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LIMITED LIABILITY AND CREDITORS' RIGHTS: THE LIMITS OF RISK SHIFTING TO CREDITORS

Frederick Tung[*]

I. INTRODUCTION

In this Symposium, we were asked to identify and articulate the nature of our passion for teaching corporate law. My passion—a bit odd in this context, perhaps—is bankruptcy. In addition to teaching the basic Corporations course, I also teach Corporate Reorganization and Bankruptcy, and my research has focused primarily on corporate reorganization issues. As I say, my particular passion may seem out of place in the context of this Symposium. The corporation is an engine for maximizing wealth. Yet we bankruptcy types obsess about financial ruin. We pray for the next recession. We sell short. Our chips sit on the "Don't Pass Line."

Given these proclivities of mine, it should not surprise that when I teach limited liability and veil-piercing, I see debtor-creditor law in the background. After all, they say when you have a hammer, everything looks like a nail. Veil-piercing fights arise only in the context of corporate financial distress, a fact that distinguishes veil-piercing from the bulk of corporate law. Most of corporate law focuses on relations among managers and shareholders, and disputes arise in times of corporate health as well as in times of distress. By contrast, limited liability and veil-piercing involve relations between the corporation and its participants, on the one hand, and creditors on the other, with corporate financial distress as the backdrop for disputes. On occasion, the party challenging the corporation's limited liability is a bankruptcy trustee.[1] You can perhaps sense my glee when we arrive at this part of the syllabus.

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[1] *See, e.g.*, Bartle v. Home Owners Coop., 127 N.E.2d 832, 833 (1955) (reporting veil-piercing suit by trustee of bankrupt subsidiary against parent corporation).

The relation between veil-piercing and debtor-creditor law is not intuitively obvious to students. Limited liability is a fundamental *corporate* characteristic, traditionally presented as one of four defining features of corporations—along with separate and perpetual existence, centralized management, and free transferability of interests.[2] Consistent with this defining aspect of limited liability, veil-piercing and other limited liability issues typically appear fairly early in the casebooks.[3] The scope and limits of limited liability are among the first things students learn about corporations. This is "bread-and-butter" corporate law.

In my teaching approach, I show that veil-piercing belongs not only to the domain of corporate law but also to the realm of debtor-creditor law. I use concepts of risk to show the relation between veil-piercing and other debtor-creditor rules. Limited liability rules affect the structuring of relations—that is, allocations of risk—between corporate debtors and their creditors. As such, these rules are a species of debtor-creditor law. I use the law of fraudulent transfer to illustrate this kinship between veil-piercing and traditional debtor-creditor rules.[4] Related to this risk-based approach is the idea that—perhaps counter to the initial intuitions of most students—debtors as well as creditors benefit from rules limiting borrowers' *ex post* ability to shift risks to creditors. Credit markets adjust to legal rules. Reduced risk to creditors translates into lower borrowing costs overall. This approach to teaching limited liability and veil-piercing serves as a useful vehicle for introducing not only theoretical questions but also basic financial concepts with which law students are typically unfamiliar.

This Essay is organized as follows. In Part II, I describe the risk-shifting function of limited liability and my teaching approach. Part III begins the discussion of limits to risk shifting. It introduces veil-

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[2] *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 74 (7th ed. 1995) (describing corporation's defining features); LEWIS D. SOLOMON ET AL., CORPORATIONS, LAW AND POLICY, MATERIALS AND PROBLEMS 1 (3d ed. 1994) (describing same); LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS, EXAMPLES AND EXPLANATIONS 3 (2d ed. 1994) (describing same).

[3] CARY & EISENBERG, *supra* note 2, at 111; SOLOMON ET AL., *supra* note 2, at 328.

[4] This idea originated with Dean Robert Clark's foundational work on corporate debtors. *See* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977) (noting relation between veil-piercing and debtor-creditor rules).

piercing and describes why veil-piercing is consistent with a hypothetical contract rationale for limited liability. In Part IV, I introduce the law of fraudulent transfer. I show its kinship with veil-piercing rules and compare and contrast the two. Throughout the Essay, I include questions I pose in class in order to drive class discussion. Also for purposes of discussion, I focus primarily on the closely held corporation, the context in which most veil-piercing issues arise.[5]

II. LIMITED LIABILITY AND EFFICIENT RISK SHIFTING TO CREDITORS

Because veil-piercing cases arise only in the context of financial distress, students tend to view limited liability rules from an *ex post* perspective. They focus only on the parties to particular disputes. From that perspective, limited liability appears to be a device that encourages business activity by forcing creditors to subsidize it. To wit, creditors are left with the losses when a corporation fails. A successful veil-piercing action is then simply judicial intervention to remedy abusive situations. Limited liability is pro-corporation; veil-piercing is pro-creditor.

Happily though, not all corporations fail. While veil-piercing is the single most litigated area of corporate law,[6] the litigated outcomes capture only after-the-fact loss allocation and damage control. Court decisions do not provide a complete picture of limited liability's effects on the behavior of creditors and their corporate

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[5] Successful veil-piercing actions almost always involve either close corporations—in which a relative handful of shareholders also run the business, serving as corporate officers and directors—or corporate groups. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) [hereinafter Thompson, *Empirical Study*] (providing empirical analysis of factors courts consider in veil-piercing cases). For simplicity of exposition, I assume a complete overlap between shareholders and managers. There are no passive investors. I therefore refer to these beneficiaries of limited liability as "insiders." As a practical matter, passive investors seem not to be at great risk of personal liability from veil-piercing. *Id.* at 1056. For a discussion of the effect on limited liability of "unpacking" these various functions, see Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 6 (1994) [hereinafter Thompson, *Unpacking Limited Liability*] (noting that reach of limited liability differs as among shareholders, officers, and directors).

[6] Thompson, *Empirical Study*, *supra* note 5.

borrowers. I try to get students thinking about the *ex ante* effects of limited liability rules. I suggest that veil-piercing doctrine may be something more than simply a collection of *ex post* judicial attempts to balance the competing interests of corporate creditors and corporate insiders. I suggest that limited liability and veil-piercing rules form a unified whole, a sensible mechanism to govern relations between corporate debtors and their creditors.

The fundamental theme is that credit markets react to legal rules. Limited liability shifts risk to creditors, but creditors can respond *ex ante.* We discuss the perspective of creditors generally, not just those caught in litigation over the limits of limited liability. We consider *ex ante* effects of the rules on creditor behavior and on corporate borrowing costs.[7]

In this Part, I focus on limited liability and why it might make sense. I introduce some fundamental concepts: (i) the relation between risk and return; (ii) the idea that some parties may be superior to others at bearing risk; and (iii) that it makes sense to set default rules to minimize transaction costs. I begin the discussion with financial creditors. I then address other, less sophisticated creditors and involuntary creditors. In the next Part, I take up veil-piercing, showing that it places a sensible limit on limited liability.

A. RISK, RETURN, AND RISK BEARING

Many students probably have not given much thought to how banks and other lenders set interest rates. They need a little prodding to understand risk and return. They see simply that limited liability forces creditors to take losses to subsidize corporate insiders' business risk-taking. This prompts my question: why do creditors *ever* lend to corporations, knowing they will not get their money back if the corporation fails? Why not simply buy government bonds—that is, lend to a riskless borrower? Or why not lend only to individuals doing business with unlimited liability? The

[7] The question of *ex ante* effects of debtor-creditor rules is a major theoretical question being debated among bankruptcy scholars. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms,* 108 YALE L.J. 573 (1999) (describing competing sets of axioms at work in corporate reorganization scholarship).

answer, of course, is that risky loans reap higher rates of interest.[8] Creditors will lend into risky situations, but not for free. They will demand a return commensurate with the risk undertaken.[9] The interest rate is simply the cost of renting money, and for a higher risk of default, the creditor will demand higher rent to reflect the possibility of loss.[10]

With this risk-return idea in mind, I turn next to the corporate insiders' perspective. If the bank charges a premium to corporate borrowers in response to limited liability, why do insiders willingly pay this higher rate—indirectly through the corporate borrower—in exchange for their limited liability? Presumably, the firm could obtain a lower interest rate were it not incorporated, and insiders assumed unlimited liability.

Well, insiders generally do not relish the thought of losing *everything*. While they may generally be optimistic about their business prospects,[11] they would rather not put their entire personal wealth at the risk of the business. They would rather incorporate and have the corporation pay the higher interest rate in return for peace of mind. From this perspective, limited liability is a sort of personal insurance policy for insiders against the failure of the business. And the incremental increase in the interest rate is simply the premium for this insurance.

Over and above insiders' financial investment in the firm, then, the bank is paid to take the risk of the corporation's failure. Why is the bank willing to take this risk, even for the higher interest? If the firm fails, insiders keep their personal wealth, but the bank may

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[8] Moreover, even for individuals operating under "unlimited" liability, their liability is limited to the amount of their wealth. No liability is truly unlimited. *See generally* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986) (considering judgment-proof individuals as well as firms).

[9] *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 153 (6th ed. 2000) (discussing risk-return relationship).

[10] I make an analogy to a car rental. If a rent-a-car company thought there were some non-trivial probability that a particular customer would not return her rented car, presumably that customer would be charged a higher rental rate to account for this risk.

[11] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) (describing individual and institutional causes of excessive optimism and overconfidence among corporate managers).

lose the full amount of its loan.[12] The corporation's owner-managers are insured against failure. Can the lender insure as well?

The bank *does* have protection against the firm's failure that functions something like insurance. First of all, the lender enjoys the same limited liability that insiders do, insofar as the lender's loss is limited to the amount of its investment in the business. Its loss is therefore capped. Second, banks make many loans. A particular loan may fail, but presumably, not all will. Banks know that there will be defaults in their loan portfolios. But if they have done their credit analysis right, the good loans will far outnumber the bad, and returns on the good loans will exceed the losses on the bad.

So with respect to a given corporate borrower, a financial creditor does have a type of insurance against the borrower's default. It is not a policy purchased from an insurance company, but a type of insurance it creates for itself. It is called diversification.[13] A creditor protects itself from the possibility of borrower default and the risks imposed by limited liability by diversifying its risk. It may, for example, allocate its loans across different industries or different regions, so that an industry-wide or region-wide downturn will not break the bank.

By contrast, corporate insiders—especially founders of businesses—may be poorly diversified. The insider makes specific, nontransferable investments of human and financial capital in her business, and, if it fails, these investments are typically difficult to recover.[14] In general, the financial creditor is likely to be better able to bear the risk of loss of its entire investment than are corporate insiders. Because the creditor is diversified and the insider is not, the latter may be more risk averse, while the former is the superior

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[12] For purposes of this discussion, I ignore the effects of the bank's institutional structure on its taste for risk. The discussion applies as readily if the financial creditor were an individual.

[13] *See* BREALEY & MYERS, *supra* note 9, at 165 (explaining that diversification reduces variability in stock portfolio, thereby reducing risk).

[14] *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 107 (1985) (noting difficulty in diversifying human capital).

risk bearer.[15] Corporate insiders would therefore generally prefer limited liability at the cost of a higher interest rate.

B. DEFAULT RULES AND TRANSACTION COSTS

There may be cases where limited liability turns out *not* to be the preferred rule for the parties. For instance, creditors may fear moral hazard from insiders' limited liability. Insured against the loss of their personal wealth, insiders in some cases may have too little incentive to be prudent in their corporate decisionmaking.[16] In those cases, limited liability would deter lenders from lending. Even if a loan is forthcoming, the rate of interest demanded might simply be too high for the likes of the corporate borrower and its insiders. What then?

Borrowers and lenders can contract around the limited liability rule. Insiders of small firms are not infrequently asked to place their personal wealth at risk along with the corporation's assets. Banks often demand personal guarantees from small business owners using the corporate form.[17] Borrowers and lenders, then, are not simply stuck with the rule of limited liability, but can contract for a different risk distribution.

Given that limited liability is only a default, could the presumption as easily be set the other way? Why not simply let the parties

[15] *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1919 (1991) ("In small closely-held firms, the firm's creditors may often be more efficient risk-bearers than the firm's individual owners."); Jonathan R. Macey, *The Limited Liability Company: Lessons For Corporate Law*, 73 WASH. U. L.Q. 433, 450 (1995) (discussing comparative risk bearing ability of small-firm creditor versus equityholder); *see also* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1630 (1991) (suggesting that even tort creditors may be superior risk bearers compared to close corporation insiders).

[16] *See* Easterbrook & Fischel, *supra* note 14, at 110 (discussing moral hazard from limited liability in close corporation context); Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 141 (1980) (noting severe moral hazard problem in small, tightly held companies).

[17] This is consistent with some commentators' view that limited liability may be inefficient for closely held corporations. *See* Easterbrook & Fischel, *supra* note 14, at 110 (noting that investor diversification and reduction in monitoring costs—advantages of limited liability for public companies—do not apply for close corporations); Halpern et al., *supra* note 16, at 148 (suggesting that unlimited liability is optimal rule for small closely held companies).

contract explicitly for limited liability if they wish, but leave general liability rules otherwise undisturbed? More generally, how do we choose between opposing default rules? How should default rules be set?

Assuming there are costs to explicit contracting, then one plausible basis for setting the default is to mimic the arrangement that most parties would generally make if bargaining were costless. To the extent that contracting costs inhibit real bargaining, a "majoritarian" default gives most parties what they would agree to most of the time for the least cost. A different default would be inefficient, forcing parties to either expend resources contracting for the desired outcome, live with a suboptimal arrangement, or not transact at all. A majoritarian default, by minimizing transaction costs, therefore facilitates more desirable transactions on the most desirable terms for the parties.[18]

Assuming, then, that most creditors and corporate borrowers prefer limited liability,[19] that should be the default rule. Explicit contracting for limited liability may be cumbersome and expensive. To duplicate limited liability by contract, insiders would need to obtain releases from all corporate creditors. Transaction costs would likely be greater than if we simply set limited liability as the default rule.[20] Economizing on transaction costs facilitates corporate debt contracts and reduces the cost of credit.

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[18] Penalty default theory provides another rationale for setting default rules. In addition to transaction costs, there may be other barriers to efficient contracting. For example, if the withholding of private information by one party is the source of inefficiency, then it may be preferable in those situations to set default rules exactly the *opposite* of what the parties would have agreed to. This approach encourages the informed party to initiate negotiation to contract around the rule, forcing disclosure of the information and more efficient contracting. *See generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (discussing utility of different default rules in different situations). For purposes of this discussion, I focus only on the transaction cost issues.

[19] I say "assuming" since in the close corporation context, this assumption may be problematic. Involuntary creditors also present problems. *See infra* 27-28 and accompany text.

[20] *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 105-06 (1991) (discussing costs of contracting for limited liability in close corporation context, and suggesting that limited liability may be efficient bargain for close corporations). This may be a closer question with close corporations than with public companies. *See supra* note 17 and accompany text.

This discussion raises another issue, however. To this point, the discussion has focused on financial creditors. Because financial creditors are typically well informed and well diversified, a hypothetical bargain approach seems to make sense. The analysis may be more problematic, however, as we consider other types of creditors.

C. REFINING THE CONTRACTARIAN RATIONALE FOR RISK SHIFTING

Some voluntary creditors have fewer self-protection mechanisms at their disposal than financial creditors. Lower-level employees and small suppliers, for example, may lack the expertise to perform credit analysis in the way financial creditors do. Their ability to assess and "adjust" to credit risk may therefore not compare to that of the financial creditor.[21] Small suppliers will typically lack the resources necessary to evaluate individual firm risk.[22] On the other hand, diversification and sufficient knowledge of its general industry might enable a supplier to charge prices that reflect its customers' default risk *on average*.[23] Employees also may not be diversified.[24] Depending on the particular employee's position, she

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[21] *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 885 (1996) (describing small voluntary creditor's incentives to remain rationally uninformed about firm's capital structure); Easterbrook & Fischel, *supra* note 14, at 113 (describing small creditor's disincentive to investigate debtor's capital). To the extent they can and do adjust to the credit risk of the corporation, employees do not charge explicit interest. Instead, they charge interest implicitly in the pricing of their services supplied to the corporation. Some suppliers take this approach as well.

[22] *See* John Hudson, *The Case Against Secured Lending*, 15 INT'L REV. L. & ECON. 47, 56 (1995) (describing bank's superior ability to determine its financial position and monitor firm as compared to trade creditors); Mark J. Roe, *Commentary on "On the Nature of Bankruptcy": Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 225 (1989) (noting trade creditors' typical lack of financial sophistication). Suppliers tend to charge uniform interest rates to all their customers buying on credit, which suggests that they do not tailor their pricing to account for individual firm default risk. *See* Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249, 2259 (1994) (noting that trade creditors do not customize terms for individual customers, but rather for industry as a whole); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1936 (1994) (noting that even sophisticated trade creditors do not charge interest rates that "anticipate [a] debtor's grant of security").

[23] Bebchuk & Fried, *supra* note 21, at 886.

[24] The degree of an employee's diversification must include consideration of her alternative opportunities in the market. Halpern et al., *supra* note 16, at 143.

also may not have the expertise or access to information necessary to gauge her employer's financial health and price her services appropriately.[25] She may be no better—and may be worse—at bearing the risk of corporate failure than corporate insiders. Therefore, it may be that the hypothetical contract she would strike with her employer would not include limited liability.[26]

What about involuntary creditors,[27] who cannot contract with the firm? For example, tort victims cannot be identified *ex ante*. They do not negotiate with—or even choose—their "borrowers." They do not engage in "credit analysis." They do not set interest rates to reflect risk or otherwise engage in *ex ante* risk allocation. For tort creditors, the hypothetical bargain approach is the most problematic. Unlike financial creditors, tort creditors cannot adjust *ex ante* to the risk of corporate failure. Limited liability therefore enables firms to externalize some of their tort costs—that is, shift them to tort victims. Firms will therefore under-invest in safety and engage in excessively risky projects.[28] And tort victims are left uncom

[25] The existence of a union may alleviate this problem somewhat.

[26] *See* Halpern et al., *supra* note 16, at 149 (proposing general exception to limited liability for employee claims). On the other hand, other arrangements like unemployment benefits may indirectly compensate employees for this financial risk.

[27] The line between voluntary and involuntary creditors is not a bright one, of course. It may be more accurate to arrange creditors along a spectrum of voluntariness. *See* Bebchuk & Fried, *supra* note 21, at 864 (describing inability of many creditors, even some voluntary creditors, to adjust terms of their credit to account for distributional consequences of secured credit); LoPucki, *supra* note 22, at 1896 n.38 (describing "reluctant" creditors, existence of which blurs line between voluntary and involuntary creditors).

[28] Easterbrook & Fischel, *supra* note 14, at 107 ("Where high transaction costs prohibit those affected by risky activities from charging an appropriate risk premium, . . . the probability that firms with limited liability will undertake projects with an inefficiently high level of risk increases."); Hansmann & Kraakman, *supra* note 15, at 1882-83.

Some commentators have asserted that no significant barriers exist to prevent optimal contracting between consumers and manufacturers in product markets. These commentators maintain that consumers possess sufficient information to assess product risk, so that the content of product warranties should be determined by markets—and not by courts or regulators. *See generally* Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 MICH. L. REV. 683, 713 (1993) (discussing debate over traditional assumptions underpinning strict liability). Adoption of this view might presumably also hold that consumer choice concerning manufacturers' limited liability should also be respected, and therefore that a hypothetical bargain rationale for limited liability also applies to products liability claimants, who voluntarily purchased corporate manufacturers' products. Put differently, the manufacturer's creditworthiness is viewed simply as one component of its warranty.

This discussion takes us a bit afield from the scope of what might plausibly be covered pensated for the risks they bear. There may be other justifications for limited liability as to involuntary creditors, but the majoritarian default analysis does not apply neatly to them.

Limited liability might still be the optimal rule. Overall, the benefits of limited liability—for example, facilitating public securities markets and investor diversification—may outweigh its costs, including the costs of externalized tort risk.[29] But this issue is hotly contested.[30] In any event, this rationale is a bit different from the hypothetical contract analysis with which we began the discussion.

Having simply highlighted the complexities of a hypothetical contract approach for different types of creditors, I do not attempt to resolve them here or in class discussion. For the balance of the discussion, we will rely on financial creditors as our paradigmatic voluntary creditors and continue with our hypothetical bargain approach.

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in a class discussion on limited liability, and so for present purposes, I assent to the traditional view that consumers and other potential tort victims are not in a position to make informed choices on these issues.

[29] In addition, while limited liability enables externalization of risk to tort creditors, other arrangements may also exist to minimize this effect. To the extent that a corporation has financial creditors, who typically impose financial and other restraints on the borrower and monitor compliance, other creditors enjoy something of a free ride. Thompson, *Unpacking Limited Liability*, *supra* note 5, at 37. Financial creditors will have some incentive, for example, to monitor the debtor's potentially hazardous activities. Therefore, while other creditors may not have the same facility at tailoring credit terms to a given borrower's risk profile, they are also not entirely at sea. In addition, managers with firm-specific investments of human capital at stake will have some incentive to insure. The insurer provides both a source of payment to tort victims and a monitor of the firm's risky projects. *See* Easterbrook & Fischel, *supra* note 14, at 104-07 (describing managers' incentives to insure and insurer's role as contract creditor).

[30] *Compare* Hansmann & Kraakman, *supra* note 15, at 1907 (advocating pro rata shareholder liability for tort obligations); Leebron, *supra* note 15 (questioning limited liability for tort obligations and suggesting pro rata shareholder liability may be more efficient) *with* Thompson, *Unpacking Limited Liability*, *supra* note 5, at 37 (arguing that because nonlegal constraints reduce externalization to involuntary creditors, limited liability should apply). *See also* ROBERT CHARLES CLARK, CORPORATE LAW 78 (1994) (suggesting insurance and tort creditor priority in bankruptcy as superior alternatives to veil piercing in favor of tort creditors).

D. SUMMARY

We have introduced students to an *ex ante* perspective—the idea that credit markets react to legal rules *ex ante*. Pointing out the relation between risk and return explains that voluntary creditors respond to higher risk by demanding a commensurate return in the form of a steeper interest rate. In addition, because voluntary creditors are generally better at bearing the risk of a given corporation's failure than are its insiders, limited liability is the right default rule. Voluntary creditors are typically diversified; corporate insiders typically are not.

On the other hand, we also note that debtors and creditors can and often do contract around limited liability. Contract creditors, corporations and insiders can tailor arrangements to suit their particular needs. A creditor may bargain for a personal guaranty or an appropriately high interest rate to reflect the risk of the creditor's investment.

In addition, we have used limited liability as a vehicle for introducing the traditional justification for how default rules should be set. The idea of a majoritarian default—that default rules should reflect the bargain that most parties would strike—is a powerful one, and it is good for students to begin to think about legal rules in this way. A majoritarian default rule saves transaction costs—and therefore more desirable transactions are facilitated—if the law provides a standard form that most parties would adopt. We also point out limits to this hypothetical contract approach with respect to involuntary creditors.

III. LIMITS OF RISK SHIFTING: VEIL-PIERCING

Having outlined the hypothetical contract rationale for limited liability, we consider the related topic of veil-piercing, which limits the risk shifting to creditors that may be accomplished through limited liability. Should there be limits to insiders' ability to shift risk to creditors? If so, what should those limits be?

Once credit has been extended, the corporation's owner-shareholders will have incentive to engage in activities riskier than the creditor would prefer. That is because the shareholders enjoy unlimited upside if a risky project succeeds, but their downside—thanks to limited liability—is limited to the amount they have invested in the firm. Creditor returns, on the other hand, are fixed. They do not share in any upside beyond their agreed interest and repayment of principal. Shareholders enjoy the rest. On the downside, the creditor stands to lose its entire investment in the firm if corporate assets turn out to be insufficient to make repayment.

When the downside comes to pass, what circumstances, if any, might justify *ex post* exceptions to limited liability? Piercing the corporate veil allows a creditor to reach insiders' personal assets in satisfaction of a corporate debt, in effect granting an exception to insiders' limited liability for the benefit of the creditor. As with the discussion of limited liability, we consider not only after-the-fact loss distributing effects of veil-piercing, but also its *ex ante* effects on the structuring of corporate debt transactions.

Why *ever* pierce the veil for contract creditors? Does not the creditor assume the risk of not getting paid? Has that creditor not bargained for whatever package of protections it holds and whatever risks are left to it? This inquiry forces us to think about different types of risk and to distinguish among them. The contract creditor can be said to have assumed some risk of business failure. Financial creditors have well-developed tools for this sort of credit analysis. Veil-piercing, however, requires something more than simple business failure. It typically requires something approaching fraud.[31]

The legal rules *could* be set in a way that initially places fraud risk on creditors and allows them to contract around that risk if they desire. How would that default rule affect the costs of credit? It would raise costs for everyone.

Fraud risk is a difficult risk for creditors to analyze. Most creditors would insist on contracting around that default rule.[32] In

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[31] *See* Easterbrook & Fischel, *supra* note 14, at 112 (describing fraud basis for veil piercing); Thompson, *Unpacking Limited Liability*, *supra* note 5, at 9 ("Courts generally refuse to impose liability on shareholders unless they have control of the corporation and there has been some misuse of the corporate form, such as fraud, undercapitalization, or intermingling of corporate and individual transactions.").

[32] Any that did not would insist on higher returns overall to compensate for fraud risk.

addition, forcing the parties expressly to contract for a fraud exception to limited liability may be costly. How would such a provision be drafted? The vagueness of veil-piercing doctrine—which frustrates students and commentators alike[33]—may give us some notion of the difficulty of specifying *ex ante* what sort of behavior is undesirable.[34] Such a contract provision might also be costly to monitor. Moreover, the contractual solution creates only a breach of contract claim, which requires a specific showing of damages by an aggrieved creditor. Not only is this costly, but it also lacks the deterrent effect of veil-piercing. Assuming, in the creditor's best case, that both the corporation *and* its insiders contractually commit not to engage in specified acts of fraud or quasi-fraud, the insider has only actual damages to lose if caught breaching its promise.[35] By contrast, a successful veil-piercing action exposes the entirety of the insider's personal wealth to the aggrieved creditor's claim.

What sort of deal would we imagine that borrowers and lenders might want *ex ante*? Would borrowers and lenders in general agree, for instance, that "siphoning" behavior should not be shielded by limited liability?[36] They probably would. It is be better for everyone *ex ante* to have a rule of veil-piercing, which penalizes an insider for inequitable conduct toward creditors. This rule enables corporate borrowers to credibly commit not to defraud creditors, thereby lowering risk to lenders, as well as lowering contracting and monitoring costs. Therefore, veil-piercing rules will lower the costs

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[33] *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983) (decrying veil-piercing decisions as jurisprudence by epithet).

[34] *See infra* notes 49-50 and accompanying text.

[35] If only the corporation were bound to the anti-fraud proscriptions, that commitment would likely be worthless to the creditor. The corporation's breach would most likely occur in the context of financial distress, leaving the creditor with only a breach of contract claim against a judgment-proof company.

Setting the default rule in this way would also forego whatever positive norm-generating effect the legal rule may have. That is, specifying penalties for fraud enforces a norm against fraud, whereas a rule that requires creditors explicitly to contract for the borrower's commitment to refrain from fraud may suggest that no anti-fraud norm exists but is instead merely a matter for private ordering. Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

[36] See *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976), discussed *infra* Part IV.C.*1*.

of credit for borrowers generally. Moreover, if we return to our insurance analogy,[37] limited liability to commit fraud is probably more insurance than most insiders would willingly pay for *ex ante.* The insurance premium would likely be steep, such that most insiders would opt out of that coverage.

Without the veil-piercing rule—as well as the possibility of additional sanctions for civil and criminal fraud—a "lemons" problem might arise in the credit markets.[38] If creditors cannot discern honest corporate borrowers from those who might fleece them, creditors must charge an average price for credit that incorporates the possibility of bad borrowers. But honest borrowers, unwilling to pay this higher average price, will be driven from the market, leaving only the bad corporate borrowers. The market then implodes, since creditors will be unwilling to lend into a market of bad corporate borrowers whose insiders are protected by limited liability.

Veil-piercing, then, is consistent with the goal of maximizing the mutual interests of creditors and their corporate borrowers. Veil-piercing rules, like limited liability in general, are a sensible part of the standard form contract between corporate borrowers and their creditors. Limits to limited liability make sense.

IV. LIMITS OF RISK SHIFTING: FRAUDULENT TRANSFER

To this point, the discussion has fallen squarely within the domain of corporate law. Veil-piercing and limited liability are fundamental elements of the basic Corporations course. I next introduce the law of fraudulent transfer. I compare and contrast it with veil-piercing rules. I draw parallels between the two, showing their kinship as rules governing debtor-creditor relations. Both effectively limit debtor risk shifting to creditors. As with veil-piercing, fraudulent transfer law constrains debtor behavior *ex post,* but its existence benefits both debtors and creditors *ex ante.*[39]

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[37] *See supra* text accompanying note 11.

[38] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q. J. ECON. 488 (1970).

[39] As with the preceding discussion, I focus primarily on the close corporation context. *See supra* note 5 and accompanying text.

A. THE DOCTRINE

I start with a thumbnail sketch of the doctrine. Fraudulent transfer law has two components. One addresses actual fraud. The other addresses constructive fraud.

1. Actual Fraud. Fraudulent transfer law responds to a classic human instinct—the instinct for financial survival. When the debtor is hopelessly mired in debt and has defaulted on multiple obligations, the creditors close in, intent on seizing the debtor's assets in satisfaction of their debts. In the face of this pursuit, the debtor may respond with evasion. She has no interest in being a sitting duck. Despite her debt obligations, she is reluctant to part with her assets. She will not wish to leave them readily available for creditor seizure. Instead, she squirrels them away. She hides them.

Or she may strategically transfer her assets. She may give them to friends, with the understanding that she will retrieve them later when the coast is clear. She may give them to relatives for safe-keeping. These transfers are problematic, however, because they work an intentional fraud on creditors. A transfer that is intended to hinder, delay or defraud creditors in their collection efforts is avoidable as a fraudulent transfer.[40] The Uniform Fraudulent Transfer Act (UFTA) enables creditors to set aside such transfers. A creditor may ignore the fraudulent transfer and pursue the debtor's transferred asset in the hands of the transferee, as though no transfer had occurred.[41] The UFTA provides a helpful list of "badges of fraud," which serve as useful indicia for determining whether the debtor-transferor acted with the requisite fraudulent intent.[42]

2. Constructive Fraud. The fraudulent transfer rules also catch constructively fraudulent transfers, for which no proof of bad intent

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[40] UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1) (1984) [hereinafter UFTA].

[41] UFTA § 7.

[42] Factors suggesting the requisite intent include the fact that the transfer was to an insider, UFTA § 4(b)(1); that the transfer was concealed, *id.* § 4(b)(3); that before the transfer was made the debtor had been sued or threatened with suit, *id.* § 4(b)(4); that the debtor was insolvent after the transfer was made, *id.* § 4(b)(9); and that the transfer occurred shortly after a substantial debt was incurred, *id.* § 4(b)(10). For the classic case applying the "badges of fraud" analysis, see *Twyne's Case*, 76 Eng. Rep. 809 (Star Chamber 1601).

or evil motive is required. Instead, proof of constructive fraud requires simply that the debtor transferred an asset (a) for less than its reasonably equivalent value, (b) while the debtor was insolvent.[43] Creditors can seize assets in the hands of the debtor's transferees if and to the extent the debtor failed to obtain reasonably equivalent value and was in financial distress at the time of the transfer.[44] In essence, the debtor may not give away an asset if that transfer impairs her ability to repay her debts.

B. MORAL AND CONTRACTARIAN UNDERPINNINGS

Historically, fraudulent transfer law carried moral overtones. Developed under English common law and codified in The Statute of Elizabeth in 1571,[45] it was partly a criminal law,[46] while also providing revenue for the Crown and a measure of protection for creditors.[47] Even constructive fraud, while requiring no explicit proof of bad intent or evil motive, may simply be—at least in part—a surrogate for actual fraud, providing a per se rule that is less costly to prove than actual fraudulent intent.[48]

Besides the moral overtones, however, fraudulent transfer law probably also reflects a majoritarian rule. Why? Would debtors and creditors generally agree to it *ex ante*? Very probably.[49] Creditors

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[43] UFTA § 5(a). Constructive fraud is also available if the transaction is for less than reasonably equivalent value and (a) leaves the debtor's business with unreasonably small assets, *id.* § 4(a)(2)(i); or (b) if the debtor intends to or believes she will incur debts beyond her ability to pay as they become due, *id.* § 4(a)(2)(ii).

[44] *See* UFTA § 8 (describing available transferee defenses and offsets).

[45] 13 Eliz., ch. 5 (1571) (Eng.); *see also* 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 58-62 (rev. ed. 1940) (analyzing Statute of Elizabeth).

[46] *See id.* § 61b (describing imprisonment for fraudulent transfer).

[47] One-half of the property transferred belonged to Crown. *Id.*

[48] Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 831 (1985); Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C.L. REV. 1165, 1167 (1995).

[49] "Fraudulent conveyance law . . . should be viewed as a species of contract law, representing one kind of control that creditors generally would want to impose and that debtors would generally agree to accept." Baird & Jackson, *supra* note 48, at 836; *see also* Clark, *supra* note 4, at 544 (noting reduced bargaining costs from default rule); Zaretsky, *supra* note 48, at 1170 (noting same). Moreover, rules against fraudulent transfer may be more than just defaults, insofar as there is no "opt-out" provision. The nature of the remedy also suggests something more than a take-or-leave default provision. *See infra* notes 52-53 and accompanying text.

would generally be unwilling to assume the risk of the debtor's fraudulent transfers. Moreover, as in the veil-piercing context, requiring explicit contracting against fraud would be expensive. The range of debtor behavior intended to be proscribed would be quite broad,[50] and drafting proscriptions both detailed and complete would be a formidable task. Instead, a state-supplied contract term solves an incomplete contracting problem, protecting creditors from particular types of risk-increasing transactions by debtors.

In addition, as with veil-piercing,[51] fraudulent transfer law provides the aggrieved creditor with more effective relief than the simple contract damages remedy. The damages remedy is not useful in the face of the breaching party's insolvency. Besides suing the debtor-transferor, the creditor is entitled to pursue the asset in the hands of the transferee.[52] The creditor's right to the asset is in effect protected by a species of property rule.[53] The creditor is entitled to *undo* the debtor's harmful act and not merely claim damages against the debtor in financial distress. This property rule protection enables a debtor to credibly and inexpensively commit *ex ante* to refrain from certain transfers that impair its ability to repay its debts.

By enabling this credible commitment, fraudulent transfer law, like veil-piercing, protects debtors as well as creditors. It lowers bargaining costs by supplying majoritarian terms. It lowers monitoring costs with its property rule remedy. It lowers the costs of credit overall, and without it, "[e]x ante the volume of loans would

[50] "The range of potential debtor misconduct is virtually limitless." Zaretsky, *supra* note 48, at 1170.

[51] *See supra* note 35 and accompanying text.

[52] *See supra* note 41 and accompanying text. Moreover, the first transferee is liable, even despite her good faith, unless reasonably equivalent value was given. A subsequent transferee may also be liable absent the giving of value in good faith. UFTA § 8.

[53] *See* Susan Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931, 950 (1985) (noting property-rule nature of fraudulent transfer law). In their classic article, Calabresi and Melamed distinguish property rules–rules that strictly protect rights by resort to injunctive relief—from liability rules, which only provide monetary damages. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

be inefficiently low and interest rates inefficiently high to take account of this possibility of hiding assets from creditors."[54]

C. WHY VEIL-PIERCING?

Veil-piercing and fraudulent transfer law, then, each provide limits on borrower risk-shifting to creditors. Both limit debtors' *ex post* liability avoidance maneuvers, but the limitations are of the sort that debtors and creditors would generally agree to *ex ante.* Also, as discussed below, the doctrinal requirements of these two areas of law overlap to some degree. Fraudulent transfer law, however, existed several centuries before general limited liability corporations came into being.[55] If we already have fraudulent transfer law, what do veil-piercing rules add?

This discussion presents students with yet another layer of complexity. The discussion further refines their appreciation of veil-piercing as a sensible addition to the rules governing debtor-creditor relations.

1. Doctrinal Overlap. Others have noted the doctrinal overlap between fraudulent transfer law and the rules of veil-piercing.[56] In particular, insiders' inequitable conduct and inadequate capital or insolvency are factors in both. Consider a particular case, *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*[57] Defendant Flemming was the dominant shareholder-owner of his corporation, which acted as a commissioned agent for fruit growers. The corporation sold fruit for growers, remitting sale proceeds to the growers less amounts for sales commission and transportation charges. The trouble was, instead of actually paying the transportation charges, the corporation kept the money. Whatever cash was in the corporation, Flemming would take for his own personal use. "[I]t would seem that Flemming's withdrawals varied with what

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[54] Rose-Ackerman, *supra* note 53, at 950. In addition, this creditor protection improves debtors' liquidation values, thereby also increasing their debt capacity. J.B. Heaton, *Debt Capacity and Fraudulent Conveyance Law,* Social Science Research Network Working Paper Series, Aug. 1998, *available at* <http://papers.ssrn.com/paper.taf?ABSTRACT_ID=85328>.

[55] *See* Halpern et al., *supra* note 16, at 117 (dating general availability of limited liability corporations to English Limited Liability Company Act in 1855).

[56] Clark, *supra* note 4, at 540.

[57] 540 F.2d 681 (4th Cir. 1976).

could be taken out of the corporation at the moment: If this amount were $15,000, that was Flemming's withdrawal; if it were $25,000, that was his withdrawal."[58] Moreover, these withdrawals–claimed salary payments—approximated the amounts owing for transportation charges.[59] The corporation had virtually no capital and apparently had never turned a profit.[60] It had never held a board meeting or shareholders' meeting.[61] When pressed by the plaintiff trucking company for payment, Flemming promised to make good on the obligations personally if the corporation failed to pay.[62] On these facts, the court pierced, finding that the corporation was merely Flemming's "instrumentality" or "alter ego."[63]

Would fraudulent transfer law have provided effective relief for the plaintiff creditor? Could Flemming have been liable for fraudulent transfer claims in addition to or instead of the veil-piercing claim? Probably so. While the facts of the opinion are not styled to a fraudulent transfer analysis, we may surmise that many of the transfers were actually fraudulent. The transfers were to an insider;[64] they may have been concealed;[65] the transfers were made while the debtor was insolvent;[66] and they may have been made shortly before or after substantial debts were incurred by the corporation.[67] Constructive fraud claims would likely also have been

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[58] *Id.* at 688.
[59] *Id.* at 689.
[60] *Id.* at 688.
[61] *Id.*
[62] *Id.* at 689.
[63] *Id.* at 688.

> [U]ndercapitalization, coupled with disregard of corporate formalities, lack of participation on the part of other stockholders, and the failure to pay dividends while paying substantial sums, whether by way of salary or otherwise, to the dominant stockholder, all fitting into a picture of basic unfairness, has been regarded fairly uniformly to constitute a basis for an imposition of individual liability under the doctrine.

Id. at 687.

[64] *Id.* at 688; *cf.* UFTA § 4(b)(1) (noting insider transfer as factor to consider in determining actual fraudulent intent).

[65] *Cf.* UFTA § 4(b)(3) (noting concealed transfer as factor to consider).

[66] *DeWitt*, 540 F.2d at 688; *cf.* UFTA § 4(b)(9) (noting debtor's insolvency as factor to consider).

[67] *Cf.* UFTA § 4(b)(10) (noting incurring of substantial debt shortly before or after transfer as factor to consider).

available. While Flemming claimed his withdrawals were salary payments, this assertion lacks credence given his pattern of merely zeroing out the corporation's available cash. The transfers certainly left the corporation insolvent, and given that the siphoned amounts bore no relation to any particular consideration given by Flemming, a failure of reasonably equivalent value was likely involved.

Quite probably, then, *DeWitt* could have been brought as a fraudulent transfer action. The same is likely true for many other veil-piercing cases.[68] Are there differences between these two areas that explain why both sets of rules exist? The facts of *DeWitt* may give us a clue.

2. A Rifle v. A Shotgun. One plausible explanation for veil-piercing is that fraudulent transfer law may not be sufficiently creditor-protective in a modern economy with corporate actors. Fraudulent transfer rules evolved at a time when most economic actors were individuals, and transactions were fairly simple. The advent of corporations, however, enabled complex paper transactions among corporate insiders and affiliates, thereby multiplying the ways in which creditor pursuit of debtor assets could be frustrated.[69] Fraudulent transfer law essentially takes a rifle shot approach. It requires a detailed transfer-by-transfer analysis. Each specific transfer of assets from the corporation to its insider must be identified. This may not be easy, especially if—as *DeWitt* illustrates—the corporation keeps no records and fails at the basic corporate formalities.[70] Then as to each identified transfer, plaintiff has to show that reasonably equivalent value was not given to the corporation. In addition, plaintiff must show the requisite corporate financial distress at the time of each transfer,[71] again a perhaps daunting task for an outsider to a firm with shabby record keeping.

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[68] *See* Clark, *supra* note 4, at 541 (noting that veil-piercing cases invoke fraudulent conveyance law, but courts ignore relationship).

[69] *See id.* at 543 ("The number of unfair transactions with insiders may be large and indefinite, and proof of unfairness and the extent of lack of fair consideration in each instance of a transaction may be difficult or extremely costly.").

[70] *See* Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 OR. L. REV. 853, 879 (1997) (explaining scrutiny of corporate formalities in veil-piercing actions as law's suspicion of hidden or unauthorized transactions with insiders).

[71] *See supra* notes 40-44 and accompanying text.

Because these issues are peculiarly within the competence of the insider, the various showings may be difficult for outside creditors to make.[72] At the least, investigation costs would be problematic.

By contrast, veil-piercing takes a shotgun approach.[73] The elements are more general and more vague. Particular transactions need not be identified—let alone dissected—provided that some misuse of the corporate form is shown. Consider a common scenario. In the one-person corporation of *DeWitt*, imagine the plaintiff's predicament. If the insider is regularly siphoning cash and running the corporation on zero capital, attacking this siphoning strategy via fraudulent transfer rules would require the outside creditor to investigate each transfer. Investigation would have to reveal the corporation's financial condition at the time of each transfer, and whether or not each salary claim was legitimate and reasonably equivalent in value to the particular transfer. It is unlikely that the corporation will keep good records in this classic one-person corporation scenario, if records exist at all.[74]

Veil-piercing, then, responds to proof problems peculiar to the corporate context that might frustrate a fraudulent transfer approach.[75] The remedies in the two areas differ as well. Avoidance of a fraudulent transfer restores the creditor to the position it would have been in, had the debtor not acted fraudulently. Avoidance allows the creditor to pursue the asset in the hands of the transferee. The remedy is compensatory and defensive in that it only reinstates the creditor's pre-transfer position.[76]

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[72] The creditor does enjoy a presumption under the modern statute that the debtor is insolvent if it is generally not paying its debts as they become due. UFTA § 2(b).

[73] Clark, *supra* note 4, at 547.

[74] With corporation groups, by contrast, the issues are slightly different. While the record keeping is likely to be adequate, and therefore financial condition will be more easy to determine, there is still the problem of attacking multiple transfers for inadequate consideration. Affiliate transactions are so common and may be so pervasive, and there are so many ways to shift assets among affiliates—management fees, licensing agreements, leases, etc.—that the plaintiff's proof problems concerning reasonably equivalent value may be significant.

[75] *See* Clark, *supra* note 4, at 552 (asserting that veil-piercing functions to "loosen[ ] up the level of proof and the atomistic nature of the analyses required in a fraudulent conveyance action").

[76] On the other hand, this property rule approach is better than a generic contract remedy, which ordinarily provides only liability rule protection. *See supra* notes 51-53 and accompanying text.

Veil-piercing, on the other hand, provides a fairly aggressive remedy to the aggrieved creditor. It makes available the entirety of the shareholder's personal wealth to satisfy the corporation's debt. This may result in a windfall to the creditor, who may recover more from the shareholder than it could have recovered from the corporation untainted by the objectionable conduct. The effect is punitive. Why?

One plausible explanation, consistent with the shotgun approach of veil-piercing, is that veil-piercing cases may present situations in which it is difficult to quantify the harm to a creditor from the insider's inequitable behavior. The imprecision of the approach not only captures more amorphous forms of undesirable behavior, but also causes some vagueness in quantifying the remedy. Resolving this remedial imprecision in favor of the aggrieved creditor seems reasonable. This approach may provide an important deterrent effect that helps to minimize the costs of corporate credit. A mere disgorgement remedy, by contrast, might not dissuade insiders of a corporation in financial distress.

V. CONCLUSION

Veil-piercing doctrine marks the intersection between corporate law and debtor-creditor law. It therefore provides an ideal tool for teaching fundamental economic ideas relating to debtor-creditor law. I use it for that purpose. I describe economic rationales for limited liability and its limits. I introduce fraudulent transfer law and show its parallels with veil-piercing doctrine. Students get a glimpse at debtor-creditor law, and I get a bit of marketing for my bankruptcy course.