Discussing factors such as the misuse of corporate assets in the context of whether they create an injustice at least gives a hint that one must consider the effect of such facts on the creditor. Using these facts instead as a sort of proxy to show the defendant’s domination or control creates the danger of a court occasionally piercing simply because the defendant shareholder controls the corporation. After all, why look at the proxy when we can determine the reality?

More broadly, listing facts to prove a test, such as “domination or control,” which does not mean what it says, simply encourages the template approach where courts compare facts against lists with no idea of why these facts should matter.

Given this, is there anything to be said for looking at control in a piercing case? The answer is yes. In the first place, requiring control screens out piercing against the shareholders of a publicly traded corporation, who, as a practical matter, do not exercise control. This provides a doctrinal underpinning to explain the fact that there has never been a case in which the court pierced to

---

40 Sea-Land Servs., Inc. v. Pepper Source, 993 F.2d 1309, 1313 (7th Cir. 1993).
hold shareholders in a public corporation liable for the company's debts. Moreover, economic policy supports this result, since it is in the public corporation that limited liability produces efficiencies.

Control also has a role to play in the closely held corporation context. We may find a situation in which one shareholder (or group of shareholders) is in control of the corporation, while one or more minority shareholders are (voluntarily or not) passive. Assuming some fraud or injustice creates grounds to pierce, the controlling shareholders, who presumably committed the fraud or created the unjust situation, should be liable, while the passive shareholders, unless they did something wrong, should not. In other words, there is wisdom in the traditional conjunctive formulation. The "fraud or injustice" element tells the court when to pierce, the control element tells it against whom.

B. Failure to Observe Corporate Formalities

Among the bramble which has grown up around the doctrine of piercing the corporate veil is the notion that a major factor in the courts' decisions is the non-observance of so-called corporate formalities. Attorneys dutifully warn their small business clients to carefully observe corporate formalities lest the bogeyman of piercing get them. Many small business clients predictably ignore such warnings. Thereafter, if the business fails, litigants and courts in a piercing case spend time evaluating how many corporate formalities the defendant had the corporation follow.

In fact, the notion that corporate formalities are a major determinant in piercing cases may be the legal equivalent of an "old wives' tale." Professor Thompson's study of piercing decisions found that courts mentioned the failure to follow formalities in only a small fraction of the cases in which the courts pierced (twenty percent of the contract cases and eleven percent of the tort cases). While it is true that courts pierced two-thirds of the time in which the opinion mentions the lack of formalities, the

42 Thompson, supra note 2, at 1047.
43 See, e.g., K.C. Roofing Center v. On Top Roofing, Inc., 807 S.W.2d 545, 548 (Mo. App. 1991) (held husband, but not wife, shareholder liable, because there was no evidence that the wife was an active participant in the wrongful conduct). The study by Professor Thompson found that courts almost never hold passive shareholders liable in piercing cases. Thompson, supra note 2, at 1056.
44 E.g., Hamilton, supra note 21, at 989-90.
45 Thompson, supra note 2, at 1067.
question is whether this is causal or coincidental. Reading "between the lines" of judicial opinions is, by definition, a speculative undertaking; still, one gets the impression reading piercing decisions that the invocation of the defendant's failure to observe corporate formalities is often a make-weight recited in support of a decision reached on other grounds. For example, while the courts in Kinney Shoe, DeWitt, and Sea-Land discussed the defendants' failure to observe corporate formalities, one suspects the lack of formalities would not have led to piercing had the defendants not undercapitalized the corporation, appropriated corporate assets, or made assurances to creditors. Conversely, one suspects that had the defendants scrupulously observed corporate formalities, then Kinney Shoe, DeWitt, and Sea-Land might have provided three more decisions for Professor Thompson's study in which the court pierced despite not finding an absence of formalities.

At any event, if the significance of corporate formalities is not merely an old wives' tale, it should be. To understand why, it useful to start by asking what one means by corporate formalities. In fact, the initial problem in this area is that courts, litigants, and writers use this term to lump together conduct whose logical significance to a piercing decision should be quite different.

Among conduct said to constitute the non-observance of corporate formalities we find: (1) failure to issue stock;46 (2) failure to have shareholder meetings to elect directors, or to hold director meetings, or to prepare minutes of such meetings;47 and (3) failure to formally approve or carefully document transactions between the corporation and its shareholder(s) or with related corporations.48

The failure to issue stock might prejudice creditors. The reason, however, has nothing to do with adherence to formalities. Issuance of stock is normally how a corporation obtains capital from its owners. Hence, the real concern here is whether the corporation is undercapitalized, and, if so, whether this should provide the grounds to pierce in favor of the particular creditor. Listing the failure to issue stock as a failure to follow formalities

---

47 E.g., Sea-Land Servs., Inc. v. Pepper Source, 941 F.2d 519, 521 (7th Cir. 1991).
only distracts from these questions. One other impact of not issuing stock is the corporation then has no shareholders. It is, therefore, amusing to see a court referring to the defendant as a shareholder in an opinion in which the court notes that the corporation never issued stock.49 Presumably, this reflects implicit recognition that it would be poor policy to allow a party, who used his or her control over a corporation to engage in conduct which justifies piercing, to avoid liability because he or she never formerly became a shareholder.50

Like the failure to issue stock, the failure to formally approve or carefully document transactions between the corporation and its owner is really only a piece of a larger problem, the significance of which is not a matter of formalities. The real concern is unfair self-dealing between the shareholder and the corporation, which results in the removal of assets from the reach of the corporation’s creditors. The lack of formal approval may be some evidence of the unfairness of various transactions. More significantly, lack of documentation may justify a remedy, as in piercing, which goes beyond unwinding specific transfers from the corporation to the defendant. We shall develop these points in more detail later. What is important for now is to note how treating this problem simply as a failure to follow corporate formalities clouds the issue.

Often, reference to the non-observance of corporate formalities brings up the failure to hold, or have minutes of, shareholder and director meetings. Why this should have any bearing on a decision to pierce is a mystery. Typically, the answer one gets is some sort of quid pro quo argument. One variation of this argument is to state that if the defendant is not going to respect the corporation, then the court also need not respect the corporation.51 Such statements substitute rhetoric for policy. One must identify the precise manner in which the defendant failed to “respect” the corporation, and then ask what practical significance does the defendant’s conduct have when weighed against the reasons for limited liability.

When dealing with contract creditors, the issue is whether the

50 For an opinion explicitly deciding to pierce against an individual who never became a shareholder, see Minton v. Cavaney, 364 P.2d 473 (Cal. 1961).
51 See, e.g., Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 513 (Minn. 1979).
non-observance of formalities involving shareholder and director meetings should be grounds to let the creditor out of its agreement to look solely to the corporation for recovery. In other words, does this mislead the creditor or fail to live up to implied obligations on the controlling shareholder? The answer is no, unless the observance of such meeting formalities would be material to the reasonable creditor—which is an unlikely result. About the only possible impact the failure to hold shareholder and director meetings might have on a creditor is to raise questions about the authority of the party dealing with the creditor to bind the corporation to the transaction in question. If the creditor had been worried about authority, it could have insisted on seeing a board resolution. At any event, in cases in which a contract creditor seeks to pierce the corporate veil, the corporation typically does not try to disown the corporation’s obligation for lack of authority. Why should the company; it is broke. Hence, even if anyone were to point out the possible lack of authority to bind the corporation, it would not matter when the corporation could not perform anyway.

With respect to tort claimants, the observance of formalities regarding shareholders and directors meeting is equally irrelevant to the policies behind limited liability. Insisting that such meetings take place will hardly help internalize the costs of accidents in order to achieve the purposes of vicarious and products liability. Moreover, even in corporations which have annual shareholder and regular director meetings, it is rare to use such meetings to consider accident avoidance measures.

The alternate formulation of the quid pro quo argument is to state that if one wishes to gain the advantage of what corporate statutes provide, limited liability, one must observe what formalities corporate statutes require. Corporations statutes typically require annual shareholders meetings to elect directors. They also state that the corporation shall be managed by or under the direction of the board of directors, who normally act through meetings. Yet, before treating such provisions as legislative requirements for limited liability, it is important to ask what their purpose is. Corporations statutes contain a host of terms.

52 See, e.g., Labadie Coal Co. v. Black, 672 F.2d 92, 96-97 (D.C. Cir. 1982).
53 E.g., Del. Gen. Corp. Law § 211(b) (codified at Del. Code Ann. tit. 8, § 211(b) (1991)).
54 See, e.g., Del. Gen. Corp. Law § 141(a), (f) (codified at Del. Code Ann. tit. 8, § 141(a), (f) (1991)).
designed to achieve a variety of purposes. Many are simply defaultrules designed to fill in gaps in agreements by participants in the corporate venture. Others may be mandatory. Of the mandatory rules, some, such as limits on dividends, are intended to protect creditors. Many, such as the requirement of an annual meeting to elect directors, however, are designed to protect shareholders. Unless the legislature designed the rule to protect creditors—something which does not appear to be the case with meeting formalities—there is no logical reason to treat compliance with the rule as a quid pro quo for limited liability.  

IV  
THE KEY FACTORS LEADING TO PIERCING  

Having spent considerable time seeking to debunk some of the mythology surrounding piercing, we can now turn to the critical factors which should lead to shareholder liability.  

A. Defendant's Wrongful Dealings With the Plaintiff  
Numerous piercing decisions find their most persuasive justification in various dealings between the defendant and the plaintiff creditor. In the DeWitt case discussed earlier, the defendant gave personal assurances to the plaintiff that, if the corporation did not pay, the defendant would. In Western Rock Co. v. Davis, the court pierced in favor of owners of property damaged by a corporation’s blasting activities. In fact, the defendants ordered the blasting, knowing it was damaging the plaintiffs’ properties. The most common example of this factor, however, involves statements or actions by the defendant which misled the creditor into doing business with the corporation.  
Technically, these cases do not involve piercing at all, at least if by piercing one means holding the shareholder liable for the debt of the corporation. The reason is that in each of these cases, the plaintiff has a tort or contract cause of action against the shareholder. The personal assurance, if enforceable, makes the share-

55 A number of courts have shown greater sophistication by expressly refusing to give any weight to a failure to follow formalities when that failure did not impact the plaintiff. E.g., Preston Farm & Ranch Supply, Inc. v. Bio-Zyme Enters., 615 S.W.2d 258, 262-63 (Tex. Civ. App. 1981). Texas recently amended its corporations statute to state that failure to observe statutory formalities for running a corporation was not grounds to pierce. TEX. REV. CIV. STAT. ANN. art. 2.21(A)(3) (West. Supp. 1995).

holder a party to his or her own contract with the creditor. If the
shareholder committed the tort damaging the plaintiff, as in
Western Rock, then the shareholder is liable for his or her own
tort. The vicarious liability of the corporation for the tort does
not change this. And, of course, the party who is the victim of
fraud can sue the party who defrauded it. Hence, in none of
these cases is it really necessary to make the shareholder liable
for the debt of the corporation. Still, the end result should be the
same whether one labels the defendant’s liability as the result of
piercing or as direct liability for the defendant’s own tort or con­
tract. The measure of damages on these claims generally ought
to equal the creditor’s unpaid judgment against the corporation.
Accordingly, one cannot complain too much if the court wants to
label this piercing—at least so long as the court avoids some of
the foibles which arise in piercing cases.

At any event, it has become customary among both courts and
commentators to state that fraud provides grounds to pierce.57
The important question is what constitutes fraud. There are
three types of representations which often arise in piercing cases.

The first are representations concerning the corporation’s fi­

nancial status. Prospective creditors, naturally, often request fi­
nancial information about corporations which seek credit with
them. It is tempting for the controlling owner of a company in
financial trouble to dissemble in response to such requests.
There is little question that any material dissembling ought to
lead to liability for such an owner. Sometimes, moreover, mis­
representations as to the corporation’s financial health may be
subtle. For example, meeting corporate obligations through
short-term shareholder loans could constitute fraud if designed
to give the corporation a misleading credit history.58

A much more difficult question arises if the prospective credi­
tor does not request financial information from the company. Is
there any duty to inform such a creditor of an unusually weak

57 E.g., DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th
Cir. 1976) (fraud is a common but not exclusive ground for piercing); Richard A.
Posner, The Rights of Creditors of Affiliated Corporations, 43 U. Chi. L. Rev. 499,
521-22 (1976) (arguing fraud constitutes the exclusive ground). Professor Thomp­
son’s study identified 169 piercing cases in which courts mentioned the presence of
misrepresentations. The courts pierced in 159 of these cases. The courts noted a
lack of misrepresentations in 391 piercing cases. They refused to pierce in 361 of
these cases. Thompson, supra note 2, at 1063-1064.

corporate financial condition? In fact, this is another way to view the question of whether contract creditors should be able to assert inadequate capitalization as grounds to pierce. We will return to the broad question later. For now, however, it is useful to note that no court is likely to pierce based upon inadequate capitalization in favor of a creditor who was fully informed of the corporation’s financial condition and chose to do business solely on the corporation’s credit. Hence, piercing based upon inadequate capitalization in favor of contract creditors is, in effect, a statement that controlling shareholders of financially weak corporations have a duty to inform prospective creditors of the corporation’s financial situation. Put another way, such a result makes non-disclosure of financial weakness a fraud.

Closely related to this problem is the possibility of finding fraud in statements made by the defendant in promising corporate performance. In fact, this is likely to be an extremely common, if not always appreciated, phenomenon in piercing cases involving contract creditors. One can imagine that owners of struggling corporations are often on the phone desperately trying to obtain further extensions of credit from the companies’ suppliers. Under such circumstances, statements that the creditor has nothing to worry about, “the check is as good as in the mail,” and the like, flow trippingly to tongue. Indeed, the world might be more sensible if attorneys of small corporate clients spent less time urging compliance with corporate formalities, and more time suggesting care and candor in communicating with creditors.

The key issue in cases involving statements promising corporate performance is whether there is fraud by the controlling shareholder, or just a breach of contract by the corporation. The fact that the corporation does not perform does not turn the promise into fraud, or else all breaches of contract would create a claim for fraud, and there could never be limited liability with respect to contract creditors. On the other hand, there is fraud if, at the time of the promise, the controlling shareholder intended to have the company default. This follows from a well-established doctrine in the common law of fraud and deceit. This doctrine is that promises contain within them an implied statement as to the speaker’s present intention with respect to performance. If the speaker never intended to perform, then this implied statement is false.

The situation uncovered by the court on remand in the Sea-
Land case discussed earlier provides a nice example. The trial court found that the controlling shareholder made assurances that the corporation would pay the plaintiff if the company had sufficient funds. At the same time the defendant was making these assurances, the trial court found he had already formed the intent to manipulate funds between various companies he owned in order to ensure the debtor corporation lacked the money to pay.

This sort of result always raises the question: How does the court know what the defendant secretly intended? Barring some confession, one can only draw inferences based upon the objective circumstances. It is important to keep in mind, however, that owners of small corporations typically are an optimistic lot, and the human capacity for self delusion is large. Hence, it should not be enough to find fraud merely because an objective observer in the defendant's position would have known the corporation was not going to be able to perform. At some point, however, the situation becomes so bleak that a finder of fact can say even a foolish defendant knew his or her promises were hollow. Inferences to this effect become particularly strong if, at the same time the defendant is busy trying to beg for corporate credit, he or she is bailing assets out of the corporation. 59

Incidentally, this sort of false promise fraud is not limited to explicit statements seeking to calm creditors' fears as to future corporate performance. Merely entering new corporate obligations at a time the controlling owner knows the corporation will never perform creates the same problem. 60

The third common problem area involves representations and other actions which lead the creditor to believe that someone, other than the corporation it is seeking to pierce, stands behind the debt. This might be either the controlling shareholder or a related corporation. If such representations meet the require-

---

59 See, e.g., Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 511 (Minn. 1979) (shortly after the defendant persuaded the plaintiff to continue dealing with his corporation by promising the corporation would perform, the defendant had the corporation transfer its principal property to him and his wife).

60 See, e.g., K.C. Roofing Ctr. v. On Top Roofing, Inc., 807 S.W.2d 545, 549-50 (Mo. App. 1991) (the trial court found that the defendant's corporation purchased substantial supplies from the plaintiff on credit at a time the corporation owed between $75,000 and $100,000 to previous suppliers which it was unable to pay; in addition, the defendant had a pattern of ceasing to do business in one corporate entity when that corporation was unable to pay its bills, only to start up the business in a new corporate entity).
ments to constitute a binding contract, then there is no need to discuss piercing. Many times, however, the representations or conduct will not be sufficient to create a contract. For example, the attempt to cast oral assurances as a personal guarantee faces a problem under the statute of frauds. Alternately, the parol evidence rule might prevent an attempt to argue that a written contract naming the corporation as a party really constituted a contract between the creditor and the controlling shareholder. Many times, such as the situation in which related corporations share an office and have similar names, or when an owner simply refers to the creditor as “dealing with me,” the communication may be too ambiguous to set up a persuasive argument in contract. In such an event, can the creditor pierce based upon fraud?

Answering this question requires resolving three issues. To begin with, will allowing such a piercing claim circumvent the policies behind the statute of frauds or the parol evidence rule? Courts have reached differing assessments of this concern. To much depends on how sympathetic one is toward the advantages of the statute of frauds or parol evidence rule in creating legal certainty—a subject best-suited for a contracts treatise. Next, should the existence of ambiguity or confusion as to who is the obligor be enough to pierce, or must the creditor be able to point to some clear statement which led it to believe that someone other than the corporation was bound by the contract? Closely related to this question is whether the defendant must have intended to mislead or confuse the creditor. To the extent the defendant intended to fool or confuse the creditor, the answer to the question concerning ambiguity or confusion should favor the plaintiff. On the other hand, if this was not the defendant’s intent, the question becomes who, between two sloppy parties, should bear the risk of loss from unintended misunderstandings: the party who created a potentially misleading or confusing situation, or the party who could have checked more carefully? An efficiency analysis might suggest that the defendant was generally in a position to have more cheaply prevented the confusion and hence ought to bear its consequences.

B. Defendant's Abusive Dealings With the Corporation's Assets

We have already confronted a couple of decisions, \textit{DeWitt} and \textit{Sea-Land}, in which abusive dealings between a controlling shareholder and his corporation provided much or all of the real grounds to pierce. In fact, after one strips away all the flak about formalities and domination, many piercing cases come down to a problem of self-dealing.\footnote{See, e.g., Robert C. Clark, \textit{The Duties of the Corporate Debtor to Its Creditors}, 90 Harv. L. Rev. 505, 542 n.98 (1977).} Often, courts refer to "siphoning" or "commingling" as labels for this phenomenon.\footnote{See, e.g., DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976).}

Understanding why unfair self-dealing should be grounds for shareholder liability is not difficult. On a superficial level, one might note that, in a variety of contexts, courts have labeled unfair self-dealing as "fraud."\footnote{E.g., Mayer v. Adams, 141 A.2d 458 (Del. 1958).} Indeed, we shall see later that many of the self-dealing transactions which provide grounds for piercing could also be attacked as fraudulent conveyances. Accordingly, such conduct can constitute "fraud," and courts commonly state that fraud provides grounds to pierce.

Beyond such semantic arguments, one can look at underlying policy. When dealing with contract creditors, we saw earlier how the defendant's failure to live up to the implied terms under which the creditor agreed to do business on the corporation's credit can justify piercing. Principal among terms which one would imply is that the controlling shareholder of the corporation will not be free to do whatever he or she wants with corporate assets. Otherwise, the owner could have the corporation borrow money, take all the money out of the corporation, and leave the creditor unpaid. In essence, the loan then becomes one which says to the owner "pay back if you feel like it," with no sanction for non-payment other than the possible loss of future loans. This is not the sort of loan we expect persons in a commercial relationship to make. Consistent with this expectation, large loan agreements with corporations often contain explicit limits on dividends, salaries, and other mechanisms by which owners might take money out of the corporation. Implied terms can create similar protection for smaller extensions of credit,
thereby saving the cost of negotiating and drafting to deal with every future contingency.

There is one caveat to this analysis. Suppose, at the time the creditor chooses to do business with the corporation, the creditor is aware of conduct which might constitute unfair self-dealing. In this event, the creditor should not expect sympathy if it complains about such self-dealing later.

This could explain the otherwise puzzling decision of the New York Court of Appeals in *Bartle v. Home Owners Cooperative*.65 This was an action seeking to hold a parent cooperative corporation liable for debts of its subsidiary. The cooperative had formed the subsidiary to build houses for the members of the cooperative. The members were veterans,66 and the subsidiary sold the houses to the members at or below cost. Such favorable prices are not what one typically finds in an arms-length transaction and may account for the subsidiary's financial failure. Nevertheless, the court refused to pierce. The key line in the opinion may be the statement that the creditors "were in no wise misled."67 This would be true, and the decision defensible, if, as seems probable, the subsidiary's creditors knew that its function was to build houses to sell at bargain prices to the cooperative's members.

Abusive self-dealing might also provide grounds to pierce in favor of tort victims. It undercuts the goal of internalizing the costs of accidents. Viewed *ex post*, if the controlling shareholder has yanked assets out of the corporation, there is less for tort victims to collect. More important, viewed *ex ante*, if the controlling shareholder knows he or she can yank assets out of the corporation before tort victims can get or enforce a judgment, there is less incentive to insure and to make sure the costs of the corporation's goods or services fully reflect the likely costs of accidents. At the same time, allowing controlling shareholders untrammeled rights to take corporate property hardly seems necessary in order to achieve the societal goals behind limited liability.

On the other hand, one might argue that if a corporation lacks adequate insurance to cover foreseeable levels of damages, courts should pierce based upon inadequate capitalization. The

---

66 *Id.* at 833. Which, some might speculate, explains the result.
67 *Id.* at 833.
fact that abusive self-dealing may have partially motivated the controlling shareholder to under-insure is besides the point. Conversely, if the corporation is adequately insured, the abusive self-dealing did not cause a failure to internalize accident costs and again seems irrelevant. Yet, many times the situation will not be this cut-and-dry. There often is some insurance, but the fact a tort claimant seeks to pierce means that the insurance coverage fell short. Hence, the question becomes whether the company had insured to the level of reasonably foreseeable damages. Given the incentive discussed above, it might be reasonable to deny the controlling shareholder who engages in abusive self-dealing the benefit of the doubt on this question.

At any event, not all self-dealing transactions between the corporation and its controlling shareholder should provide grounds to pierce. A closely held corporation often will purchase or rent important assets from its controlling shareholder. The controlling shareholder typically works for the company and legitimately is entitled to compensation. Should there be profits, the shareholders expect to get some distribution of them. To say that some self-dealing is sufficiently abusive or unfair to justify piercing, therefore, forces one to define a standard for determining when this occurs.

Fortunately, one does not need to undertake such an analysis from scratch. Corporations statutes contain limits on dividends or similar distributions from the corporation to its shareholders. Typically, such statutes prohibit a distribution when the corporation is, or the distribution will render the corporation, insolvent in either the bankruptcy sense (assets less than liabilities) or equitable sense (unable to pay its bills as due). Cases in which shareholders alleged directors breached their fiduciary duty to the corporation provide a well-developed jurisprudence on when compensation, or any exchange between a corporation and one in control of it, is unfair. By and large, these cases look to see if the corporation received a fair equivalent to what it gave in the sense that this was the sort of exchange the company would have made if dealing with an outsider. Fraudulent conveyance acts employ concepts from both sources. Among transfers constituting a fraudulent conveyance is one made when the debtor is (or thereby becomes) insolvent and without the transferor receiving

69 E.g., Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).
fair consideration in exchange. Transfers intended to hinder creditor collection are also fraudulent conveyances.\textsuperscript{70}

These rules give us a fair proxy of the terms we might infer that the typical creditor expects from the controlling shareholder of a corporate borrower. They are also a judgment as to what conduct society does not find necessary to allow in order to obtain the policy goals sought in granting limited liability from tort claims. The presence of these rules, however, raises another question: Why pierce, rather than simply relying on these statutes and judicial doctrines to provide a remedy?

To address this question, it is important to note two related differences between piercing and these alternate theories. The first is that these alternate theories require careful evaluation of specific transactions: What did the corporation transfer? What is the defendant's justification for the transfer? How does this measure up against the specific tests of fairness or solvency imposed by the relevant statute or judicial doctrine? By contrast, one does not find this same sort of careful transaction-by-transaction scrutiny in piercing cases. The second difference is in remedy. These alternate approaches lead to the return of the property taken in the transaction under challenge (or the monetary equivalent). Piercing, in comparison, creates liability measured by the debt the corporation owes to the plaintiff creditor (which could be much greater than what the defendant took from the company). Hence, while we discussed earlier why abusive self-dealing should lead to liability, this did not entirely answer why liability should take the form of piercing. More precisely, what, if anything, justifies these differences in both the manner of scrutiny and the measure of damages?

The difference in damages might reflect a policy of deterrence. Merely forcing the return of property does not deter its taking. Yet, this simply forces one to ask why deterrence is more important in the context of piercing cases than in situations in which the only remedy is return. There are several possible answers. Consider first the situation in which a party receives property from a debtor who is an individual rather than a corporation. Here, there can be no piercing claim against the transferee, but only a fraudulent conveyance action to force return of the property. Yet, in this situation, the transferee cannot have the complete control over the debtor who is an individual, which a

\textsuperscript{70} E.g., Unif. Fraudulent Conveyance Act §§ 3, 4, 7.
controlling shareholder can have over a corporation. After all, real people do have minds of their own. When the transferee is not the person who decided to make the fraudulent conveyance, there seems less need to deter the transferee by making him or her liable for the entire debt. There also may be greater need for the measure of damages to deter unfair self-dealing in a piercing context than in the normal breach of fiduciary duty context. Piercing invariably involves a terminal relationship between owner and creditor. By contrast, the continued power of the shareholders to sack directors provides (at least in theory) an ongoing deterrent to director self-dealing. Of course, the difference in remedy could be accidental. In these other contexts, there is not a natural measure of compensatory damages, as there is in the piercing context, aside from return of the property.

Alternately, perhaps the need to deal with uncertainties can explain both the differences in remedy and in scrutiny. For example, one can never be sure the corporation received fair consideration in any transaction with its controlling shareholder. After all, we are speculating on what the result would have been had there been an arms-length exchange in a situation in which there was no such exchange. Also, merely forcing the return of assets risks under-compensating the creditor because of uncertainties. Are we sure the creditor has been able to identify every transaction in which the controlling shareholder obtained assets from the corporation? Can we be sure that, if the corporation had use of the property taken, it would not have been able to avoid failure altogether and, thereby, have paid the plaintiff? Piercing places the burden of these uncertainties on the controlling shareholder.

Here then is where the notion of formalities has a grain of merit—albeit one obscured by the focus on holding regular shareholder and director meetings for their own sake. Failure to make contemporaneous records of all transactions between the corporation and its controlling shareholder—including precisely what the corporation transferred, what, if anything, it received in exchange, what was the rationale for the transaction, and what steps the controlling shareholder took to evaluate whether there was either equivalence in the exchange or the corporation was solvent at the time—makes the court suspicious. While contemporaneous documentation is no guarantee against abusive self-dealing, the lack of such documentation, and the resultant need
for an after-the-fact reconstruction, contributes to the uncertainties. Indeed, in the most extreme situation, the absence of financial records combined with a pattern of commingling shareholder and corporate funds, could make it impossible to even figure out what funds belong to the debtor corporation. It is not surprising that courts resolve such uncertainties against the party who caused them, the controlling shareholder.

The DeWitt case, discussed earlier, illustrates this sort of approach. The controlling shareholder made withdrawals of between $15,000 and $25,000 per year from the corporation. In condemning these payments by listing them as a factor for piercing, the court spent no time trying to measure the payments against any justification. While the defendant testified that the payments represented a salary, the lack of any contemporaneous formal approval, and especially the fact that the defendant set the size of the payment by the amount of money available to the corporation, was enough to make them irrevocably suspect.

Our discussion so far has focused on intentional misconduct by the controlling shareholder in dealing with his or her corporation. What about negligent misconduct? Specifically, suppose, instead of dishonestly transferring assets into his or her own pocket, the controlling shareholder causes the corporation to fritter away its assets through negligent business decisions?

This sort of negligent mismanagement does not appear to be a significant factor in piercing decisions. For example, the study by Professor Thompson does not list it among the common factors courts recite in such decisions. Moreover, there is a policy hazard to venturing down this track. Piercing decisions involve failed businesses. Typically, a post mortem of a business failure can identify mistakes made by those in charge. This, in turn, may make it too easy for those who look at the business wreck in “twenty-twenty hindsight” to find negligence. Therefore, making such negligence grounds for piercing could potentially destroy limited liability.

Besides, there are actions which may allow recovery against those in charge of a corporation specifically for negligent mismanagement.71 Admittedly, the existence of alternate remedies did not prevent us from using abusive self-dealing as grounds to pierce. Yet, when dealing with negligence instead of intentional

---

misconduct, there is neither the same moral culpability or need for deterrence. More significantly, there is more risk of confusing decisions which turn out badly with legally culpable decisions. Hence, it may make more sense to confine a negligence theory to claims for damages suffered because of specific negligent business decisions, rather than allowing it to become the basis for a loosely applied piercing remedy.

C. Inadequate Capitalization

1. Should Inadequate Capitalization be Grounds to Pierce?

In contrast to fraud and unfair self-dealing, which may explain far more piercing decisions than reading the literature on the subject would lead one to believe, inadequate capitalization may explain far fewer. In fact, Professor Thompson's study found inadequate capitalization mentioned in only nineteen percent of the torts and thirteen percent of the contracts opinions in which courts pierced. 72

Still, even if inadequate capitalization is not the most prevalent grounds for piercing, we must address how significant this fact should be when it is present. The issue is sufficiently complex to require a longer discussion than necessary with the more common factors considered so far. To begin with, Professor Thompson's study suggests some judicial ambivalence. Courts pierced between seventy and seventy-five percent of the time when they found inadequate capitalization, and refused to do so in twenty-five to thirty percent of the cases, depending on whether the case involved a tort or contract creditor. These statistics are consistent with the impression one gets from reading a sampling of cases.

Some court opinions have held that inadequate capitalization leads to piercing. In Minton v. Cavaney,73 the California Supreme Court dealt with a claim brought on behalf of a girl who drowned while swimming in a pool operated by a corporation with no assets. The corporation leased the pool and had never issued stock. Pointing to the lack of capital, the court pierced.74

At the other extreme (and, coincidentally, at the other coast) one has the often discussed New York Court of Appeals’ opinion

72 Thompson, supra note 2, at 1066.
74 The court remanded, however, in order to give the defendant an opportunity to show that the corporation should not have been held liable for negligence. Id.
in *Walkovszky v. Carlton*. A taxicab operated by a corporation struck the plaintiff. The corporation's assets consisted of a couple of cabs, its non-transferable license to operate cabs in New York, and a liability insurance policy in the minimum amount required to drive a vehicle in New York. The situation is confusing because of the plaintiff's mixing together three potentially separate concerns in seeking to pierce. One is his allegation that the shareholder defendant, Carlton, had broken up Carlton's taxicab business into ten corporations, each owning one or two cabs, apparently for the purpose of limiting the loss which would result in case of an accident. For reasons we shall explore later, the court treated this as irrelevant to the plaintiff's right to pursue Carlton, as opposed to stating a claim against the other nine cab companies. There was also an allegation that Carlton was taking assets out of the corporation. What is important for present purposes is the allegation that the corporation was undercapitalized. The Court of Appeals held that this was insufficient to state a cause of action. The scope of this holding, however, is not entirely clear. One reading is to reject the argument that inadequate capitalization provides grounds to pierce. On the other hand, the court's opinion placed much weight on the corporation possessing the minimum liability insurance required to operate a vehicle. This might allow a role for inadequate capitalization in a case where no minimum insurance statute applies.

Most courts have avoided following a broad reading of either *Minton* or *Walkovszky*. Instead, the tendency has been to exploit the indeterminacy of a multi-factor approach to piercing by stating that inadequate capitalization is a factor for the court to consider. This dodge is not very satisfactory. Once we concede that inadequate capitalization is a factor toward piercing, the inevitable question becomes whether it alone can be enough to pierce.

A number of courts (including, surprisingly in light of *Minton*,

75 223 N.E.2d 6 (N.Y. 1966).

76 The court gave the plaintiff an opportunity to amend his complaint. Two years later, the Court of Appeals held that the plaintiff's amended complaint alleged grounds for piercing, albeit the court never explained precisely how the amended complaint differed from the one it earlier found inadequate. *Walkovszky v. Carlton*, 244 N.E.2d 55 (N.Y. 1968).

77 E.g., *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976).
several intermediate appellate courts in California) have held that the answer to this question is no.\textsuperscript{78} Perhaps some of these courts simply meant that one must look at the nature of the plaintiff and defendant in deciding whether to pierce based upon inadequate capitalization. This is reasonable. As we shall discuss in more detail shortly, inadequate capitalization should not be grounds to pierce in favor of many contract creditors who could have checked into the corporation’s financial posture. Also, we should ask if the particular defendant was in sufficient control of the corporation so as to bear responsibility for its undertaking operations without adequate capital. Alternately, perhaps some of these courts recognized that, in some cases, inadequate capitalization will not be relevant on its own, but will provide part of the basis for a claim of fraud or abusive self-dealing. We shall explore this in detail shortly. Unfortunately, however, some courts, in holding that inadequate capitalization is not enough to pierce on its own, seem to have factors like a failure to follow formalities in mind for what else may be necessary.\textsuperscript{79} For example, one could point to the corporation’s failure to issue stock in \textit{Minton}. Yet, the \textit{Minton} court was too sophisticated to rely on this sort of irrelevancy, and it would be hard to justify a different outcome simply because a corporation issues stock for some token amount.

This then brings us squarely to the question of whether courts should pierce, at least in some cases, based upon inadequate capitalization? At the outset, the court’s opinion in \textit{Walkovszky} raises a legislative interpretation question: Will piercing based upon a lack of capital contravene legislation which either imposes financial requirements the corporation met or imposes no financial requirements on the corporation? The court in \textit{Walkovszky} thought so, although there the particular insurance requirement had nothing to do with corporate law. It was a minimum insurance requirement for anybody to drive in the state. Hence, it is unlikely that the legislature, in enacting the requirement, gave any thought to its impact on piercing doctrine.

Historically, many corporations statutes required a certain amount of paid in capital (often $500 or $1000) before a corpora-

\textsuperscript{78} E.g., Harris v. Curtis, 87 Cal. Rptr. 614 (Cal. App. 1970).
\textsuperscript{79} E.g., Consumer’s Co-op. v. Olsen, 419 N.W.2d 211 (Wis. 1988).
tion could commence business. Such requirements have faded from the scene. Does either the existence of such requirements or their disappearance tell us anything about legislative views of piercing for inadequate capital? The answer is probably no. The problem with legislative minimum capitalization requirements is that different businesses have different capital needs. Hence, the old statutes set a token sum suitable for the smallest venture. This is hardly a legislative determination as to what is adequate capital for any corporation, no matter what its business. The repeal of these provisions simply recognizes the futility of attempting to attack the adequate capital question through across-the-board legislative requirements. Case-by-case judicial evaluation through piercing decisions is a different matter.

Looking at the question as one of policy, we again must divide our analysis between contract and tort plaintiffs. In fact, it is in dealing with claims of inadequate capitalization that a number of courts have drawn the distinction between tort and contract creditors, often speaking of “waiver” or “estoppel” of the contract creditor to complain of inadequate capital. This focused lack of sympathy for contract creditors complaining about inadequate capital is fairly consistent with the results of Professor Thomp-son’s study, once we recognize how fraud (which should only help contract creditors) and unfair self-dealing are more prevalent in piercing cases than is inadequate capitalization.

As we saw earlier, piercing an underfinanced corporation in favor of contract creditors is as much about nondisclosure as it is about inadequate capitalization. After all, had the controlling shareholder fully disclosed the financial status of the corporation, and the creditor still agreed to do business solely on the company’s credit, a court presumably would not, and it should not, pierce based upon inadequate capitalization. Moreover, had the creditor requested financial information, and the controlling shareholder lied in response, there would be fraud and grounds to pierce without the need to discuss capital in itself. Hence, the question becomes should the law protect creditors who neglect to protect themselves by demanding financial information before doing business?

81 E.g., Consumer’s Co-op v. Olsen, 419 N.W.2d 211, 221 (Wis. 1988).
To answer this question, it is useful to ask another: Why did the creditor not demand financial information before doing business? There are three possible answers to this question. First, the creditor is dumb. Alternatively, the creditor rationally concluded that other information is more probative of the risks than financial data. Finally, the creditor rationally concluded that the size of this transaction did not make it worth the added costs of demanding and analyzing financial information. Piercing based upon inadequate capitalization in favor of contract creditors often leads into a discussion of the relative frequency and policy significance of these three possibilities. For example, some writers draw a distinction between creditors engaging in large negotiated transactions with the corporation—where, presumably, the failure to demand the data reflects either the first or second possibilities and where the court should therefore not pierce—and those engaging in small short-term transactions, such as the trade creditor who ships with an invoice giving thirty days to pay. These writers suggest the latter sort of creditor should be able to pierce, since it would not be fair or efficient to require such a creditor to incur the transaction costs of investigating the financial status of every corporation with which it does business.83

This model of the trade creditor who could not reasonably expend the effort to investigate, however, may be divorced from the reality of piercing plaintiffs. The reason is simple. A lawsuit seeking to pierce is not an inexpensive proposition. Hence, a fairly sizable bill is involved or the creditor would not have brought the action. Given this, why did the creditor not deem it worthwhile to demand financial data to start with? Perhaps the prospect of being stiffed on any given short-term bill is so rare that even transactions large enough to provoke a piercing action are not worth an advance investigation into the corporation’s finances. Alternately, perhaps other data (especially credit history) is usually more predictive of problems in most short-term credit transactions. If either of these two suppositions is true, this raises the question of whether financial data showing inadequate capitalization is simply not material to those extending short-term credit and hence its non-disclosure does not constitute fraud. Put another way, might the only result of piercing in favor of short-term contract creditors based upon undisclosed under-

83 E.g., Easterbrook & Fischel, supra note 22, at 113.
capitalization be to encourage the pro forma transmittal of financial information which such creditors will ignore?

Perhaps not, since we might argue that the very act of stepping forward to warn the creditor about the corporation's financial health would serve as a flag to the creditor that in this case financial information is worth paying more attention to. If we assume that creditors face a "lemons problem"—there are a few undercapitalized corporations which it is not worthwhile to search for before extending short-term credit—and that the owners of those corporations know their companies are the "lemons," it might make sense to force those owners to identify themselves. Yet, this works if only those owners whose corporations present extraordinary short-term credit risks come forward. If, instead, the owners of every muddling through small business issue warnings, the creditors will not know which warnings to pay attention to. What this means is that the critical information to the creditor is not financial data at all. Instead, it is the owner's realization that the corporation is in serious enough trouble that the company will probably be unable to pay even short-term credit. Once we have reached this point, however, we have come back to false promise fraud. The owner who promises corporate performance knowing, at the time, the corporation will never be able to perform, has obtained limited liability by fraud. Under this analysis, inadequate capitalization no longer provides the grounds to pierce, but serves simply as evidence of the defendant's scienter.

The notion that inadequate capitalization might play a supporting role as part of another theory for piercing is not limited to fraud. It might also apply to abusive self-dealing. Recall, this Article earlier identified abusive transfers from the corporation to its owners by looking to the standards encompassed within the rules on dividends, conflict-of-interest transactions, and fraudulent conveyances. Under this approach, the owner can receive corporate assets in exchange for fair consideration. Alternately, the owner can receive property from his or her corporation when the corporation is not insolvent or rendered insolvent by the transfer. Interestingly, the fraudulent conveyance statutes also proscribe transfers without fair consideration when the transferor is left with unreasonably small capital in light of the business the transferor expects to do.84 Hence, in cases like DeWitt and Sea-Land, the problem is not just the gratuitous taking of

84 E.g., UNIF. FRAUDULENT CONVEYANCE ACT § 5.
assets. The problem is that the defendant took the assets, without fair consideration, from a financially imperiled corporation. To this extent, proof of inadequate capitalization may help prove that the defendant's self-dealing was abusive.

Turning to tort victims, the direct relevance of inadequate capitalization is much easier to see. Inadequate capitalization externalizes the costs of accidents. This is not simply a matter that, after the accident, the undercapitalized corporation finds itself unable to pay the victim. The more important problem arises before the accident. If a corporation insures to cover foreseeable accidents, it pays premiums. Lower premiums can reward cost effective accident prevention measures (such as a taxi company hiring drivers with better safety records). As the company incorporates the premiums into the price of its goods or services, the consumer, who must choose, say, between taking a cab, the subway, driving one's own car, or walking, makes this choice based upon a price which includes, among many other things, the relative accident risks of these various means of transportation. If, however, one can operate a corporation with insurance which will not cover foreseeable risks, the corporation’s premium costs are lower. Its incentives to take premium reducing accident prevention measures is, in turn, less, and the consumers of its products receive a subsidy from accident victims.

This sort of externalization of accident costs is not what limited liability should achieve. Viewed both historically, and in terms of economic efficiency, limited liability is principally for the protection of shareholders in a widely held corporation. It is acceptable for closely held corporations dealing with contract creditors since, in this context, parties could always contract in or out of a limited liability regime regardless of corporations law. Limited liability is even acceptable for the closely held corporation which faces tort liability that its owners did not reasonably foresee. After all, without a limited liability regime, one presumably would not have insured against unforeseeably large claims. Hence, the firm's goods or services would not have reflected those costs anyway. The use of limited liability by owners of a closely held business to deliberately externalize foreseeable accident costs, however, simply undercuts the goals of tort law.85

85 This point is distinguishable from the earlier observation that there is nothing wrong with incorporating a business for the purpose of limiting liability in general. The corporation allows its owner to offer to deal on a limited liability basis with
2. What is Inadequate Capitalization?

Thus far, we have been discussing “inadequate capitalization” without defining what we mean by the term. The reason for this organization is because defining the term “inadequate capitalization” sensibly requires evaluating why this factor might lead to piercing. In fact, it turns out that once we start to determine inadequate capitalization with reference to the policies discussed above, we should reject much of the conventional wisdom recited by commentators and courts on how to measure this factor.

Addressing whether a corporation is adequately capitalized requires answering three questions. First, what is “capital;” in other words, what are we measuring? Second, how much capital is enough? Finally, when do we measure the amount of capital?

In a number of cases, such as Kinney Shoe and Minton, courts are able to ignore all three questions because the corporation never had any assets at all. Once we get past such stark facts, opinions on what counts as capital become confused. Some courts look to all the corporation’s assets. 86 Most, however, focus on assets that came from the shareholder(s). 87 This works simply enough when shareholders put money into the corporation in exchange for stock. It creates a difficult issue, however, when, as is common, shareholders put much or all of their contribution into the corporation in the form of loans, or guarantees of third party loans. Opinions on whether to treat such transactions as capital for purposes of determining if the corporation is undercapitalized are in hopeless conflict. 88

Court opinions also supply little guidance on how much of whatever assets that count as capital is enough. The court in Minton referred to capital which was “trifling compared with the business to be done and the risks of loss” as insufficient. 89 The notion that one must measure needed capital by the nature and

---

risks of the business is reasonable enough, but how small is “trifling”?

The rule for when to measure capital, at least, appears clear. Most courts and commentators agree that one measures this at the inception of the venture. A possible exception exists if the corporation expands the size and risks of its business.

We started the discussion of what is inadequate capitalization with the concept that a sensible definition should follow from the reasons one thinks this factor ought to lead to piercing. Let us see how the views just outlined do under this approach. Notice that the focus of most courts and commentators seems to be on the shareholders’ initial investment in the corporation. At first glance, this seems strange. After all, whatever the shareholders put into the company is gone or we would not have unpaid creditors seeking to pierce. The creditors are concerned with what the corporation has to pay them now. The notion could not be that the shareholders are supposed to invest up front enough money to cover all the corporation’s future debts, or else limited liability would be rather meaningless. Indeed, why would a corporation ever incur debt if its shareholders had put in all necessary funds for its operations at the start?

In fact, the focus on the shareholders’ initial investment is only indirectly, if at all, concerned with making sure creditors get paid. Rather, the idea is that shareholders should be forced to put some of their own funds at risk. There are a couple of rationales for this. Some writers and courts have viewed the question as one of fairness or quid pro quos. If a party wants the advantage of engaging in a business on a limited liability basis, that party ought to be willing to risk at least some of his or her own money, rather than shifting the entire risk of the venture onto others. The second rationale looks to economic incentives. A party with none of his or her own funds at risk has an incentive to engage in non-economically risky investments.

If we accept this as the reason for looking at inadequate capitalization, we can answer some of the questions upon which

---


91 See, e.g., Consumer’s Co-op, 419 N.W.2d at 219.

92 E.g., ELVIN R. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS: A STUDY IN STOCKHOLDERS’ LIABILITY 120-21 (1936).
courts seem confused. As far as what to look at, consideration paid for stock clearly counts. Courts have had difficulty with loans and guarantees because they have attempted to treat this as an all-or-nothing proposition. Shareholder loans and guarantees put the shareholder’s money at risk and provide an incentive for responsible decisionmaking. On the other hand, the risk is not quite the same as a purchase of stock. Barring subordination, a shareholder loan, or the loan the shareholder guarantees, may receive some payment after the failure of the business—assuming, of course, the corporation has any assets—even if all the creditors do not get fully paid. Hence, shareholder loans and guarantees should count as capital under this rationale, but perhaps at some discounted rate.

As far as how much capital is enough, it is a mistake to say that the standard is enough to cover the foreseeable needs or debts of the business. Otherwise, the mere fact of corporate borrowing for anything other than an unforeseen contingency would show a lack of capital. Yet, even the most financially sound public corporations engage in long-term borrowing as part of their capitalization. Instead, one is looking for enough capital for the shareholders to meet a “fair” share of the risks of business failure, or, to be more results oriented, enough capital to create an incentive for the controlling owners to make reasonable business decisions. Rather than speculate on this amount, we might examine the practices used by sophisticated lenders in assessing whether to make business loans.

The discerning reader may have noticed that the idea of requiring capital in order to achieve a “fair” sharing of risks, or to provide an incentive for reasonable business decisions, came out of our discussion of the traditional definition of inadequate capitalization. None of this appeared in our consideration of when and why inadequate capitalization should lead to piercing. The reason is simple—this has little to do with why the courts should pierce.

93 See, e.g., Costello v. Fazio, 256 F.2d 903, 909-10 (9th Cir. 1958).
94 Along this line, the suggestion of some writers that the shareholders ought to provide enough capital to give the corporation a “reasonable chance of success” fails to provide a workable guideline as to what should be the shareholders’ initial investment. Admittedly, potentially viable start-up businesses may fail if they lack access to sufficient cash to get through the development and early marketing phases and reach profitability. Yet, there is no inherent reason that this investment must come from the initial shareholders’ equity, rather than borrowing or later investors.
The traditional view reflects a notion that limited liability is a privilege made available through the granting of corporate status and that courts can condition this privilege based on the courts' views of fairness or efficiency. We have already seen, however, with respect to contract creditors, that limited liability fundamentally exists because this is what the owners and creditors agreed. It is rather presumptuous for a court to trash this agreement simply because the court thinks the parties have agreed to an unfair or inefficient allocation of risks. Accordingly, while creditors making long-term larger loans to a corporation often are concerned about making sure the shareholders have a sufficient stake in the company to avoid excessive risk-taking, such creditors are fully able to protect against inadequate initial capitalization by investigating this fact.

This is not a case, as with abusive self-dealing, in which we might imply terms, rather than require creditors to set everything out in a contract. Addressing abusive self-dealing in a contract requires anticipating and negotiating over variations of future conduct which normally will not come to pass. Implied terms save parties this often wasted effort. Moreover, decades of judicial and legislative experience have created a set of general guidelines which we might reasonably assume are the minimum any creditor would demand. Application of either these or contractually tailored guidelines to specific conduct requires, in any case, an ex post judicial decision. Hence, recognizing and enforcing implied terms regarding self-dealing through piercing decisions is efficient. By contrast, the shareholders' initial investment in the corporation is a present fact that any prospective creditor can establish, without elaborate negotiation and drafting, by simply requesting information from the corporation. Each long-term creditor is in as good or better position than the courts to evaluate whether this level of investment is adequate to ensure proper incentives. There does not presently exist any long-developed judicial or legislative standards as to what initial investment is enough. Nor, unlike the situation with abusive self-dealing, does an after-the-fact evaluation of conduct provide an efficient mechanism for the evolution of standards, since one can never be sure that the subsequent failure of the business resulted from a lack of incentives. This is also not a situation in which, if the creditor attempted self-protection, we would end up with a judicial evaluation of later events in any case. Accordingly, estab-
lishing that the shareholders' initial investment is satisfactory to the long-term creditor is something long-term creditors can most efficiently do for themselves. If the long-term creditors do not find this effort worth their while, neither should the courts.

What about smaller short-term extensions of credit? Here, as we discussed earlier, one might argue that owners of inadequately capitalized corporations ought to inform creditors of this status. Yet, then we must ask what are the critical financial facts short-term creditors want to know. It is extremely unlikely that short-term creditors want to know about the shareholders' initial investment in the corporation. After all, the question of whether the shareholders originally had an incentive to make responsible business decisions is rather academic to one only concerned about payment in the next thirty days.

If the shareholders' initial investment should not be the relevant criteria for inadequate capitalization as far as short-term creditors, then what should? Such creditors are concerned with the corporation's near-term ability to pay its bills. This suggests a focus on current resources and liabilities (in other words, the company's working capital), as well, perhaps, as its cash flow. Recall, however, that previously this Article speculated that short-term creditors may not be interested in any raw financial data at all, because it would generally not be efficient to spend the effort digesting such information.95 What such creditors might find more efficient to know is the owner's expectations as to their payment. Under this analysis, the relevant measure of capital is the corporation's ability to pay its short-term bills as incurred, and particularly any financial facts which suggest that the owner knew the corporation was unlikely to pay.

The notion that limited liability exists by legislative grace has validity for tort claims. Here, as we discussed before, piercing for inadequate capitalization based upon judicial views of fairness or efficiency (or, to be more precise, about the trade-offs between internalizing the costs of accidents and allowing limited liability) is appropriate. Yet, once we focus on the goal of internalizing the costs of accidents, the concept of measuring inadequate capitalization by the shareholder's initial investment still makes little sense. We do not expect corporations to pay for accident costs out of what the shareholders invested for their stock. We expect them to buy insurance (albeit, large firms might self-insure).

95 See supra text accompanying note 83.
Hence, the relevant measure is how much insurance the corporation has, not how much the shareholders invested.\textsuperscript{96}

In rebuttal, one might argue that the shareholder’s investment remains relevant because it gives the controlling shareholder an incentive to make sure the corporation has adequate insurance. This is true, but not determinative. To see why, assume we have a corporation with negligible shareholder investment, but which maintains insurance adequate to meet reasonably foreseeable levels of damages. Little would be served in this case by piercing for lack of shareholder investment if the purpose for looking to shareholder investment is to provide an incentive for adequate insurance. Conversely, suppose there was a corporation with substantial shareholder investment, but which has unreasonably small insurance coverage. The large shareholder investment should not distract the court from piercing. Of course, this discussion is somewhat unrealistic in its assumption that determining what are reasonably foreseeable damages is free from doubt. Accordingly, perhaps in a case when there is a borderline insurance policy, as in \textit{Walkovszky}, one might look to the size of the shareholder investment to see if it gave the shareholder enough incentive to adequately insure. On the other hand, what is an adequate shareholder investment is itself as much or more uncertain as what are reasonably foreseeable damages. Thus, about the best one can say is that an unarguable case of inadequate shareholder investment (the shareholder has no equity at all in the corporation) could provide some indirect evidence that a borderline insurance policy is inadequate.

This discussion suggests that the conventional wisdom not only measures the wrong thing, it also looks at the wrong time. If the corporation has allowed its insurance to lapse, the fact that it had a policy at the outset should not preclude piercing. The question is: Did the company internalize the risk of accidents into the cost of the goods or services which led to the accident? In other words, did it have insurance in effect for the activity which resulted in the injury? Similarly, the short-term trade creditor wants to know about the corporation’s current financial picture. Along the same lines, if we are using inadequate capitalization to show the abusiveness of gratuitous transfers from the corporate-

\textsuperscript{96} For a recent opinion which recognized this point see Radaszewski v. Telecom Corp., 981 F.2d 305 (8th Cir. 1992).
tion to the defendant, we need to look to the corporation’s financial state at the time of the transfer.

The commonly stated rationale for the measure-at-the- inception rule is that otherwise limited liability becomes illusory because obviously the corporation was inadequately capitalized when it failed. This rationale becomes inapropos once we reframe the inadequate capitalization issue for contract creditors as a disclosure concern (or as a matter of not making gratuitous withdrawals of corporate assets), and reframe the issue for tort victims as one of maintaining insurance. The law should not require the shareholders to treat their corporation as a black hole into which they are obligated to put unlimited funds. If, however, the corporation cannot get needed supplies, services, or other items on credit from fully informed parties, or maintain insurance policies for foreseeable injuries, it should close its doors.

Finally, the policies discussed earlier also provide a benchmark for how much “capital” is adequate. Insurance ought to cover foreseeable risks. One way to measure this is to ask how much insurance would a reasonable person seeking to protect his or her own assets from the potential tort liabilities of this business have purchased. Seen in this light, the Walkovszky court was not completely wrong to look at the insurance requirement in the vehicle code, even though the insurance requirement did not relate to any legislative policy on piercing. If the $10,000 requirement reflected a legislative assessment as to the likely extent of damages in the vast majority of auto accidents, then the court’s end result could be correct. Of course, this is a big “if,” and it would be useful to know more about how the legislature reached this figure and whether most of the auto policies sold in New York at this time had only this amount of coverage. Moreover, one should ask if cabs present significantly greater risks of going over the policy limit. Probably not, because, even if cabs might get into more accidents, it is difficult to say that they get into worse ones than other vehicles.

We might also use a reasonable person standard in the contract creditor context. Specifically, would a reasonable creditor have found the state of the corporation’s working capital important in deciding to extend the credit at issue (in other words, was this information material)? The problem here, however, is that we are dealing with a situation in which the creditor did not ask about working capital. If we are basing our analysis on fraud, it
really comes from the misrepresentation as to the controlling shareholder’s intent to perform.

More fundamentally, our rationale for looking to adequate capital in the contract creditor context was to force owners, who knew that the corporation’s financial situation made short-term credit unusually dangerous, to step forward and point this out to the creditor. If the owner did not perceive the extraordinary danger, we cannot ask him or her to point it out. True, the owner may have been unreasonable in failing to perceive the danger, and thereby negligent. Yet, we noted earlier the importance of not encouraging every muddling through small business to drown short-term creditors in data.97 Otherwise, such creditors will ignore the warnings they should heed. Hence, an approach which penalizes non-disclosure when a reasonable person would have seen the danger, even though the defendant did not, may well be counterproductive. Following this logic, capital is inadequate when the finder of fact infers from the corporation’s financial position that the controlling shareholder knew the corporation was not likely to perform contracts it was entering. As far as gratuitous transfers, one can look to the financial tests developed under the dividend and fraudulent conveyance statutes.

Finally, understanding what one means by inadequate capitalization, and why it might lead to piercing, helps clear up a question sometimes raised by writers in this area. Why should the defendant pay the entire debt owed to the plaintiff, rather than the amount by which the corporation was undercapitalized?98 To the extent inadequate capitalization refers to the lack of an initial investment by the shareholder, and the rationale is to require a “fair” sharing of risks, then the only reason for going beyond requiring the shareholder belatedly to put in adequate capital would be to punish the shareholder (perhaps for the sake of deterrence). On the other hand, if the rationale for focusing on the shareholder’s initial investment is to ensure incentives for reasonable business decisions, then one can justify going beyond making up the shortfall in initial investment on the grounds that the poor incentive structure may have contributed to the ultimate corporate failure. If the real problem is a failure to disclose the lack of capital, then the creditor can argue it would not have extended the corporation credit had it known the truth. Failure to

97 See supra text accompanying note 83.
98 See Clark, supra note 62, at 547.
have insurance coverage for reasonably foreseeable levels of damages logically leads to liability to the extent of the plaintiff's unpaid judgment, unless the plaintiff's recovery goes beyond a foreseeable level. In that case, the only way to justify liability beyond the extent of insurance the corporation should have carried would be to invoke some sort of punitive or deterrence rationale.

V
PIERCING IN THE CONTEXT OF MULTIPLE CORPORATIONS

Many piercing cases involve more than one corporation. To begin with, the controlling shareholder of the debtor corporation might be another corporation, instead of an individual. In other words, we are dealing with parent and subsidiary corporations. Alternately, we have the situation found in *Kinney Shoe, Sealand* and *Walkowszky*. In each of these cases, one individual owned a controlling interest in a number of corporations which engaged in related activities. These are sometimes referred to as “brother-sister” corporations. What, if any, impact will the presence of multiple corporations have on piercing?

Let us start with the situation in which the controlling shareholder is a corporation rather than an individual (the parent-subsequent situation). As a first approximation, we might assume that this should not make any difference at all. Rather, one can employ the same analysis for piercing against controlling shareholders regardless if such shareholders are individuals or corporations.

Some writers have asserted, however, that courts should be more willing to pierce against a corporation than an individual. The argument is that no real people face the risk of unlimited liability when the defendant shareholder is another corporation. Yet, the Thompson study found that courts actually pierced in a somewhat higher percentage of cases against individuals as opposed to corporate defendants. Moreover, courts in piercing cases tend to cite and apply prior opinions interchangeably regardless of whether the cases were against individual or corpo-

---

100 Courts pierced around 43% of the time against individuals, versus around 37% of the time when dealing with a corporation as the defendant. Thompson, *supra* note 2, at 1056 n.108.
rate shareholder defendants. Hence, whatever the merits of the argument that courts should be more willing to pierce against corporate shareholders, it seems to have fallen on deaf ears.

So, who has it right? Let us go back to our basic analysis for contract and tort creditors. The reason that the subsidiary is liable to contract creditors, and, in the absence of piercing, the parent is not, remains because this is what the parties agreed. If this agreement resulted from fraud (including perhaps undisclosed inadequate capitalization), or the parent has engaged in abusive self-dealing with the subsidiary, then there can be grounds to pierce, just as when dealing with an individual shareholder. Suppose there is no fraud or abusive self-dealing. Why should the fact that the defendant is another corporation, rather than an individual, allow the creditor to get out of the agreement to limited liability?

As to tort claims, to this point the key to our analysis has been maintaining adequate insurance to cover a foreseeable extent of damage. If a corporation owned by an individual did not, the court should pierce. Suppose a subsidiary corporation does, but faces liability for a mass tort which it did not foresee. Here the court should not pierce solely upon the justification that the liability would flow to a parent corporation rather than an individual. After all, if the extent of damage exceeded what the parent would have insured for even if it had faced the liability in the first instance, then piercing does not advance the purposes of internalizing the costs of accidents.

Our discussion so far suggests no reason to distinguish between corporate and individual controlling shareholders. What then might explain the fact that courts actually pierce less often against parent corporations? One possibility is that there is greater sophistication among management of parent corporations. This, in turn, might lead such managers to avoid quite the degree of misleading communications and abusive self-dealing as found in the small business context (or, at least, to have better documentation to meet later challenge).

There is another possibility, however, which returns us to the element of control. Unlike an individual who is a controlling shareholder, a parent corporation can only act through its personnel. Hence, it may be a difficult question in some cases as to whether personnel of the parent undertook fraudulent or abusive conduct in the scope of their employment for the parent, so as to
make the parent responsible for the conduct. The problem arises because the personnel in question can be directors, officers, or employees of both the parent and the subsidiary.

_Craig v. Lake Asbestos_\(^{101}\) provides an illustrative case. The case involves an attempt to hold an investment corporation, Charter Consolidated, liable for default judgments against another corporation, Cape Industries, in which the investment company held two-thirds of the stock. The district court found fraud or injustice based upon the activities of Cape Industries to avoid liability on asbestos claims. These claims arose out of the activities of Cape’s wholly owned United States subsidiary. Cape dissolved the subsidiary and allowed American courts to enter default judgments against itself in various suits arising out of the United States subsidiary’s asbestos sales. The plaintiffs were unable to get the English courts to enforce these judgments against Cape. Presumably because Charter Consolidated had assets in the United States, the plaintiffs attempted to pierce.

The court of appeals did not challenge the district court’s finding of fraud or injustice.\(^{102}\) Instead, it reversed due to failure to show that Charter had the requisite control over Cape.\(^{103}\) The facts of the opinion provide limited detail regarding who made the decision to dissolve the subsidiary and not to defend the suits in American courts. The district court found that Charter’s three nominees on Cape’s board were aware of the scheme to avoid liability prior to the meeting of Cape’s board which approved the subsidiary’s dissolution. Moreover, Cape’s chairman, who one supposes may have had some input into this plan, was also a director of Charter. This said, however, it is still difficult to conclude that the evidence showed Charter’s personnel, in the course of their employment for Charter rather than Cape, hatched the scheme to engage in the conduct the court condemned. At any event, the court of appeals avoided even trying to parse out this question. Instead, it wandered off into the question of whether Charter’s control over Cape reached the level of “domination.”\(^{104}\) Noting that “Charter” did not intrude into the day-to-day management of Cape, and that the two corporations maintained separate records, offices, and staffs, the court of ap-

---

\(^{101}\) 843 F.2d 145 (3d Cir. 1988).

\(^{102}\) Id. at 151 n.5.

\(^{103}\) Id. at 149-52.

\(^{104}\) Id. at 152.
peals concluded that there was no such domination.\textsuperscript{105}

Now, let us turn to the brother-sister corporation context. With respect to contract creditors, again, those who choose to do business on one particular corporation’s credit cannot, barring fraud or abusive self-dealing, go beyond that company for repayment. Nevertheless, while not altering the basic grounds for piercing, the presence of brother-sister corporations creates additional prospects for fraud or self-dealing. For example, in \textit{Sealand}, not only did the controlling shareholder withdraw funds from the debtor corporation for his personal use, he also transferred funds between various corporations he owned.\textsuperscript{106} In \textit{Zaist v. Olson},\textsuperscript{107} the plaintiff agreed to clear and grade land. He also agreed to look to one of the controlling shareholder’s corporations for payment. It turned out, however, that another of the defendant’s corporations actually owned the land which the plaintiff cleared and graded, and the debtor corporation lacked the funds to pay for the work (presumably because the debtor corporation gained no benefit from this undertaking). Not surprisingly, given this self-dealing, the court pierced.

The situation in which a number of corporations share a common office and telephone lines, or have similar sounding names, may mislead a creditor as to which company it is extending credit to. This problem could exist as well in the parent-subsidiary situation. Perhaps this could apply to the two corporations in \textit{Kinney Shoe}, since the leasing corporation had a similar name to the manufacturing corporation.\textsuperscript{108} If the plaintiff had been confused into leasing to a corporation with no assets, rather than to the manufacturing corporation, this could explain the court’s complaint about the defendant’s establishing the two corporations. The problem in \textit{Kinney Shoe} is that nowhere does the court refer to any claim, much less any evidence, that the creditor was, in fact, confused. The mere possibility of confusion should not result in piercing in favor of creditors who were not misled.

\textit{Walkovszky} brings us to consider the significance of brother-sister corporations to piercing in favor of torts claimants. Carlton was following what one might refer to as a “Titanic” strategy. Much as the designers of the famous ocean liner had divided the

\textsuperscript{105} \textit{Id.}.
\textsuperscript{106} See supra text accompanying notes 39-40.
\textsuperscript{107} 843 F.2d 145 (3d Cir. 1988).
\textsuperscript{108} See \textit{supra} text accompanying note 8.
ship into eight watertight compartments, any two of which could flood without sinking the ship, Carlton broke up his taxicab venture into ten separate corporations so that accident liability would not sink the whole business. The court decided this was irrelevant to the issue before it. Specifically, the appeal in the case arose from the trial court's granting the motion to dismiss the action against Carlton. Evidently, in what was probably a tactical decision to create a more sympathetic situation for Carlton, the other nine cab corporations, who Walkovszky had also named as defendants, did not move to dismiss the action against themselves. The court, while it did not need to reach the issue, seemed to feel that breaking up the venture in this manner provided grounds for piercing to make the other corporations liable, but held that this did not state a claim against Carlton.

In suggesting that all ten cab companies can be liable for the tort claim against one, the court followed the urging of some writers to disregard artificial divisions between separate corporate entities of what is, in effect, one enterprise or business.\(^1\) We have already addressed whether this should matter for contract creditors. At first glance, we might find it persuasive grounds to pierce in favor of torts claimants. After all, there seems to be an attempt to avoid internalizing the costs of accidents, with little offsetting social utility (save extra filing fees from forming more corporations).

A practical problem, however, is to decide when there is an artificial division of one business. Consider the situation in Walkovszky, for example. There are cab companies throughout the world who only operate one or two cabs and whose owner does not have any other cab companies. Hence, can we say that the debtor corporation in Walkovszky was just an artificially created fragment of a larger business?\(^2\)

A broader problem, however, is the risk that the court may have wandered from what it should be attempting to accomplish when piercing in favor of tort creditors. After all, forcing the sale of the twenty cabs owned by Carlton's companies is not going to help much either Walkovszky's cause or internalize accident

\(^1\) E.g., Adolf A. Berle, Jr., The Theory of Enterprise Entity, 47 COLUM. L. REV. 343, 348 (1947).

\(^2\) On the other hand, it would be interesting to know whether small cab companies often operate out of a common garage (and presumably with a common dispatcher) with other independently owned companies. Walkovszky, 223 N.E.2d at 8-9.
costs. What was needed was more insurance. Hence, if the debtor corporation was unreasonably underinsured, the court should have pierced for inadequate capitalization against Carlton. If the corporation had reasonable insurance, then Carlton’s artificial division was of little consequence.

Yet, this discussion assumes no uncertainty as to what is adequate insurance; a point we have noted before in considering the relevance of abusive self-dealing and shareholder investment to piercing for tort plaintiffs. Indeed, the court may have been too eager to compartmentalize Walkovszky’s three arguments. Both the siphoning and the artificial division of the business reduced Carlton’s incentive to purchase more insurance. In a case in which one can say with confidence that $10,000 of coverage is, or is not, enough, this would not have mattered. In a case in which we are not sure, Carlton’s conduct—particularly the division of his cabs into ten companies—is strong evidence that Carlton himself did not view the insurance as adequate for the risks of the business. This suggests that the Walkovszky court had it upside down. It should have pierced against Carlton and left the other nine cab companies alone.

This, in turn, brings us to the broader issue of determining who is the appropriate defendant when dealing with an abuse involving brother-sister corporations. The Walkovszky court appears to have felt that if the wrong involved using multiple corporations, the logical remedy was to make the other corporations liable. This may have misconstrued the wrong in the situation there. In a case in which the controlling shareholder misleads the creditor as to which corporation will be liable, or engages in abusive transactions between the brother-sister corporations, however, making the other corporation(s) liable may rectify the precise harm complained of. Should the court go beyond this to hold the controlling shareholder personally liable? The controlling shareholder cannot complain too much if, as in Zaist, the court does, since he or she mislead the creditor or caused the abusive transactions. While holding the controlling shareholder personally responsible goes beyond undoing the wrong in these cases, perhaps this is justified to achieve deterrence.

Yet, we need to ask a further question about holding brother-sister corporations liable for each others’ debts. Notice, in this case, we are not piercing against a shareholder (individual or cor-

\[111\) See supra Part IV.B-C.\]
porate). Should this matter? Recall from our discussion of the relevance of control to piercing that our goal in looking to control is to point the finger at the party who committed the fraud or wrongful act which led the court to pierce. In fact, this is typically the controlling shareholder of the brother-sister corporations, rather than the non-debtor corporations. One could argue perhaps in some cases that the controlling shareholder committed the fraud or abusive self-dealing in the scope of his or her employment for the non-debtor corporation(s). Better, one can often avoid getting into such a subtle inquiry by noting it may not matter. Among the controlling shareholder’s assets are his or her stock in the brother-sister corporations. Hence, if the court pierces against the controlling shareholder, his or her stock in the other corporations can be available to satisfy the plaintiff’s claim. If there is only one stockholder and no other creditors, then the other corporations could be dissolved or sold to pay the judgment against the controlling shareholder. Thus, there is little practical impact if, instead, the other corporations simply pay off the plaintiff’s claim.

The problem arises, however, when the brother-sister corporations have other creditors or shareholders. Making the other corporations directly liable to the plaintiff grants the plaintiff a priority over the other shareholders, and places the plaintiff on a par with the other corporations’ unsecured creditors, neither of which would be the case with a levy on the controlling shareholder’s stock.

*Sea-Land* provides an illustration. Among the corporations held liable for the plaintiff’s claim was Tie-Net. The individual defendant only owned half the stock of Tie-Net; an apparently passive investor owned the other half. While Tie-Net evidently engaged in questionable dealings with its brother-sister corporations, there was no evidence that Tie-Net had come out ahead from the debtor corporation. Moreover, in piercing, Tie-Net became liable for the entire debt, rather than just whatever unfair excess it might have received from the debtor corporation. The court’s rationale was to point to the controlling shareholder’s abuse of Tie-Net. In other words, the fact that the controlling shareholder had already victimized the passive shareholder justified somehow the further injury of allowing collection by another corporation’s creditor. Perhaps the court felt no sympathy because of the other shareholder’s neglect of the situation. We do
not know, because the court never explores why the other share­
holder remained passive, or whether this breached any sort of duty. Indeed, the court never seems to see the real issue.

Of course, piercing also can impact innocent shareholders and creditors in the parent-subsidiary situation. Indeed, it can impact the personal creditors of a controlling shareholder who is an individual. Hence, in a multi-corporation bankruptcy, the court might attempt to analyze the situation in terms of the relative equities of competing groups of claimants. One should not get too carried away with this approach, however. After all, a debtor, be it a corporation or individual, can always do things which expose the debtor to further liability and thereby prejudice the position of its unsecured creditors in a bankruptcy.

VI
PROCEDURAL ISSUES

It is well established that the law of the state of incorporation governs the internal affairs of a corporation. Does this apply to piercing? By and large, judicial opinions have given little attention to this question. For one thing, courts have often cited and applied the same general principles regarding piercing without clear delineations between different states. In addition, piercing claims typically have involved small corporations incorporated in the same state in which they are doing business and incurring liability. Still, the issue arises from time to time. When this has happened, courts usually have chosen to follow the law of the state of incorporation.

To determine what approach courts should follow, it is useful to go back to the rationales for the internal affairs rule. One rationale is shareholder choice. If shareholders do not like the laws of the state of incorporation, they do not have to invest in this corporation (or, they can discount the price they are willing to pay for the stock to offset the added risks they face from inferior state law protections). The second rationale is the practicality
problem created if corporations must comply with potentially inconsistent state law rules for their internal governance.

Do either of these rationales for the internal affairs rule apply to piercing? The shareholder choice rationale does not. Instead, because piercing involves the rights of creditors, it creates the potential for states to compete for corporate charters by establishing rules whose costs are not born either by the individuals selecting where to incorporate or by those investing in the company. Contract creditors might adjust the interest rates they charge to compensate for risks of dealing with corporations from different states with varying willingness to pierce. Yet, this ability might be more theoretical than practical. Moreover, tort victims cannot make such adjustments. This strongly suggests that the internal affairs rule is inappropriate for piercing.

What about concerns over imposing inconsistent state rules for corporate governance? Here, one must look at the specific grounds for piercing. For example, to the extent the ground involves dealings between the controlling shareholder and the creditor (fraud), there seems to be little objection to inconsistent standards. Each state ought to be able to control specific business transactions within the state. A more persuasive case for a single standard exists for piercing based upon abusive self-dealing, inadequate capitalization, or (if one insists) failure to follow formalities. Even here, however, we will not be dealing with a situation (which might exist for some other issues in corporate governance) in which one state could command actions that another prohibits.

Another problem in choice of law occurs when the piercing claim involves liability under a federal statute. This problem has arisen with greater frequency in recent years, especially for liability imposed under CERCLA.\textsuperscript{116} In dealing with federal statutes, it is useful to start by separating out the question of who the statute imposes direct liability upon, from the question of whether to pierce in order to extend one corporation's liability to its controlling shareholder. For example, CERCLA imposes liability upon an "operator" of a facility releasing hazardous substances. Courts have interpreted the term "operator" to include a person (including a parent corporation) who controls the activities of a company which operates the facility in question. By contrast, courts have held that liability under CERCLA as an "owner" of

a facility releasing hazardous substances rests only with the corporation owning the facility—unless there are general grounds to pierce the corporate veil.\footnote{E.g., Lansford-Coaldale Joint Water Auth. v. Tonolli Corp., 4 F.3d 1209 (3d Cir. 1993).}

Piercing the corporate veil for CERCLA or for liability under other federal statutes, in turn, creates the question of whether to look to state law piercing standards or to develop a federal approach. Generally, the federal courts have opted for the latter.\footnote{E.g., United States v. Pisani, 646 F.2d 83, 87 (3d Cir. 1981).} This seems appropriate if, as discussed earlier, piercing should depend upon the underlying policies behind the type of liability.

Beyond the question of whose law to apply, there is the question of who decides whether the grounds exist to pierce. Specifically, is this a factual issue for a jury to resolve or an equitable evaluation for the trial court judge? Courts in different jurisdictions are in disagreement on this question.\footnote{Compare Castleberry v. Branscum, 721 S.W.2d 270, 277 (Tex. 1986), with Kinney Shoe Corp v. Polan, 939 F.2d 209, 211 (4th Cir. 1991).} There are obvious reasons for discomfort with leaving the matter to a jury when piercing results from the application of multiple factors of indeterminate weight or from some intuitive sense of inequitable conduct—albeit one might question whether trial court judges are going to do much better. On the other hand, if piercing should result from some relatively specific conduct—fraud, abusive self-dealing, inadequate insurance to meet foreseeable tort recovery—then there is no reason that the jury cannot find the specific factual predicates which would justify piercing (such as whether the defendant knew the corporation could never perform a contract when it entered it).

VII

PIERCING IN SPECIAL CONTEXTS

Most piercing cases involve disregarding the separate entity status of a corporation in order to impose liability for the company’s debts on its shareholders. Sometimes, however, courts must decide whether to disregard the separate entity status of a corporation for other purposes.

One common context in which this occurs is when a party forms a corporation with the hope of gaining an advantage under a statute or contract, which the party would not gain if he or she
acted as an individual. For example, suppose an individual enters a covenant not to compete. Can the individual set up a corporation and have the corporation go into competition against the beneficiary of the covenant? 120

This general sort of issue arises frequently in dealing with tax and employee benefit statutes. It is sometimes the case that individuals who are employees will qualify under statutory social welfare schemes (such as unemployment compensation, social security retirement, and disability benefits) or for tax-advantaged fringe benefits (such as retirement plans and health insurance) which would not be available, or available to the same extent, for those who are self employed. Hence, it is tempting to set up a corporation whose principal employee is its owner. 121 Alternatively, the existence of a progressive income tax rate structure might lead an owner to conduct a business through a number of corporations in order to split up income and thereby have more income taxed at the lower rates.

These sort of cases explain why some formulations of the criteria for piercing speak of “fraud, wrong, or violation of a statutory or other legal duty.” 122 Nevertheless, the factors we examined for piercing in the liability context are not particularly relevant in these statutory and contractual contexts. Instead, a better analysis might focus on interpreting whether the statute or contract is meant to cover the situation at hand. Ultimately, as experience shows the potential for unintended use of the corporate form, legislatures have redrafted statutes, and parties have drafted contracts, to clarify their application to corporations in potentially abusive situations. 123

Another problem regarding the separate entity status of corporations involves jurisdiction. The activities of subsidiary corporations in a state may give the state a basis for asserting personal jurisdiction over the parent corporation. 124 However, we shall leave this question to works on civil procedure.

Finally, sometimes it is the shareholder (or a creditor of the shareholder) who seeks to have the court disregard the separate entity status of a corporation. For example, in one case, a hus-

---

120 See, e.g., Hirsh v. Miller, 167 So.2d 539 (La. App. 1964).
121 See, e.g., Stark v. Flemming, 283 F.2d 410 (9th Cir. 1960).
122 See supra text accompanying note 29.
124 See, e.g., Quarles v. Fuqua Indus., 504 F.2d 1558, 1561 (10th Cir. 1974).
band and wife placed their farm in a corporation. After both the corporation and the couple suffered a judgment against them, the couple sought to claim a homestead exemption in the farm. Since only individuals were entitled to such an exemption, this meant disregarding the fact that the couple owned a corporation which owned the farm. This is sometimes referred to as “reverse piercing.” While in this case the court was willing to reverse pierce, needless to say, there is often great resistance to allowing individuals to seek the advantages of corporate status and then to ask the court to disregard the corporation whenever the choice turns out to be a mistake.

**Conclusion**

Ultimately, it is possible to make sense out of the area of piercing. It just takes work to carefully integrate broad policy concerns with specific grounds for piercing. Specifically, one must always focus on the reasons why the corporation was liable to contract creditors or tort victims in the first place. For contract creditors, corporate liability is what the parties agreed; for tort victims the goal of liability is to internalize accident costs. Accordingly, piercing in favor of a contract creditor should require grounds to let the creditor out of its agreement to look only to the corporation. This means either fraud or the failure to live up to implied terms governing the controlling shareholder’s dealings with corporate assets. Inadequate capital—in this case working capital—largely assumes a subordinate role as a means to show that promises of corporate performance were fraudulent given the owner’s knowledge that the corporation could not perform. The key to internalizing accident costs is insurance. Hence, lack of insurance to cover reasonably foreseeable risks provides the primary grounds to pierce in favor of tort claimants.

---

125 See, e.g., Cargill, Inc. v. Hedge, 375 N.W.2d 477 (Minn. 1985).