Chapter 16

Doing the Numbers, page 475: Arrow Bar's Balance Sheet

[By the Editors]

Please see the module titled "Solving for X and Other Friends from High School."

Room to Argue, page 478: Is Limited Liability Good or Bad?

Reading One

This reading summarizes the moral hazard problem in limited liability and discusses the evidence of excess risk taking.

A CONTROL-BASED APPROACH TO SHAREHOLDER LIABILITY FOR CORPORATE TORTS
Nina A. Mendelson
102 Colum. L. Rev. 1203

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III. Excessive Risk Taking Under Limited Liability

Limited liability's moral hazard is the incentive created for corporations to engage in excessively risky activity, shifting the costs of this activity to tort and environmental victims. Much commentary has recognized the problem as a general matter. The following Sections outline the basic problem and provide some additional comments on evidence collected to date. These Sections also discuss the phenomenon of the corporation with a controlling shareholder. The corporate temptation to choose excessively risky activity will be especially pronounced when corporate equity is in the hands of a parent corporation or controlling shareholder.

A. The Basic Moral Hazard Problem

At least with respect to risky activities for which tort victims might seek to obtain legal recourse, limited liability presents an opportunity to avoid paying the appropriately-sized tort judgment. A corporation may be created or operated in a way that renders it "judgment-proof" - having only nominal assets available to pay a tort judgment. Or, a corporation simply may have inadequate assets available to fully cover its responsibility. And once the corporate assets are exhausted, the shareholder typically has no personal responsibility for the judgment except under quite limited circumstances - when the corporate veil can be pierced or when the shareholder's own conduct violates the law.

Consequently, corporate managers may select overly risky projects more often than is socially optimal. As a matter of economic theory, a shareholder will favor increases in risky activity as long as the anticipated marginal benefit to the shareholder from an increase in risky activity (for example, the present value of increase in expected dividends from corporate income) exceeds the anticipated marginal loss (present value of reduction in expected dividends or share price from costs of the activity, liability judgments, and the like), up until the point where the marginal benefit and marginal loss from an incremental increase in risky activity are equal. Under limited liability rules, the shareholder's total losses are capped at the value of the shareholder's potential lost equity. Thus, such risky projects may appeal to the shareholder even though they may be socially costly.

Further, as between two projects with equal benefit, each of which presents, say, a 10% risk of some liability that exceeds the corporation's assets, the shareholder will be indifferent between them, even though one might be more socially costly than the other. Suppose now the two projects are characterized by different potential benefits. Because the corporation will bear the project's costs only up to the amount of total corporate assets, rather than bearing full costs, the shareholder will prefer the project with a greater potential benefit, even if the net social benefit is smaller.

More generally, limited liability reduces the shareholder's incentive to gather and process information regarding a subsidiary's potentially hazardous activities, even when the shareholder is in a position of control or for other reasons can cheaply acquire that information. Consequently, even a risk averse shareholder may make fewer attempts to encourage management to obtain more insurance, take more precautions, or avoid the risky activity altogether. Thus the costs of excessively risky corporate decisions for which shareholders bear no responsibility (because corporate assets have been exhausted) are shifted to third parties, including tort victims, the environment, and the community, as well as other "involuntary creditors" to which the corporation is liable.

This moral hazard has a number of consequences. The easy availability and effectiveness of limited liability in protecting the corporation's shareholders or parents will lead companies to select corporate restructuring as a means of managing the risk presented by hazardous corporate activities. Restructuring is essentially an investment in transaction costs.

Because corporations can limit liability by forming subsidiaries, the corporate tendency will be to divert investment from other, more efficient risk management strategies. For example, a corporation will be less likely to purchase adequate insurance or otherwise allocate risk through contracts. Further, a corporation may invest less in directly reducing the risks of its hazardous activities - say, by changing technologies or adding additional safeguards. With respect to environmentally hazardous activities, for example, because application of limited liability could be as, or more, effective in reducing potential environmental liability as investing in pollution-reducing technology, corporations whose managers [1235] decide to engage in environmentally risky activities often will direct their resources to creating a new corporate layer.

For example, in one case, a company engaged in oil transport incorporated separate subsidiaries, each of which owned a number of barges that transported oil on Lake Champlain. The companies had identical officers and directors, and the subsidiaries remitted profits to the parent by way of dividends. The parent had substantial involvement in subsidiary operations. Poor barge operation led to a number of spills on Lake Champlain. The

spills resulted from employees continuing to pump oil into the water after encountering a leak, employee failures to cap pipelines, and disregard of navigation agreements. The limited liability doctrine apparently encouraged resources to be devoted to corporate restructuring as a way to minimize environmental liability. Instead, the parent should have invested (or encouraged the subsidiary to invest) in training barge employees regarding appropriate measures to avoid oil spills.

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C. The Evidence of Excessive Risk Taking

As a general matter, there is little disagreement that limited liability encourages companies to engage in excessively risky activity. Excessively risky activity could be defined as the activity generating externalized social costs - those not, as a practical matter, collectible through tort liability judgments. Since we lack the "control set" of an industrialized regime without limited liability, the extent of the overinvestment in this type of excessively risky activity remains an empirical question that is difficult to answer precisely.

Some commentators have suggested that bankruptcy cases or unpaid tort judgments of corporate subsidiaries might prove to be an indicator of this excessive risk taking. However, even a systematic examination of reported cases in which tort or statutory plaintiffs attempted to obtain compensation from corporations or their controlling shareholders likely would seriously underestimate the association of limited liability with excessive risk taking. This is because claims are very often resolved out of court prior to judgment. A large study of state court tort cases found that nearly three-fourths were resolved through settlement and the details of settlement generally were unknown. Moreover, claims frequently are resolved, explicitly or implicitly, in the shadow of limited liability rules and with the recognition that tort claimants do not fare well under bankruptcy rules.

Bankruptcy filings could be a more reliable indicator of excessive risk taking in mass tort cases, where the presence of large numbers of uncoordinated plaintiffs (or perhaps an overly aggressive plaintiffs' class action attorney) might lead some or all of the plaintiffs to litigate to judgment, with the combined weight of the suits forcing the company into bankruptcy.

However, in tort cases where there are only a few plaintiffs, the plaintiffs are well-coordinated, or the government is the plaintiff, bankruptcy filings would tend to underrepresent the size of the externality.

Again, environmentally risky activity presents a good example. Here, corporations clearly rely on limited liability as a means of minimizing liability exposure, but not in a way that lends itself to systematic documentation. As noted, this type of activity can present the small risk of a large liability likely to be favored under a limited liability regime. The federal government, for example, brings large claims under the Comprehensive Environmental Response, Compensation, and Liability Act for cleaning up hazardous substance releases. Claims under this statute very often are in the millions of dollars, and the statute authorizes courts to impose response costs on a wide array of entities with some connection to the hazardous substance release.

If corporations used subsidiaries for environmentally risky activities, one might expect to observe a significant number of subsidiary bankruptcies in response to government

enforcement. However, the vast majority of government claims are settled, very often for less than the face value of the claim. The government guidelines for settlement expressly internalize limited liability rules as the backdrop to settlement. For example, the EPA's settlement policies based on a defendant's "ability to pay" judge a company as "unable to pay" if paying would result in "undue financial hardship." "Undue financial hardship" means that a company would go out of business, have its viability jeopardized, or lack the ability to pay "ordinary and necessary business expenses." In determining "ability to pay," the settlement policies assume that parent company assets are unreachable: "A corporation's owners (i.e., shareholders) generally enjoy limited liability for any of the corporation's debts or legal claims … . In assessing the financial health of a corporation, only the financial resources of the corporation are relevant." Consequently, any count of the number of actual subsidiary bankruptcies in the face of large government environmental claims would substantially undercount the number of companies that have tried to limit exposure to environmental claims by moving their hazardous activities to a subsidiary.

The explicit government settlement policy for environmental claims simply codifies the more general calculation of a tort plaintiff that is considering settlement and attempting to determine expected returns from litigating. What a private plaintiff is likely to be able to obtain in court from a subsidiary also is constrained by current limited liability rules. Bankruptcy's high transaction costs and low priority for unsecured creditors will discourage invoking the bankruptcy court's protections. Thus, the general incentive for "tort victims suing under a regime of limited liability … to accept a settlement for less than the full value of the firm" suggests that subsidiary bankruptcies in the face of tort or statutory claims are likely to understate the extent to which corporations externalize the costs of risky activities.

So what can be learned about the reality of excessive risk taking by corporations, especially corporations with a parent company or controlling shareholder? Several pieces of evidence suggest that such risk taking is significant and that incorporating represents a strategy to reduce liability flowing from the risk taking.

First, a plaintiff's attempt to pierce the corporate veil generally means that the plaintiff, at least, believes that the liable corporate entity lacks sufficient assets to compensate the plaintiff and that a major shareholder has significant additional assets. Otherwise, the plaintiff would have simply filed against the corporation alone and would not have spent the resources necessary to file a lawsuit against a shareholder. In the 1970s and 1980s, approximately 1500 out of 2000 cases that mentioned veil piercing or a similar phrase actually consisted of attempts by plaintiffs to pierce the corporate veil. In Robert Thompson's study of these cases, as well as with the approximately 2100 veil piercing cases between 1985 and 1995, a little over half involved tort claims or claims of statutory violations.

Second, anecdotal evidence regarding bankruptcies and claims against subsidiaries supports the claim of excessive risk taking. Again, on an aggregate level, the most relevant information might be the extent to which judgments against a corporation that arise out of tort or statutory claims exceed the assets available to a corporation, even though shareholders have significant assets. Judgments against a close corporation or a wholly-or largely-owned subsidiary would be of particular interest, since the shareholders more likely could have affected the corporation's ability to pay legal claims by influencing dividend distribution policy or other operational decisions. As noted, such aggregate data is difficult to obtain and almost certainly understates the amount of excessive risk taking that takes place.

However, subsidiary bankruptcies do occur. Litigation over injuries from the Dalkon Shield and breast implants resulted in A.H. Robins and the Dow Corning Company, respectively, filing in bankruptcy. Further, in 1992, an involuntary bankruptcy petition was filed against Gulf USA Corp. for its inability to pay $ 70 million in cleanup costs at a mining and smelting complex at Bunker Hill, Idaho. Gulf had been controlled by a series of individual shareholders that apparently had drained assets from its operations. After reorganization, the company paid less than $ 17 million toward cleanup.

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Reading Two

This reading summarizes the moral hazard problem and examines its relationship to piercing the corporate veil.

THE PLACE OF ENTERPRISE LIABILITY IN THE CONTROL OF CORPORATE CONDUCT
Christopher D. Stone
90 Yale L.J. 1

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The question arises whether, whatever the theoretical misgivings about the doctrine, and whatever the historical clouds on its title, the limits on investor liability make much practical difference. In the case of most giant, publicly held corporations, there will almost inevitably be enough funds in the treasury to satisfy virtually any uninsured legal judgment imaginable. As a result, the principle is likely to conflict with public policy only in the case of the thinly capitalized venture engaged in a high-risk activity. Nevertheless, we should not underestimate the continuing potential of limited liability to work social mischief. The problems extend far beyond the financially unaccountable taxicab companies that supply the paradigm case for the law schools; I have in mind, even more troublesomely, the firms that produce and handle such products as toxic chemicals. As long as limited liability is available as a protection, it is precisely in such areas of substantial third-party risk that we can expect to find a disproportionate population of small, financially unaccountable companies. Major firms will incline to externalize the risks of their more jeopardous undertakings by establishing subsidiaries; by leaving the “dirty business” to small, specialized outfits that are themselves questionably capitalized; or by creating “independent suppliers” whose umbilical cord to the firm is a loan and output contract, rather than stock, so that the major company that in reality stands behind the operation may be able to avoid some of the entanglements of being a technical stockholder-parent.

To deal with some of the situations where limited liability most strongly conflicts with fundamental law-enforcement goals, prosecutors and plaintiffs can, with varying degrees of satisfaction, circumvent the doctrine. In close corporation contexts, for example, where the firm's investors are often also its managers, there is the possibility of holding the key individuals directly accountable, both in crime and in tort, on the basis of their personal participation. Particularly where a subsidiary is involved, plaintiffs can allege a joint tort, a conspiracy between the two entities, or aiding and abetting.[271] There are, moreover, special

legislative possibilities that would deal with some of these problems on an area-by-area basis: mandatory insurance, for example, or, where licensing is required, a condition that companies engaged in high-risk ventures demonstrate financial capability adequate to meet the expected liability claims.

Whatever the merits of these various options, none of them can be regarded as the functional equivalent of piercing the corporate veil. It is one thing to hold investors secondarily liable for judgments secured against the corporation for the corporation's wrongs, and quite another and more difficult task, especially where criminal-law burdens of proof are concerned, to establish their independent culpability by showing a conspiracy or aiding and abetting. Moreover, while mandatory insurance for companies engaged in high-risk activities may be appropriate to advance compensation goals, it would not be well suited for specific deterrence, since the consequences of intentional wrongdoing are generally uninsurable.

There will remain, therefore, a considerable range of circumstances in which specific deterrence is desired, but will be realizable only by resort to “piercing the corporate veil.” Unfortunately, the standards for doing so remain, as Judge Cardozo lamented fifty years ago, “enveloped in the mist of metaphor,” and are, ironically, more readily available to contract creditors who can claim to have relied on the investors' assets than to non creditors, like the public prosecutor, who obviously cannot.

The better approach would be to reverse the present presumption that limited liability is the norm, at least when applied to certain corporate delicts. The argument is built on the same principles already set forth in the discussion of Clusters 1 and 2. There are certain outcomes that society is particularly anxious to restrict, as evidenced by the superimposition of penalties on the market-determined, general-deterrence base that we have associated with harm-based liability rules (HBLRs). One way to restrict this excess is to increase the legal pressure on those with control over their supply, a technique examined in Cluster 1 in the context of imposing liability on managers as a way of inducing them to exercise intensified control over their subordinates. The same, obviously, could be done by intensifying the liability of the investors for the acts of the managers, who can be conceived of as the agents or subagents of the investors.

Even if increased investor liability could improve deterrence, its potential is restricted by much the same efficiency and morality constraints that we saw earlier. Particularly as share ownership diversifies, with all the problems of high monitoring costs for large numbers of investors, each with a relatively small stake, the level of monitoring we can realistically expect from the investors declines. In all likelihood, the added legal risk to investors would increase the cost of equity capital without significant reduction in unwanted behavior (other than through some unlamentable decrease in investment available for jeopardous activities). And from a moral perspective, there are the same reservations about imposing vicarious punitive liabilities on superior agents— in this case, the investors. Indeed, one wonders whether the imposition of a “penalty” on the numerous, faceless shareholders of a defunct corporation would advance any of the real moral goals of the law.

But if these are, as I assume, the considerations that form the true basis for the present presumption in favor of limited liability, they constitute not so much warrants for protecting shareholders from liability absolutely, as for protecting them from the peculiarly onerous character of the joint and several liability that would prevail in the absence of limited liability. That is, if the limited liability rules are withdrawn, the only option that exists in

present law may be to treat the investors, *inter se*, as partners, in which case each shareholder of a corporation like the Penn Central would have to stand behind every delict judgment in its indivisible entirety. This would surely be unacceptable. But our choice need not be restricted to limited liability or ordinary partner's liability as the only alternatives. As a compromise, we could provide that when an insolvent corporation has unpaid debts arising from a criminal fine or punitive damage award, or perhaps even civil liabilities arising under federal statutes whose policies do not appear fully discharged by compensation, shareholders would be held liable on the debt as guarantors but not as partners: each would be liable only in proportion to his or her equity interest.

In effect, this proposal would dispense with the present practice of deciding whether to disregard corporateness—absolutely and after the fact—by reference to metaphorical, vague, and often questionably relevant inquiries into whether the actors maintained the various traditional niceties of separate corporate existence: adequate capitalization, separate books, different officers, and segregated bank accounts. In their place, we would substitute a relatively simple, predictable, ex ante rule, under which the risk that the investors might bear punitive liabilities would rise, but only in some proportion to their actual ability to select and monitor their management. In the typical giant, publicly held enterprise, where the fragmentation of shareholdings makes controlling agents extremely costly, and the small-stakes problem makes doing so less worthwhile, no ordinary investor's exposure would be more than nominal. But as we move into situations where the investors constitute an increasingly tight-knit control group—the limiting case being the corporation that has set up a wholly owned subsidiary aimed at externalizing the risks of legal hazard—the prospective pro rata liability of each investor would rightly increase. In these small-number settings, moreover, the investors could arrange in the management-compensation contracts for an indemnity against the responsible managers, thereby bargaining towards the most efficient balance of risk bearing and control.

Whether or not we adopt this proposal, in cases where the corporation appears unable to discharge penalty debts, prosecutors should intensify efforts against responsible corporate agents, giving increased consideration to imprisonment, even in circumstances where such penalties would otherwise not be indicated. Indeed, harsher punishment could well be imposed on superior agents whose vicarious responsibility for the misconduct itself seems attenuated, if, as controlling persons or directors, they had responsibility for maintaining capital levels to permit satisfaction of the penalty and appear derelict in not having done so. It is true that, if the law should move in this direction, managers will demand additional compensation when their companies are thinly capitalized relative to the penalties they are likely to incur. But the resulting incentives are, after all, the very sort that an adequate model of corporate control should provide for our society.

Room to Argue, page 482: Is the Enterprise Entity Concept Good or Bad?

Reading Three

This reading briefly summarizes the enterprise entity theory.

PIERCING THE CORPORATE VEIL UNDER CERCLA: TO CONTROL OR NOT TO CONTROL – WHICH IS THE ANSWER?

Cindy A. Wolfer

59 U. Cin. L. Rev. 975

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Virtually all state courts have found that a corporate entity structure may be disregarded in order to place liability on the shareholders. The courts are reluctant to do so, however, unless the corporate structure has been clearly abused by the owners. In the case of a parent corporation owning all the stock of its subsidiary, the courts will examine closely the relationship between the two corporations to determine whether the subsidiary's integrity as a separate entity has been respected by the parent company. A court of equity generally requires that a plaintiff, usually a creditor, demonstrate that the parent blatantly disregarded the subsidiary's separate legal status, before it will disregard a subsidiary's corporate structure. Historically, corporations have been formed to engage in some type of profitable business activity. One method of abusing the corporate structure occurs when a corporation is not a viable entity in and of itself. A corporation which engages in a particular business may attempt to protect itself from liability by separately incorporating its various operations or departments. The courts would look at the integrity of the each of the corporate entities to exist as a viable enterprise. If a subsidiary appeared to have no separate existence apart from its parent company, its corporate structure would be ignored and liability would be placed on the parent company by breaking down the walls between the two companies and treating all the combined assets of the parent and subsidiary as one entity.

In Martin v. D.B. Martin Co., the Delaware Court of Chancery analyzed what conduct should be considered to find an enterprise common to all the related corporations.49 The first concern is whether the companies have been organized for a common purpose and for mutual advantage. The second concern is whether the companies have common managing officers who are involved in the companies' day-to-day operations, thereby influencing common decisions. The final issue is whether one company has given financial support to the other company. The court asserted that these factors must be weighed to determine whether the corporate entity was being used to perpetuate a fraud or the corporation has been conducted so that it becomes a mere instrument of another corporation. The court cautioned that no one factor alone is determinative and it takes a strong case before a court will disregard a legal entity's structure. In weighing these factors, if the court determines that the related corporations are part of the same entity, the legal fiction of the separate corporations will be disregarded and the court will perform a legal consolidation of the various companies. The enterprise entity theory is one way a court may find that a parent excessively controlled its subsidiary.

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In concluding that the statute does not expressly place liability on a parent company for merely owning stock in a subsidiary, an analysis of corporate liability theories is necessary to settle the issue. While liability is normally limited to the amount of investment, three corporate theories for piercing the corporate veil become important in answering the question. First, the enterprise entity theory will place liability on a parent for a subsidiary which is not alone viable. Secondly, the alter ego doctrine will place liability on a parent who

both controls its subsidiary and is involved in some type of bad conduct. Finally, the doctrine developed in some federal courts will place liability on a parent if the statute places no importance on the corporate structure and it is necessary to pierce the corporate veil in order to serve “public convenience, fairness, and equity.”

The first two theories of liability do not change existing state corporate law. The extension of liability under the enterprise entity rule may be justified because the subsidiary in this case is not economically a responsible party, because it is not an entity that may realistically survive without its parent. The subsidiary is used by the parent for its own benefit, and one of Congress' purpose was that CERCLA liability should be extended to those parties benefiting from the hazardous waste activity. The enterprise entity theory recognizes that the parent is benefiting, often to the subsidiary's detriment.

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Reading Four

This reading discusses enterprise entity in the context of corporate personality.

TO WHOM IT MAY CONCERN: FIDUCIARY DUTIES AND BUSINESS ASSOCIATIONS
Paula J. Dalley
26 Del. J. Corp. L. 515

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3. Corporate Personality

Initially, corporations were considered to be "artificial entities" created by the legislature through the act of incorporation. The artificial entity did not have personal characteristics (such as citizenship, residence, and mens rea) of its own, and the artificiality of the entity subjected it to the will of the legislature. Corporate law theorists for a time also advocated an "aggregate theory" of corporations which resembled a simplified understanding of partnership law that treated the corporation as a mere group operating under a common name, or, as one commentator phrased it, as a set of parentheses in an algebraic formula. Under this "mere group" theory, the nature of the individuals constituting the group is no different when they are in their group than when they are out of it. Under this theory, the corporation was best seen as a relationship similar to a partnership and not as an entity at all. The mere group theory of the corporation fell from favor and the "natural entity" theory, holding that a corporation was a real person separate from the state and from the individuals the corporation was composed of, essentially won the field.

The natural entity theory recognized a corporation as a real, rather than a fictitious, being based on the actual nature of the group. If the corporation was a legal person in its own right and not dependent upon a status granted by the legislature, where did it get its personality? A legal person was generally defined as the "subject of legal rights and duties." Why was a corporation such a subject? For that matter, why were human beings? One theory based personality on the existence of a "will." This created a problem for corporations, which do

not have a will in the sense that an individual does. One solution to this problem is to argue that a corporation has a "will" because the board of directors is empowered to speak for the corporation. Another solution is to define personality based on purpose or interest rather than on will, or on some combination of purpose and will. The corporate "purpose" is the purpose for which the individual members have joined, or in other words, the interest they have in common, rather than their respective individual interests, which will vary among them. A theory that combines purpose and will enables the "organ" of the entity, which expresses the entity's will, to define, amend and execute their purpose. One early corporate law commentator also proposed a "representation" theory based on the recognition of the unified purpose of the corporate group.

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Reading Five

This reading discusses enterprise entity in the context of consolidation.

ALTER EGOS: DECIPHERING SUBSTANTIVE CONSOLIDATION
Mary Elisabeth Kors
University of Pittsburgh Law Review
59 U. Pitt. L. Rev. 381 (1998)

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A number of courts justify consolidation on the basis that the entities were excessively unified (i.e., "alter egos" of one another). The analysis is typically rote: if alter egos, then consolidate. However, most of these substantive consolidation decisions beg the question of why alter ego fact patterns (i.e., facts demonstrating excessive unity) demand a remedy, in this case the consolidation of two legal entities. Accordingly, the analysis shifts to another corporate disregard doctrine, "piercing the corporate veil," to discern the reasons alter ego fact patterns might justify the disregard of the corporate entity.

The standards for piercing are as myriad, inconsistent and vague as those for substantive consolidation. Like substantive consolidation, piercing is not usually mandated by statute and is determined on a caseby-case basis. The courts also frequently ignore remedial theory. However, piercing is the subject of far more case law and scholarly analysis than consolidation and thus provides more information as to why "alter ego" facts might warrant corporate disregard.

Like "alter ego-style" consolidation decisions, in piercing decisions the court asks whether an excessive degree of unity exists among the entities. This unity may be operational (whether through excessive control, administrative integration or economic interdependence) as well as formal (i.e., the failure to maintain the corporate formalities required by corporation law to maintain a separate legal entity).

In addition to the unity which is the sine qua non of piercing, courts in piercing situations typically require that plaintiff/creditors demonstrate that they were unfairly harmed by the excessive unity….

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Courts, but more often scholars, justify piercing on the basis that (i) the relevant entities are functionally part of one economic enterprise (e.g., one manufactures and one distributes the same product); (ii) one entity heavily controls the other; and/or (iii) their operations are integrated. Professor Berle first epoused this theory as "enterprise entity theory."

Under the enterprise theory, a high degree of unity alone would be sufficient to justify piercing without any additional requirement of unfair injury arising from the unity. But without injury and inequity, what is the need for a remedy? The implicit "inequity" may be the failure to attach the consequences of the enterprise's actions to the enterprise as a whole. If a number of legal entities are operated as one enterprise, then all elements of that enterprise should both reap the rewards as well as bear the risks of the enterprise's operations, whether as a matter of efficiency or "equity." Instead, under limited liability, the creditors bear much of the entrepreneurial risk of the fragmented enterprise. Substantive consolidation would, of course, achieve an appropriate enterprisewide risk allocation.

Moreover, like the failure to maintain corporate formalities, the fragmentation of one economic enterprise into many corporations may be considered an abuse of the corporate form, justifying piercing to those who view the grant of a corporate charter as a privilege. However, as with formal unity, while this abuse of the corporate form may be grounds for punishing shareholders or other members of the groups, it does not provide a compelling reason to harm the rights of creditors who did not participate in the group.

Other courts suggest that excessive control or integration may give rise to direct responsibility for the liability of affiliates. For instance, if a parent corporation controls the activities of the subsidiary, then the parent may have actually committed (and should be responsible for) the subsidiary's torts or breach of contract. Of course, if an affiliate is truly involved in the tort or the breach, liability can be imposed directly or under a true agency theory without use of corporate disregard law.

A multi-entity enterprise may also create a subtle form of misappropriation. Managers of the enterprise would tend to run each legal entity for the benefit of the whole corporate group as opposed to the entity itself, thereby depleting the entity's financial position. While these subtler misappropriations theoretically can be remedied by fraudulent transfer law, the "transfer" and its "equivalent value" may be exceedingly difficult to measure. Several commentators have advocated a baseline rule of substantive consolidation for related entities, due in part to concerns over fraudulent transfer law's ability to measure and redress this harm.

While enterprise liability may offer some appeal, measuring the extent of an "economic unit" introduces an intolerable level of uncertainty into the question of liability. The task of marking the limits of liability on the basis of incorporation is relatively simple: the corporation has either complied with the technical requirements of incorporation or it has not. Extending liability to the edges of the enterprise requires courts to determine the scope of the economic enterprise. The answer to this issue will rarely, if ever, be clear. Creditors extending credit would not be able to determine with any precision the liabilities for which their debtor will be responsible and the assets that will be available to satisfy their claims. Such uncertainty substantially reduces both the efficiency and fairness of corporate law.

More to the point, enterprise liability is simply not the law. Corporate law limits liability at the parameters of legal entities, despite an onslaught of recent scholarship questioning the value of limited liability (especially in the tort context). Fundamentally changing the extent

of liability--measuring it by the economic or operational enterprise (rather than the legal entity)--should be accomplished directly and completely by legislative action to change the basic rules of limited liability, not by ad hoc court-made exceptions to the doctrine.

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JD/MBA, page 490: Income v. Revenue

[By the Editors]

Please see the module titled "Solving for X and Other Friends from High School."