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Form and Substance of the Doctrine of Piercing of Corporate Veil

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FORM AND SUBSTANCE OF THE DOCTRINE
OF PIERCING THE CORPORATE VEIL

Thomas K. Cheng*

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INTRODUCTION

The doctrine of piercing of the corporate veil remains one of the most confused areas of corporation law.1 This is so despite the fact that, together with the related topic of limited shareholder liability, it is one of the most extensively written and closely examined topics of corporation law. The courts have not gone much beyond circumstance-specific inquiries into the equities of each case. Commentators have struggled to distill clear trends in or come up with an overarching theory that accounts for the case law. Given the volume and variety of the cases, the search for such a theory may remain elusive. This is not to say, however, that a more focused approach to veil piercing cannot be formulated upon a clearer understanding of the doctrine.

Much of the academic literature on the topic has either been doctrinal analysis of the case law or theoretical examination of the economic basis of limited liability. There is a distinct lack of theoretical analysis of the doctrine itself. For instance, the existing literature sheds little light on the objective of the doctrine. What is the purpose served by the

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1 This article will only consider cases in which the corporate veil is pierced to impose liability on shareholders. There are a considerable number of cases in which the veil is pierced for other purposes, such as contractual construction or establishment of jurisdiction. See Robert W. Hamilton, The Corporate Entity, 49 Tex. L. Rev. 979, 1002-07 (1971). However, this article will not focus on them. Only in those veil piercing cases in which liability is imposed on the shareholders is the principle of limited liability at stake.
doctrine? Does it merely reinforce the functions of the area of law that underlies the corporate veil claim? Or does it serve an independent purpose? If it does, is it compensation, deterrence, punishment, or something else altogether? There is also little systematic evaluation of the relationship between the doctrine and limited liability, the general rule to which the doctrine serves as an exception. The purpose of this Article is to examine the formal and the substantive relationships between the doctrine and limited liability and to ascertain the objective of the corporate veil doctrine. With the insights gleaned from this exercise, the doctrine will be reoriented so that it focuses on what truly motivates the courts to pierce the veil.

Applying the formal dichotomy of rules and standards and the substantive dichotomy of individualism and altruism developed by Professor Kennedy in his seminal article “Form and Substance in Private Law Adjudication,” this Article ascertains the formal and substantive relationships between limited liability and the corporate veil doctrine.\(^2\) It will be shown that in formal terms, limited liability shows all the relevant characteristics of a legal rule while the corporate veil doctrine functions as a standard. In substantive terms, limited liability is distinctly individualistic in nature while the corporate veil doctrine possesses an altruistic character. Analysis along these two formal and substantive dimensions enhances our understanding of the corporate veil doctrine. In particular, the altruistic character of the corporate veil doctrine will be used as a basis upon which to launch an inquiry into the objective of the doctrine. After an assessment of the effects of veil piercing and its interaction with the underlying contractual or tortious liability, it will be shown that the principal objective of the doctrine is in fact the prevention of the unjust enrichment of the shareholders at the expense of the corporation’s creditors. What ultimately drives the court’s

\(^2\) See Id. Corporation law technically is not an area of private law. However, many of the insights developed by Professor Kennedy are applicable to areas outside of private law. At least from a formal perspective, there is nothing distinctive about rules and standards in private law as opposed to their counterparts in public law and other realms of law. This is consistent with the fact that Kennedy’s discussion about the formal characteristics of rules and standards draws on examples from other areas of law such as criminal law and constitutional law.
decision to pierce the veil is the fact that the shareholders have benefited to the detriment of the creditors in an unjust manner.

This Article proposes a reconsideration of the doctrine in light of this shareholder enrichment rationale. In particular, it proposes that veil piercing analysis should focus on conduct that results in shareholder enrichment at the expense of the creditors. Other considerations either only reflect the probability of shareholder enrichment, in which case it would be better to focus on the fact of enrichment itself, or worse still obscure the analysis. Applying this prevention of shareholder enrichment rationale to the two main components of the doctrine, the formalities prong and the impropriety prong, this Article suggests that most of the criteria under the first prong, such as observance of corporate formalities, shareholder domination, overlap in corporate personnel, and lack of substantive separation between the shareholders and the corporation, do not focus on the most relevant consideration in the corporate veil cases. Instead, the courts should draw their attention to instances of inadequate capitalization, asset stripping, deliberate unprofitable operation of a corporation, and other similar conduct that enriches the shareholders at the expense of outside creditors.

It is important to note that the discussion in this Article will be confined to contractual and tortious corporate veil cases. There are a number of reasons for this. First, the statutory corporate veil cases present different policy issues and require a different mode of analysis from the contractual and tortious cases. Determination of the statutory cases must take into account the policy of the underlying statutes and often hinges on statutory interpretation. For example, veil piercing under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) may depend on the court’s interpretation of the term “operator” and how the court reconciles limited liability with the environmental policy underpinning CERCLA.³ Veil piercing in taxation cases requires a balancing of “the broad social and governmental policies under federal income tax laws” and the policy

justifications for limited liability.\textsuperscript{4} Second, confining our discussion to the corporate veil cases premised on private law claims is appropriate in light of this Article’s invocation of Professor Kennedy’s formal and substantive dichotomies, which were developed in the context of private law adjudication. The individualism-altruism distinction has limited application to the statutory cases.

This Article is divided into four sections. Section I examines the formal relationship between limited liability and the corporate veil doctrine as a rule and a standard respectively. Both theoretical and practical implications for the corporate veil doctrine will be drawn from this examination. Section II delves into the substantive relationship between limited liability and the corporate veil doctrine and confirms their respective individualistic and altruistic nature. Building on this altruistic foundation, an inquiry will be made into the principal objective of the doctrine. It will be shown that the doctrine is ultimately concerned with the prevention of the unjust enrichment of shareholders at the expense of creditors. Section III proposes a reformulation of the doctrine in light of this newly ascertained rationale. In particular, it will be argued that the various criteria under the formalities prong of the doctrine should be de-emphasized, as they fail to focus on the crux of the veil piercing cases. Section IV concludes the Article.

I. THE FORMAL RULE-STANDARD DICHOTOMY OF THE CORPORATE VEIL DOCTRINE

A. Limited Liability as a Rule and the Corporate Veil Doctrine as a Standard

The default rule in corporation law is that shareholders enjoy limited liability protection. Their exposure to corporate liabilities is confined to their equity investments in the firm. They can lose no more than the value of their entire shareholding in the event of a corporate failure. A related rule to limited liability is separate corporate personality—the

\textsuperscript{4} Hamilton, supra note 1, at 998.
notion that a corporation is an entity distinct from its shareholders in the eyes of the law. The two rules are closely related, but are not synonymous. While holding shareholders liable for corporate debts entails ignoring the separate corporate personality, the corporate entity can be set aside without resulting in shareholder liability. Recognition of separate corporate personality means that the corporation possesses the capacity to enter into contracts and own property in its own name, and the capacity to sue and be sued. It is capable of committing torts, for which it alone is liable except under narrow circumstances under which others may be held responsible. Moreover, conduct of the corporation is generally not attributable to its shareholders and vice versa. These are simple and clear-cut rules that are of general applicability. As long as a corporation is duly incorporated, it functions as a distinct legal entity, and its shareholders enjoy limited liability protection.

The piercing of corporate veil doctrine is an exception to the general rules of limited liability and separate corporate personality. Under the doctrine, limited liability protection for

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5 For example, the corporate veil doctrine can be pierced to allow the plaintiff to assert jurisdiction over the parent corporation which has no business presence in a state except for its subsidiary. In such a case, veil piercing does not immediately result in shareholder liability. See Radazewski v. Telecom Corp., 981 F.2d 305 (8th Cir. 1992). For other veil piercing cases that did not involve imposition of shareholder liability, see Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925); see also Pauley Petroleum, Inc. v. Cont’l Oil Co., 239 A.2d 629 (1968). This Article will focus on instances of veil piercing which directly implicate limited liability.

6 Liability may be imposed on others associated with the corporation through various tort doctrines such as vicarious liability. See Robert B. Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, 47 VAND. L. REV. 1, 24-39 (1994) (hereinafter Thompson I).

7 The doctrine may apply to set aside the separate corporate entity without imposing shareholder liability. For example, the identity of a subsidiary may be ignored to allow a court to exert jurisdiction over a corporate parent. See, e.g., Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925); Empire Steel Corp. of Tex., Inc. v. Super. Ct. of L.A. County, 366 P.2d 502 (1961); Pauley Petroleum, Inc. v. Cont’l Oil Co., 239 A.2d 629 (1968). Or the separate personality of a subsidiary may be disregarded to prevent the circumvention of a statute. See, e.g., State v. Swift & Co., 187 S.W.2d 127 (Tex. App. 1945). Therefore, separate corporate personality and limited liability are not necessarily synonymous with each other, and the former can be overridden without implicating the latter. For the purpose of this Article, the discussion will focus on application of the corporate veil doctrine which results in the imposition of shareholder liability. These cases arguably present the most interesting theoretical issues.
shareholders and separate corporate personality may be overridden if certain conditions are met. The courts have repeatedly asserted that the doctrine is an equitable one and requires a weighing of the totality of the circumstances.\textsuperscript{8} There are a number of formulations of the doctrine. Many states have promulgated a two-prong test, requiring a showing that first, there is such a unity of interest and ownership between the corporation and its owners that their separate personalities have ceased to exist in reality, and second, an adherence to separate corporate personality would create inequitable results.\textsuperscript{9} A commentator has called the first prong the

\begin{footnotesize}
\textsuperscript{8} Laborers' Pension Fund v. Lay-Com, Inc., 580 F.3d 602, 610 (7th Cir. 2009) ("Veil piercing is an equitable remedy governed by state law . . . ."); Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335, 340 (D.C. Cir. 2009); Williamson v. Recovery Ltd. P'ship, 542 F.3d 43, 53 (2d Cir. 2008) ("Instead of a firm rule, the general principle guiding courts in determining whether to pierce the corporate veil 'has been that liability is imposed when doing so would achieve an equitable result.'" (quoting William Wrigley Jr. Co. v. Waters, 890 F.2d 594, 601 (2d Cir. 1989))); United States v. Farr, 536 F.3d 1174, 1182 n.4 (10th Cir. 2008) ("Courts and commentators have long referred to the equitable principle of lifting or drawing aside the thin guise that is the veil of corporate entities to expose the actual individuals hiding behind it." (internal quotation marks omitted)); HOK Sport, Inc. v. FC Des Moines, L.C., 495 F.3d 927, 935 (8th Cir. 2007) ("Piercing the corporate veil is a common-law equitable remedy whereby an entity's corporate form is disregarded to prevent an injustice."); Bridas S.A.P.I.C. v. Gov't of Turkmenistan, 447 F.3d 411, 420 (5th Cir. 2006) (referring to corporate veil doctrine as equitable remedy); Dearth v. Collins, 441 F.3d 931, 935 (11th Cir. 2006) (corporate veil doctrine governed by equitable principles); IFC Interconsult, AG v. Safeguard Int'l Partners, LLC, 438 F.3d 298, 312 (3d Cir. 2006) ("Moreover, garnishment actions are distinguishable from veil-piercing because they require a pre-existing contractual or statutory basis for garnishment, whereas veil-piercing is an equitable procedure that involves the creation of liability in spite of the contractual and statutory separateness of corporate entities.") (internal citation omitted); Taylor Steel, Inc. v. Keeton, 417 F.3d 598, 606 (6th Cir. 2005) ("[P]iercing the corporate veil is an equitable remedy, available not where a set list of factors are established but where maintaining the corporate form would work injustice upon an innocent party."). But see Wm. Passalaqua Builders, Inc. v. Resnick Developers South, Inc., 933 F.2d 131, 136 (2d Cir. 1991) (concluding that veil piercing is both legal and equitable in nature); see also David H. Barber, \textit{Piercing the Corporate Veil}, 17 \textit{WILLAMETTE L. REV.} 371, 374 (1980) ("A 'totality of the circumstances' rule allows the courts to deal with each case on its own facts but fails to provide entrepreneurs with firm guidelines for avoiding personal liability."); Smetherman v. Wilson, 626 So. 2d 71, 73 (La. Ct. App. 1993) (noting that totality of circumstances approach applies to corporate veil cases).\textsuperscript{9} See, e.g., Sonora Diamond Corp. v. Super. Ct., 99 Cal. Rptr. 2d 824, 836 (Cal. Ct. App. 2000) ("In California, two conditions must be met before the alter ego doctrine will be invoked. First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation
formalities prong and the second the unfairness prong. In his authoritative survey of the doctrine, Professor Thompson identified the following substantive factors as being most frequently considered by the courts in their analysis: lack of substantive separation between the shareholders and the corporation, intertwining, inadequate capitalization of the corporation, non-observance of corporate formalities, shareholder domination, and overlap of corporate personnel and management. These factors are mostly relevant to the question of unity of interest and ownership. Another authoritative formulation is the instrumentality doctrine first propounded by Frederick J. Powell. Under the

and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone.); Laborers' Pension Fund, 580 F.3d at 610 (Under Illinois law, “[t]he standard test for piercing the corporate veil is two-pronged. The plaintiff must demonstrate both that there is such unity of interest and ownership between the individual or entity and the corporation that the separate personalities of the corporation and the individual or entity no longer exist, and that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.”) (internal quotation marks omitted); Dursharm v. Elegant Custom Homes, Inc. 302 F. App’x 571, 572 (9th Cir. 2008) (To establish a corporate veil claim, “[p]laintiffs must prove . . . that observance of the corporate form would sanction a fraud or promote injustice”).

Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036, 1063 (1991) (hereinafter Thompson II). For other lists of factors considered by the courts, see Cathy S. Kendl & James R. Kendl, Piercing the Corporate Veil: Focusing the Inquiry, 55 DENV. U. L. REV. 1, 16-17 (1978); Barber, supra note 8, at 374-75. These substantive factors are to be distinguished from labels such as instrumentality, alter ego, dummy, or agency. These labels merely encapsulate the conclusions drawn by the courts about the formal integrity of the corporation. They tell us nothing about the precise basis upon which the courts determined that the corporation lacked formal integrity.

This doctrine, as applied by the court in Lowendahl v. Baltimore & Ohio R.R., Co., states that the corporate veil should be pierced if the following three elements are present in a case:

(1) Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and

(2) Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff’s legal rights; and

(3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.
instrumentality doctrine, a corporate veil claim requires the plaintiff to show parent domination of the subsidiary corporation, the presence of improper conduct or purpose, and proximate causation between the defendant’s conduct and the plaintiff’s loss. Powell further enumerated eleven criteria for determining the existence of shareholder domination and seven situations in which impropriety is said to exist. The criteria focus on the degree of operational and financial independence of the subsidiary corporation, overlap in corporate personnel between the parent and the subsidiary, and the formal integrity of the subsidiary. The seven instances of impropriety are: (1) actual fraud; (2) violation of a statute; (3) stripping the subsidiary of its assets; (4) misrepresentation; (5) estoppel; (6) torts; and (7) other cases of wrong or injustice. The instrumentality doctrine further requires the plaintiff to show that the defendant’s conduct proximately caused the plaintiff’s loss. Only some states have incorporated this requirement.


The instrumentality doctrine was originally conceived to apply in the parent subsidary setting, but has been extended by the courts to cases involving individual shareholders.

Frederick J. Powell, Parent and Subsidiary Corporations § 6 (1931). The eleven criteria circumstances are: (1) the parent corporation owns all or most of the capital stock of the subsidiary; (2) the parent and subsidiary corporations have common directors or officers; (3) the parent corporation finances the subsidiary; (4) the parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation; (5) the subsidiary has grossly inadequate capital; (6) the parent corporation pays the salaries and other expenses or losses of the subsidiary; (7) the subsidiary has substantially no business except with the parent corporation, or no assets except the ones conveyed to it by the parent corporation; (8) in the papers of the parent corporation or in the statements of the officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation’s own; (9) the parent corporation uses the property of the subsidiary as its own; (10) the directors or executives of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the latter’s interest; and (11) the formal legal requirements of the subsidiary are not observed.

Krendl & Krendl, supra note 11, at 12.

Some of the states that have incorporated this proximate causation requirement include Alabama, Florida, Missouri, New Jersey, New Mexico, New York, North Carolina, Ohio, Tennessee, and Wisconsin. Messick v. Moring, 514 So. 2d 892, 894-95 (Ala. 1987); Johnson Enters. of Jacksonville, Inc. v. FPL Group, Inc., 162 F.3d 1290, 1306 (11th Cir. 1998); Gasparini v. Pordomingo, 972 So. 2d 1053, 1055 (Fla. Dist. Ct. App. 2008); Collet v. Am. Nat’l Stores, Inc., 708 S.W.2d 273, 284 (Mo. Ct. App. 1986); Craig v. Lake Asbestos of Que., Ltd., 843 F.2d 145, 148 (3d Cir. 1988); Scott v. AZL
Many of them have not. For the purpose of this Article, the first prong of the corporate veil doctrine will be referred to as the formalities prong and the second, the impropriety prong.\[^{17}\]

It should be obvious that the corporate veil doctrine has a putative standard-like quality to it, in contrast to the distinctly rule-based character of limited liability. A more in-depth assessment, however, is needed to substantiate this tentative observation. In a seminal article, Professor Duncan Kennedy proposes three dimensions along which rules and standards can be aligned: formal realizability and open-endedness, generality and particularity, and legal commands governing formalities (formalities directives) and legal commands aiming to deter morally wrong conduct (conduct directives).\[^{18}\] A legal rule is said to be formally realizable and general and a standard open-ended and specific. The last dichotomy requires a bit of explanation. First, it is probably a misnomer to call it a dichotomy. A spectrum would be more apt; between the two ends of the spectrum lie hybrid formalities-conduct directives. Second, rules and standards are not neatly aligned at the two ends of the spectrum. Conduct can be regulated through the use of either rules or standards. As for formalities, although there is nothing inherent in standards that preclude them from being used to govern formalities, the practical reality is that most formalities directives are rule based. The ensuing

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\[^{17}\] Impropriety is chosen over unfairness because the former conveys more specifically the focus of the inquiry. While the second prong is generally concerned about unfairness resulting from upholding separate corporate personality, it more specifically looks for evidence of improper conduct or purpose on the part of the shareholders that allows them to be enriched at the expense of outside creditors. Krendl & Krendl, supra note 11, at 23 (stating existence of improper purposes as ultimate issue in veil piercing analysis).

analysis will illustrate the extent to which these dimensions describe limited liability and the corporate veil doctrine.

Formal realizability refers to the ability to be applied clearly and predictably to easily distinguishable factual situations. Limited liability clearly fits this description. The factual situation to which it applies is easily distinguishable: when a corporation has been properly formed. Once that condition is met, limited liability provides that shareholders' maximum exposure to corporate liabilities is confined to the value of their equity investments. It has also been said that legal rules possess an “all-or-nothing” character, which aptly describes limited liability. If a corporation was formed in full compliance with the procedures and requirements stipulated in the statute, its owners benefit from the protection of the rule of limited liability. If the incorporation process was incomplete or otherwise faulty, the shareholders would not enjoy limited liability.

Whether the corporate veil doctrine possesses standard-like open-endedness entails a more nuanced explanation. One of the distinct features of an open-ended standard is that it “refers directly to one of the substantive objectives of the legal order . . . [such as] good faith, due care, fairness, unconscionability, unjust enrichment, and reasonableness.” H.L.A. Hart calls this quality of a standard desirability. A standard is desirable because it refer[s] more or less explicitly to some purpose, goal, entitlement, or value, [is] regarded from some point of view as desirable to maintain, or to adhere to, and so not only as providing an explanation or rationale of the rules which exemplify them, but as at least contributing to their justification.” In other words, a standard encapsulates and reinforces desirable goals and values. What are the goals and values pursued by the corporate veil doctrine? According to Professor Ballantine, whether the corporate entity should be

19 H.L.A. HART, THE CONCEPT OF LAW 261-62 (2d. 1994). Hart actually uses the term “principle”, while Kennedy offers a number of possibilities for the opposite of a rule—“a standard or principle or policy”—before settling on standard. Kennedy, supra note 18, at 1688.
20 Kennedy, supra note 18, at 1688.
21 Hart, supra note 19, at 260.
set aside “comes down to a question of good faith and honesty in the use of corporate privilege for legitimate ends.”

A federal court asserted that veil piercing is justified “when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime.” These statements suggest that the corporate veil doctrine requires good faith and fair use of the corporate entity. Dean Clark has referred to this duty of good faith and fairness as principles of truth and respect in a corporation’s dealing with its creditors.

Good faith, fairness, truth, and respect are some of the substantive objectives of the legal order, or desirable goals or values, as according to Hart.

Another distinct feature of an open-ended standard is that its application “requires the judge both to discover the facts of a particular situation and to assess them in terms of the


24 Robert C. Clark, The Duties of the Corporate Debtor to its Creditors, 90 HARV. L. REV. 505 (1977). Clark defines the ideal of truth as a requirement that in connection with transfer of property to others, a debtor cannot tell lies that will lead to non-satisfaction of the creditor’s claim. Id. at 509. The ideal of respect imposes on the debtor “a moral duty in transferring his property to give primacy to so-called legal obligations, which are usually the legitimate, conventional claims of standard contract and tort creditors, as opposed to the interests of self, family, friends, shareholders, and shrewder or more powerful bargaining parties.” Id. at 510-11. For example, removal of assets by a shareholder from the corporation which leaves its creditors’ claims unsatisfied would likely result in veil piercing, and violates the ideal of respect.

25 Kennedy, supra note 18, at 1688. One interesting question about the good faith and fair use of the corporate entity is whether it encompasses efforts to incorporate specifically to limit future liability. A number of courts have observed that this use of the corporate entity is fully legitimate. See Radaszewski v. Telecom Corp., 981 F.2d 305, 311 (6th Cir. 1992) (“The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. . . . We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment.”); NLRB v. Fullerton Transfer & Storage Ltd., Inc., 910 F.2d 331, 338 (6th Cir. 1990) (“Virtually all corporations are formed for the purpose of limiting liability. Only where an attempt to limit liability is of a type that typically involves a specific attempt to thwart labor law obligations is the application of the relaxed alter ego principles justified.”); Craig v. Lake Asbestos of Que., Ltd., 843 F.2d 145, 149 (3d Cir. 1988) (“Evasion of tort liability has never, in itself, been sufficient basis to disregard corporate separateness.”); Arnold v. Phillips, 117 F.2d 497, 502 (5th Cir. 1941) (“That it [a corporation] was created to shield the owners from liability beyond the capital set up by the charter does not show an unlawful or fraudulent intent, for that is a main purpose of every incorporation.”).
purposes or social values embodied in the standard."\textsuperscript{26} Hart calls this non-conclusiveness.\textsuperscript{27} Determination of a veil piercing claim requires the judge to ascertain facts such as the extent of overlap in corporate personnel, inadequate capitalization, non-observance of corporate formalities, and the degree of shareholder domination of the corporation, and evaluate them in light of the doctrine's underlying values of good faith and fairness. It is not uncommon for an identical fact to be interpreted differently by two courts, producing divergent results.\textsuperscript{28} Moreover, concepts such as unity of interest and ownership and inequitable results are highly malleable, especially in light of repeated affirmations by the courts that mere complete share ownership on its own does not justify veil piercing.\textsuperscript{29} Complete share ownership does not necessarily result in veil piercing, whereas the veil has been pierced in cases in which the controlling shareholder's stake is less than complete.\textsuperscript{30} Whether unity of interest between the corporation

\textsuperscript{26} Kennedy, \textit{supra} note 18, at 1688.

\textsuperscript{27} In addition to non-conclusiveness and desirability, Hart also identified breadth as a characteristic of a standard. The breadth of the corporate veil doctrine is demonstrated by the range of circumstances to which it applies. The doctrine applies to cases involving contractual claims, tort claims, statutory claims, criminal claims, etc. It can be invoked for a variety of purposes, including imposition of shareholder liability, assertion of jurisdiction, and prevention of circumvention of a statute.

\textsuperscript{28} See, \textit{e.g.}, Automotriz del Golfo de Cal. v. Resnick, 306 P.2d 1 (Cal. 1957); Zubik v. Zubik, 384 F.2d 267 (3d Cir. 1967); Fisser v. Int'l Bank, 282 F.2d 231 (2d Cir. 1960); Empire Steel Corp. v. Super. Ct. of L.A. County, 366 P.2d 502 (Cal. 1961). In \textit{Resnick}, non-observance of corporate formalities was one of the principal grounds for veil piercing, whereas in \textit{Zubik}, separate corporate personality despite serious failure to comply with corporate formalities. In \textit{Fisser}, the plaintiff's awareness of the subsidiary's financial difficulties effectively defeated its corporate veil claims, while such knowledge was tolerated by the court in \textit{Empire Steel} in ordering the veil to be pierced.

\textsuperscript{29} Doughty v. CSX Transp., Inc., 905 P.2d 106 (Kan. 1995) (complete stock ownership alone does not turn subsidiary into parent's instrumentality); Berkey v. Third Ave. Ry. Co., 155 N.E. 58 (N.Y. 1926) ("Stock ownership alone would be insufficient to charge the dominant company with liability for the torts of the subsidiary."); Lowendahl v. Balt. & Ohio R.R. Co., 154, 287 N.Y.S. 62, 72-73 (N.Y. App. Div. 1936) ("Control through mere ownership of a majority of even all the capital stock . . . will not in and of itself predicate liability."); Elenkreig v. Siebrecht, 144 N.E. 519, 521 (N.Y. 1924) (affirming separate corporate personality of one-man corporations so long as they are "doing business as permitted by the laws of this State.").

\textsuperscript{30} Thompson II, \textit{supra} note 11, at 1055. Thompson found that the courts have pierced the veil in 46% of the cases in which the corporation at issue had two to three
and its shareholders is found depends on the totality of circumstances and the court’s assessment of them. In short, the corporate veil doctrine is non-conclusive. With its reference to desirable values and its non-conclusiveness, the corporate veil doctrine exhibits the open-endedness of a standard.

A rule is said to be general and a standard specific. Limited liability is clearly of general application. It applies to all corporations regardless of the number of shareholders, the business in which they operate, or even whether they have business operations at all or merely function as a shareholding parent within a corporate group. In comparison, the corporate veil doctrine has a much narrower scope of application. It only concerns a small subset of corporations exhibiting characteristics that suggest a lack of independence and economic substance. Therefore, limited liability and the corporate veil doctrine fit into the generality-particularity dichotomy of rules and standards posited by Kennedy. To sum up, limited liability is formally realizable and general, while the corporate veil doctrine is open-ended and specific in application. The extent to which limited liability and the corporate veil doctrine govern issues of formality or aim to deter immoral conduct will be dealt with subsequently.

B. The Practical Implications of the Formal Rule-Standard Dichotomy

It has been said that rules create legal certainty and promote investments. By informing parties of the legal consequences of their action ex ante, rules allow them to plan their affairs in advance. In contrast, standards discourage commercial activities. The open-ended nature of legal

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31 Kennedy observes that rules need not be of general application. Nor are standards necessarily particular in scope. However, in reality, general rules and particular standards tend to be the norm. Kennedy, supra note 18, at 1688.

32 Kennedy, supra note 18, at 1698 (“If an actor knows that the use of a formality guarantees the execution of his intentions, he will do things that he would not do if there were a risk that the intention would be defeated.”).

33 Kennedy further added two reasons that standards retard investment. First, the attendant legal uncertainty “if the judge is at large in finding intent, rather than
standards and the balancing that is involved in their application means that legal consequences can only be ascertained ex post. This will make it more difficult for parties to plan their business activities. Within the context of limited liability and the corporate veil doctrine, the implication of these assertions is that limited liability promotes investment while the corporate veil doctrine deters it. Limited liability does exhibit the investment incentive effects of rules. By capping investor exposure to corporate liabilities, it enhances the flow of capital to corporations. There is a substantial body of legal scholarship devoted to explaining how limited liability encourages investment and serves as the foundation of the capital markets.\textsuperscript{34} The definiteness of the rule spurs commercial activities, while externalizing the costs of business failure to counterparties that are unable to negotiate additional protection for themselves.

Commentators have argued that at least for contractual creditors, there is little externalization of uncompensated default risks because the creditor can always negotiate for extra credit protection or a higher rate of return.\textsuperscript{35} This is in keeping with Kennedy's idea that the formal realizability of legal rules leads actors in society to "invest in formal proficiency", i.e., adjust their behavior in light of the rules.\textsuperscript{36} However, the kind of adjustment that is required of the creditors under limited liability is more difficult and complicated than the kind of investment in formal proficiency bound to respond mechanically to ritual acts like sealing, will reduce the payoff that can be expected from being careful." \textit{Id.} at 1698. Second, the incentive to take care is lowered if "the judge may bail you out if you blunder." \textit{Id.}


\textsuperscript{35} Easterbrook & Fischel, \textit{supra} note 34, at 105; Larry E. Ribstein, \textit{The Deregulation of Limited Liability and the Death of Partnership}, 70 WASH. U. L.Q. 417, 442 (1992) (asserting that contractual creditors, including employees, adjust their rates of return to incorporate increased default risks).

\textsuperscript{36} Kennedy, \textit{supra} note 18, at 1698.
alluded to by Kennedy. All that a party needs to do to invest in formal proficiency under contract law, as explained by Kennedy, is to familiarize themselves and comply with the rules to make sure that their contracts will be recognized by the courts. The only significant obstacle to this type of formal proficiency is arguably the time and the resources needed to acquire it. The necessary “formal” adjustment under limited liability entails negotiation by the creditors for a higher rate of return or credit protection from the corporation in the form of shareholder personal guarantees or pledge of security. With respect to formal proficiency under contract law, both parties strive for the same outcome and are equally interested in creating a legally binding contract. Meanwhile, the shareholders of the corporation have every incentive to resist the outside creditors’ requests. Even if the creditor has the time and the resources to attempt the negotiation, its lack of bargaining power vis-à-vis the corporation may render its effort futile. This is very likely to be the case for employees and to a lesser extent, trade creditors. With respect to tort victims, there is effectively no opportunity for them to negotiate for any formal adjustments, as they almost never know the identity of the tortfeasor in advance. The externalization of accident risks is unmistakable. Therefore, similar to Kennedy’s critique of legal rules, limited liability promotes investments through greater ex ante certainty but not without imposing substantial costs on those which are unable to acquire formal proficiency.

The central critique of the corporate veil doctrine from the previous paragraph, which remains unaddressed, is whether it discourages commercial activities. The obvious argument is that given the incentive effects of limited liability on corporate investment, the corporate veil doctrine, by overriding limited liability, must inhibit investment. The extent to which this argument is true depends on the circumstances under which


the courts have invoked the doctrine. By expressly requiring improper conduct or injustices in order to pierce the veil, it is unlikely that the corporate veil doctrine will deter *bona fide* investors. One may argue that what the courts deem to be improper conduct or injustices are so vague that potential investors are bound to be put off. This argument is unlikely to be valid for a number of reasons. First, while it is admittedly true that the class of conduct which the courts have deemed improper has been broad, few would disagree that the conduct is clearly objectionable. The corporate veil decisions should give clear indications of the scope of permissible conduct that will preserve limited shareholder liability. Second, as Thompson’s survey shows, the U.S. courts have never pierced the veil of a public corporation. Setting aside the issue of whether this disparate treatment is theoretically justifiable, the practical reality is that the type of corporation that is most likely to attract passive investments has not been affected by the doctrine. Lastly, and most importantly, liability under the corporate veil doctrine is only imposed on the shareholder who is responsible for the improper conduct. Passive shareholders are almost never implicated, even in close corporations. The corporate veil doctrine will not deter passive investments. As for the culpable shareholders, there should be little disagreement that they should be deterred.

The last argument, in particular, points to an important distinction between the corporate veil doctrine and a general rule of unlimited liability. While some commentators have argued that any difference between the two is largely rhetorical, the two in fact operate quite differently. As just mentioned, the corporate veil doctrine only applies to the culpable shareholder, while a general rule of unlimited liability

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40 Investors in close corporations are unlikely to be completely passive in the sense of having no relationship with the controlling shareholders whatsoever. These investors are likely to be family members or friends of the controlling shareholders, which should give them somewhat better access to information and a greater ability to monitor the management. They should have fewer concerns about being subject to limited liability because of conduct by wayward management.

41 Thompson II, *supra* note 11, at 1056.

would implicate all shareholders. Moreover, unlimited liability would be a default rule of corporation law that sets out the parties’ liability positions \textit{ex ante}, while the corporate veil doctrine intervenes \textit{ex post} to alter these positions. An \textit{ex ante} rule generally has greater impact over parties’ conduct than an \textit{ex post} rule, not to mention an \textit{ex post} standard. While one can try to improve the formal realizability of the corporate veil doctrine, it is unlikely to achieve the effectiveness of an \textit{ex ante} rule. The corporate veil doctrine was never intended to be a surrogate for unlimited liability. It is only meant to be a circumscribed exception to the general rule.

One further argument that has been made about the deterrent effects of standards on investments is that parties will have reduced incentives to take care if they know that they will be bailed out by judicial intervention. Transposed in the corporate veil context, the argument would be that if creditors know that they can ask the judge to impose shareholder liability \textit{ex post}, they will make less effort to investigate the creditworthiness of the corporation \textit{ex ante}. That clearly would be undesirable. However, there is little evidence to suggest that this should be a serious concern. The courts have repeatedly said that contractual parties should be less entitled to veil piercing in light of their \textit{a priori} opportunity to investigate and negotiate.\footnote{Southeast Tex. Inns, Inc. v. Prime Hospitality Corp., 462 F.3d 666, 679 (6th Cir. 2006) (“Viewing this case from its proper perspective—a consensual contractual agreement between sophisticated parties—we are not persuaded that Southeast has pleaded extraordinary circumstances that justify piercing May-Ridge’s corporate veil.”); Williams v. Midwest Employers Cas. Co., 34 F. App’x 152 (5th Cir. 2002) (“[I]n contract cases plaintiff chooses to rely solely on obligation of corporation without any additional guarantees from its shareholders.”); Birbara v. Locke, 99 F.3d 1233, 1238 (1st Cir. 1996) (“Several courts and commentators have suggested that it should be more difficult to pierce the veil in a contract case than in a tort case . . . . We have found no Massachusetts Supreme Judicial Court case applying the veil piercing doctrine in a contract case.”) (internal citations omitted); Perpetual Real Estate Servs., Inc. v. Michaelson Props., Inc., 974 F.2d 545, 550 (4th Cir. 1992) (“Courts have been extraordinarily reluctant to lift the veil in contract cases, such as this one, where the creditor has willingly transacted business with the corporation.”) (internal quotation marks omitted).} Moreover, the courts have often refused to bail out contractual parties who failed to obtain adequate \textit{ex ante} credit
protection when given the opportunity to do so.\textsuperscript{44} In conclusion, while limited liability exhibits the general investment incentive effects of a rule, it externalizes uncompensated default risks and accident risks of a corporation to outside creditors. Meanwhile, if judiciously enforced, the corporate veil doctrine does not retard investments.

\textit{C. The Corporate Veil Doctrine as a Hybrid Formalities-Conduct Directive}

The third dimension of the rule-standard dichotomy is whether a legal command is used to encourage members of society to conform to certain legal formalities or whether the command is used to deter immoral conduct, or a mixture of both. As mentioned earlier, this dimension consists more of a spectrum than a dichotomy as there are legal commands that implicate both. Moreover, this dimension does not align neatly along rules and standards. At least conduct directives can be formulated as either rules or standards.\textsuperscript{45}

It has been said that formalities directives serve cautionary and evidentiary functions by ensuring that “the parties know what they are doing, and . . . that the judge will know what they did.”\textsuperscript{46} Moreover, “[f]ormalities are premised on the lawmaker’s indifference as to which of a number of alternative relationships the parties decide to enter.”\textsuperscript{47} Lawmakers are presumably indifferent about whether some private parties use a contract to govern their business transaction. The purpose of conduct directives is to reduce the incidence of morally objectionable conduct in society. These directives indicate a clearly expressed preference of the lawmaker against such conduct. These properties of formalities

\begin{footnotesize}
\begin{enumerate}
\item Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336 (Tex. 1968) (court refused to pierce veil noting that creditor received the promise it had bargained for); Moore & Moore Drilling Co. v. White, 345 S.W.2d 550 (1961) (court refused to pierce veil since creditor had prior opportunity to investigate corporation’s financial conditions); Fisser v. Int’l Bank, 282 F.2d 231 (2d Cir. 1960) (court refused to pierce veil since creditor knew subsidiary was undercapitalized and did not ask for guarantee from parent).
\item Meanwhile, formalities directives are usually in the form of rules.
\item Kennedy, \textit{supra} note 18, at 1691.
\item \textit{Id.}
\end{enumerate}
\end{footnotesize}
directives and conduct directives will assist in the classification of limited liability and the corporate veil doctrine along the spectrum of directives. An attempt will be made to determine the extent to which they serve evidentiary and cautionary functions and deter immoral conduct. This classification exercise is important because it will improve our understanding of the precise nature and purpose of limited liability and the corporate veil doctrine as legal commands.

Limited liability cannot be appropriately classified as a formalities directive. There are a number of reasons for this. First, it serves neither cautionary nor evidentiary functions. It is not a rule governing the procedures of incorporation so that business people know that they have adopted a corporation as the legal form of their business venture, or so that the judge knows that these co-venturers intended to conduct their business in the form of a corporation. Second, it cannot be said that the lawmaker is indifferent between alternative liability rules. The legislature has indicated a clear preference for protecting shareholders at the expense of creditors by choosing limited liability as the default rule. This is because once the default rule has been set, it takes a considerable amount of bargaining power and incentives on the part of the creditor to alter the rule through negotiation. Contrary to what has often been argued, it is not as easy to negotiate to override the default rule as it is to preserve it. It takes considerably more time and resources to negotiate against the default rule of the legal regime. Therefore, the adoption of limited liability indicates a conscious policy choice on the part of the lawmakers to favor shareholders and hence to encourage entrepreneurship and capital flow to corporations. Nor does limited liability aim to deter immoral conduct. It merely prescribes the liability positions of the shareholders and creditors following successful incorporation. The best way to characterize limited liability is as a hybrid formalities-conduct directive. Despite the lack of evidentiary and cautionary functions, limited liability is to some extent concerned with formalities. A corporation that was not properly formed may put the limited liability protection for its owners in jeopardy. Limited liability also has a conduct element, except that rather than deterring immoral conduct, it
is more aptly viewed as being concerned with encouraging desirable conduct—that of business activities and investments in corporations.

With respect to the corporate veil doctrine, the intuitive response is that it primarily aims to deter immoral conduct, such as the use of the corporate entity to perpetrate fraud or to evade legal obligations. This is manifested in the second prong of the two-part test adopted by many states and the impropriety prong of the instrumentality doctrine. Deterrence is meant to be achieved by holding shareholders responsible for corporate liabilities should they be found to have exploited the privileges of incorporation in an unfair or dishonest manner.\textsuperscript{48} This characterization is, however, incomplete as the corporate veil doctrine is also concerned with corporate formalities. One of the criteria identified by Thompson as being frequently applied by the courts is non-observance of corporate formalities. In fact, in the context of veil piercing, the notion of corporate formalities can be understood as going beyond such procedural matters as whether shares were properly issued or whether shareholders’ meetings have been properly convened to a broader range of indicia for the formal integrity of the corporation. In this sense, the criteria enumerated by Thompson—lack of substantive separation between the shareholders and the corporation, inadequate capitalization of the corporation, non-observance of corporate formalities, shareholder domination, and overlapping of corporate personnel and management—can be said to be matters of formalities. They are formalities that connote the extent to which the corporation functions autonomously from its shareholders and deserves to have its separate legal personality respected. They signify the formal integrity of the corporation. The courts will only accord limited liability protection to the putative shareholders if these expanded formalities requirements are met.

By piercing the veil when these requirements are not met, the courts have tacitly extended the formalities of incorporation beyond what is specified in the various states’

\textsuperscript{48} The extent to which the corporate veil doctrine achieves effective deterrence will be dealt with subsequently.
corporation statutes. This extension in fact can be quite substantial, and is most vividly illustrated by the inadequate capitalization cases. Most states have no minimum capital requirement for corporations.\(^49\) Only a handful of jurisdictions, such as District of Columbia, still maintain a minimum capital requirement of some kind.\(^50\) However, by piercing the veil on the grounds of inadequate capitalization, the courts have raised the *de facto* minimum capital requirement from a non-existent one under the statutes to a substantial one requiring corporations to have “sufficient funds to meet obligations to those who must deal with it.”\(^51\) The corporate veil doctrine has also extended the temporal dimension of the incorporation formalities. Most of the statutory incorporation procedures only apply at the time of incorporation. There are few ongoing obligations on the shareholders imposed by the state corporation law statutes. The corporate veil doctrine imposes an ongoing obligation on the shareholders not to commingle their assets with the corporation’s, not to dominate the daily operations of the corporation, and not to permit overlap in corporate personnel.

These judicially expanded formalities do not completely fit Kennedy’s description of formalities directives. They do not serve any evidentiary function. The issue in these corporate veil cases is almost never about conveying the intention of incorporation to the judge. There is usually no mistake about the putative shareholders’ intention. These formalities requirements do serve a cautionary function in some instances. To the extent that creditors of a corporation are confused about the identity of their counterparty—i.e., whether it is a corporation or its shareholders in their individual capacity—because of non-compliance with these formalities requirements, the courts have been willing to find misrepresentation by the

\(^{49}\) For example, the Model Business Corporation Act used to require a minimum capital contribution of $1,000. *Model Bus. Corp. Act Ann.* § 51 (1966). That was abolished in 1969.


\(^{51}\) Consol. Sun Ray, Inc. v. Oppenstein, 335 F.2d 801, 806-07 (8th Cir. 1964) (emphasis removed). *But see* Walkovszky v. Carlton, 223 N.E.2d 6, 10 (N.Y. 1966) (suggesting that minimum liability insurance requirement imposed by legislature represented full extent of protection legislature intended taxicab passengers to enjoy).
corporation and impose shareholder liability. The rationale is that non-compliance with these requirements constitutes a failure on the part of the putative shareholders to convey to the counterparty that it is transacting with a corporation. Veil piercing provides incentives to the putative shareholders to be forthcoming to the creditors about the precise relationships between the shareholders and the corporation.

Kennedy argues that lawmakers are indifferent about compliance with formalities directives. This suggests that judges should be equally neutral about the non-compliance with these judicially imposed requirements. While this may sound surprising, it is consistent with the weight of the case law that requires a finding of improper conduct or purpose in order for the corporate veil to be pierced. The courts have repeatedly held that evidence indicating unity of interest and ownership between the shareholders and the corporation alone is insufficient to justify veil piercing. A close examination of the case law suggests that the ultimate motivation behind

52 Doughty v. CSX Transp., Inc., 905 P.2d 106 (Kan. 1995) (plaintiff worker’s veil piercing rejected partly because he had no mistake about identity of his employer); Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336 (Tex. 1968) (court refused to pierce veil as there was no misrepresentation and mistake about identity of corporation); Zaist v. Olson, 227 A.2d 552 (Conn. 1967) (court pierced veil partly on grounds of confusion of identity between shareholder and corporation); Black & White, Inc. v. Love, 367 S.W.2d 427 (Ark. 1963) (two corporations sharing dispatch and other functions reasonably led plaintiff to assume that they were same corporation); Oriental Investing v. Barclay, 64 S.W. 80 (Tex. App. 1901) (plaintiff workers did not know of existence of subsidiary).

53 Posner has similarly argued for a misrepresentation exception to the general rule of limited liability. According to him, misrepresentation increases the costs which a creditor must incur to investigate and understand the corporation’s finances with no corresponding social benefits. Such expenditure of information costs is socially wasteful and can be obviated by creating a misrepresentation exception to limited liability, Posner, supra note 34, at 520-21.

54 Kennedy, supra note 18, at 1691 ("Formalities are premised on the lawmaker’s indifference as to which of a number of alternative relationships the parties decide to enter."). Kennedy’s discussion assumes that the legislature crafts the formalities rules, whereas in the context of the corporate veil doctrine, this is undertaken by the judiciary.

55 In this Article, improper purpose and conduct is meant to encompass all the usual circumstances under which the courts pierce the veil, such as to prevent fraud, illegality, injustice, a contravention of public policy, or circumvention of a statutory prohibition.

56 See supra text accompanying note 9.
judicial intervention in the corporate veil cases is the existence of fraud or injustice, and not whether corporate formalities, broadly or narrowly defined, have been complied with.

Given its dual concerns with conduct and formalities, the corporate veil doctrine is more appropriately classified as falling within “an intermediate category of legal institutions that partakes simultaneously of the nature of formalities and of rules designed to deter wrongdoing.” 57 Absent an improper purpose or conduct, the non-observance of corporate formalities will not result in shareholder liability. However, by making such non-observance a prerequisite for veil piercing, the courts have clearly expressed a desire to encourage shareholders to respect the formal integrity of their corporations. The foregoing analysis thus confirms the corporate veil doctrine as a specific, open-ended standard that encourages compliance with corporate formalities and aims to deter immoral conduct.

What is most didactic about the classification of the corporate veil doctrine as a hybrid formalities-conduct directive is Kennedy’s inclusion in the same category legal directives which he claims to evince an ambiguity of purpose. Examples of such directives are rules defining liabilities and assessing damages in contract and tort law. Kennedy argues that these rules may be viewed as harboring moral ambivalence about a contractual breach or a tort so long as the damages are paid. 58 Equally plausibly, they may be characterized as taking a determinedly moralistic view and desiring to deter such conduct. 59 This claim of ambiguity of purpose leads one to ponder the purpose of the corporate veil doctrine. The important question, which does not seem to have been raised, let alone answered, by previous commentators is: what is the objective of the corporate veil doctrine? Does it aim to punish, deter, or compensate? Is it indifferent toward improper conduct and disregard of corporate formalities so long as shareholders bear full responsibility for the corporate liabilities? These questions will be answered in the next two sections.

57 Kennedy, supra note 18, at 1692.
58 Id. at 1694.
59 Id.
II. THE SUBSTANTIVE INDIVIDUALISM-ALTRUISM DICHTOMY OF THE CORPORATE VEIL DOCTRINE

A. Limited Liability as an Individualistic Rule and the Corporate Veil Doctrine as an Altruistic Standard

The relevance of Kennedy’s framework to understanding the relationship between limited liability and the corporate veil doctrine is not confined to the formal dimension. His assertion of the correspondence between the rule-standard classification and the individualism-altruism dichotomy sheds light on the objective of the corporate veil doctrine. One of the greatest insights in his analysis of the choice between rule and standard is the fact that this choice reflects a more fundamental conflict between two opposing philosophies or ways of life: individualism and altruism.60 He explains individualism as

[T]he making of a sharp distinction between one’s interests and those of others, combined with the belief that a preference in conduct for one’s own interest is legitimate . . . . The form of conduct associated with individualism is self-reliance. This means an insistence on defining and achieving objectives without help from others . . . .61

Altruism is in turn defined as “the belief that one ought not to indulge a sharp preference for one’s own interest over those of others. Altruism enjoins us to make sacrifices, to share, and to be merciful.”62 Kennedy observes that there is a close parallel in the arguments made by a lawyer for the strict adherence to legal rules and the arguments in defense of individualism.63 Likewise, there is a distinctly altruistic undertone in the advocacy for standards.64 The ensuing analysis demonstrates the extent to which limited liability and

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60 Kennedy, supra note 18, at 1745-47.
61 Id. at 1713.
62 Id. at 1717.
63 Id. at 1738.
64 Id. at 1740. More relevant to this Article is the association between arguments for rules and laissez-faire economics, and advocacy for standards and liberal economic views, which are more receptive of the imposition of altruistic duties on the well-to-do in society. Id. at 1740-51.
the corporate veil doctrine reflect individualistic and altruistic beliefs as articulated by Kennedy.

There are three specific ways in which rules encapsulate individualism. First, rules are meant to be non-interventionist or at least non-resulted oriented. This is consistent with the requirements of an individualistic society, in which the state takes a back seat and allows individuals the maximum room to take private initiatives and to realize their potential. Second, rules, especially those governing the formalities of transactions, encourage members of society to acquire formal proficiency by punishing non-compliance with non-enforcement of transactions. Similarly, individualism motivates members of society to acquire substantive proficiency, i.e., being economically productive and self-sufficient, by vowing not to bail them out if they fail or lay idle. Third, by increasing legal certainty, rules encourage transactions and exchanges, which are dearly valued by individualists and are presumptively good for society.

It should be obvious that limited liability is individualistic in nature. Limited liability itself emerged in the nineteenth century as an economic policy tool to promote industrialization. As the capital need of businesses grew, state legislatures were under pressure to introduce limited liability to help corporations attract investments from passive shareholders. Limited liability was first adopted in quick succession by the northeastern states, which faced regulatory competition with one another and did not want to lose businesses to other states. In England, limited liability was not adopted until the Limited Liability Act of 1855, and not without a bitter struggle which saw proponents of laissez-faire

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65 Id. at 1741. Kennedy disagrees with the assertion that rules are non-interventionist and argues that both rules and standards are interventionist, simply to different degrees. Id. at 1747-48.

66 Id. at 1744. Moreover, Kennedy points out rules have been traditionally associated with classical laissez-faire economics of the nineteenth century. Id.


69 Blumberg, supra note 37, at 590-94.
economics emerge triumphant. In fact, alongside negligence, limited liability is one of those legal rules that encapsulated nineteenth-century laissez-faire economics. Limited liability is probably the quintessential non-interventionist legal rule. Its nature is facilitative instead of regulatory by setting out the default liability positions of the shareholders and the creditors. The main purpose of limited liability, as identified by many scholars, is to encourage equity investments in corporations and facilitate transactions between corporations and outside creditors. It has been argued that limited liability is crucial to the efficient functioning of the capital markets and to corporations’ ability to attract passive investments. Limited liability also reduces the need for monitoring by contractual creditors by permitting the compartmentalization of corporate and shareholder assets. Lastly, there is a distinct undertone of self-reliance in limited liability. The rule enjoins creditors of a corporation to use their wherewithal to fend for themselves. It encourages them to spend time to investigate the corporation’s financial position and to bargain for additional credit protection. The incentive to undertake precautions ex ante is provided by the refusal of the law to bail out ex post creditors which have neglected to do so, were mistaken in their effort, or dissatisfied with their bargain. All these characteristics point to a distinctly individualistic nature of limited liability.

The corporate veil doctrine is altruistic in the sense that it softens the harshness of the highly self-reliant world.

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70 Halpern et al., supra note 34, at 118.
72 Halpern et al., supra note 34, at 135-38; Fischel & Easterbrook, supra note 34, at 95-97; Thompson I, supra note 6, at 17-18; Posner, supra note 34, at 507-09.
73 Halpern et al., supra note 34, at 135-38; Fischel & Easterbrook, supra note 34, at 95-97.
74 Hansmann & Kraakman I, supra note 34, at 424.
75 William O. Douglas & Carrol M. Shanks, Insulation from Liability through Subsidiary Corporations, 39 Yale L.J. 193, 211 (1929) (“The very reasonable question must be met and answered why one who contracted with the subsidiary and received the promise which he bargained for but who has been disappointed in the fulfillment by the subsidiary of its commitment should then be allowed to look to the parent. As a matter of contract it is evident he may not.”).
envisioned by limited liability. In this world, a contractual creditor has the opportunity to bargain with the corporation ex ante and should not be allowed to overturn the bargain ex post. Even with respect to fraud and misrepresentation, the individualist may argue that the creditor should and could have anticipated such occurrences and bargained for protection accordingly. Fraud and misrepresentation is common after all, and creditors should be aware of them in advance. Despite its lack of opportunity to engage in prior bargain, a tort victim is no more deserving of special favor from the law as it can protect itself with insurance coverage. The corporate veil doctrine takes exception from this world-view and offers assistance to those who have been unfairly prejudiced by shareholder misconduct. It rejects the individualist stance that every corporate counterparty is in a position to protect itself from shareholder abuses. Nor will the law tolerate sharp practices by unscrupulous shareholders the full brunt of which is most likely to be borne by the weak. In this sense, the corporate veil doctrine takes on a somewhat paternalistic tone, which Kennedy identifies as a characteristic of altruism. The doctrine undertakes a highly particularized inquiry into the specific facts of each case to determine when assistance should be extended. This requires standard-based legal intervention, which, of course, is an altruistic tool. Moreover, while the individualist largely sees the role of the law as facilitative, the altruist is more ready to use it to achieve regulatory objectives. In the context of the corporate veil doctrine, the “regulatory” objective pursued is the prevention of abuses of the corporate entity, especially at the expense of other members of society.

In short, not only do limited liability and the corporate veil doctrine demonstrate the respective formal characteristics of rules and standards, they also conform to the individualist-altruist paradigm posited by Kennedy. Both in formal and substantive senses, limited liability and the corporate veil doctrine fit into Kennedy’s formal and substantive dichotomies of private law litigation.

76 Kennedy, supra note 18, at 1736.
77 Id. at 1740.
B. Objectives of the Corporate Veil Doctrine

A determination that the corporate veil doctrine is altruistic in nature does not definitively address the question of what its main objective is, which will be answered in the ensuing inquiry. Two observations are in order before embarking on this inquiry. First, the purpose of the inquiry is not to ascribe a single objective to the doctrine, but to ascertain its principal, or at least its most important one. Given the variety of corporate veil cases, it is probably impossible to arrive at a single objective that encapsulates all the cases. In fact, not only can a multitude of objectives be found among the cases, they can be sometimes detected in one single case. These objectives are not mutually exclusive; the courts have expressed a desire both to compensate and to deter or punish within one case. Second, there are few explicit references to the objectives of the doctrine in the cases. What the courts have repeatedly said is that the corporate veil doctrine is meant to prevent injustices. However, a review of the case law shows that the courts have cited prevention of injustices not so much as an overarching justification for the doctrine as a necessary condition for its invocation.

A determination of the principal objective of the doctrine entails an understanding of the interaction between the doctrine itself and the underlying causes of action. Or to frame the inquiry differently, one needs to determine whether the doctrine serves any independent purpose, or merely reinforces the objectives of the underlying contractual or tort claims—which may be compensatory or deterrent, or even punitive if

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78 HOK Sport, L.C. v. FC Des Moines, L.C., 495 F.3d 927, 936 (8th Cir. 2007); In re Blastein, 192 F.3d 88, 100 (3d Cir. 1999); In re Schimmelpenninck, 183 F.3d 347, 357 n.21 (5th Cir. 1999); Green v. Windsor Mach. Prods., Inc., 173 F.3d 591, 594 (6th Cir. 1999); United States v. Cordova Chem. Co. of Mich., 113 F.3d 572, 585 (6th Cir. 1997); McCall Stock Farms, Inc. v. United States, 14 F.3d 1562, 1567 n.4 (Fed. Cir. 1993); NLRB v. Greater Kan. City Roofing, 2 F.3d 1047, 1051 (10th Cir. 1993); Manville Sales Corp. v. Paramount Sys., Inc., 917 F.2d 544, 552 (Fed. Cir. 1990).

79 For instance, the Manville Sales court asserted that “a court may exert its equitable powers and disregard the corporate entity if it decides that piercing the veil will prevent fraud, illegality, injustice, a contravention of public policy, or prevent the corporation from shielding someone from criminal liability.” Manville Sales, 917 F.2d at 552.
the corporation is subject to punitive or liquidated damages. The answer to this question depends on whether the doctrine expands the underlying contractual or tortious liability beyond its original scope or merely preserves it.

Despite statements by some courts to the contrary, the corporate veil doctrine does not expand the liability imposed on the corporation. The amount of liability imposed on the corporation remains the same after operation of the doctrine. It merely ensures that liability is met to the fullest extent possible. This is corroborated by the judicial pronouncement that the doctrine is “an equitable remedy, not a cause of action unto itself, which is used as a means of imposing liability.”

This statement implies that the doctrine is not an independent basis of liability. It merely transposes the liability, to the extent that it is unmet after corporate assets have been exhausted, from the corporation to the defendant shareholder.

This observation, however, is only partially correct. The primary consequence of veil piercing is of course the imposition of shareholder liability. There is in fact a secondary and often overlooked consequence, which is the concentration of liability. While it is true that the doctrine does not alter the size of the underlying liability, it concentrates the entire liability on one or a few culpable shareholders. So long as the corporation has only one shareholder, this concentration makes no difference. For corporations with more than one shareholder, the extent to which the corporate veil doctrine concentrates liability crucially depends on whether shareholder liability is imposed on and

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80 IFC Interconsult, AG v. Safeguard Int'l Partners, LLC, 438 F.3d 298, 312 (3d Cir. 2006) (“[V]eil-piercing is an equitable procedure that involves the creation of liability in spite of the contractual and statutory separateness of corporate entities.”) (citation omitted).

81 The extent to which liability will be paid in full also depends on the amount of shareholder assets. In a way, every liability is limited in the sense that it is subject to the possibility of judgment-proof defendants, corporate or individual. Leebron, supra note 38, at 1575.

prorated among all the shareholders. This is because for a solvent corporation that is not subject to a veil piercing claim, the impact of liability will be borne by the shareholders proportionate to the value of their shareholdings. Take the example of a corporation with $10 million assets and five equal shareholders. If the corporation is subject to $5 million tort liability, each shareholder’s claim to the corporate assets will be reduced proportionately by half, absent alternative arrangements. If the tort liability is increased to $15 million, this proportionate allocation would only be maintained if the excess liability of $5 million were distributed equally among the five shareholders. In other words, the unmet liability must be imposed on the entire body of shareholders and be prorated among them.

A review of the corporate veil cases, however, suggests that this is not the way in which the corporate veil doctrine operates. Veil piercing claims are almost invariably targeted at one or a few shareholders responsible for the wrongdoing. They are almost never filed against all the shareholders at the same time. In this sense, the corporate veil doctrine is different from a regime of general unlimited liability that has been proposed by some commentators. A veil piercing court does not prorate liability among the shareholders. Instead, the entire unmet portion of corporate liability is concentrated on the culpable shareholders. The shareholders’ incidence of liability is increased through the operation of the corporate veil doctrine. This suggests that the doctrine does not merely reinforce the objectives of the underlying contract or tort law. By altering the incidence of liability, the corporate veil doctrine pursues independent objectives.

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83 This author is not aware of any corporate veil cases in which liability was imposed on innocent and culpable shareholders alike.

84 Hansmann & Kraakman II, supra note 38, at 1880-81. Leebron’s proposal of unlimited liability, at least with respect to corporate groups, is only limited to majority shareholders of a subsidiary. Leebron, supra note 38, at 1612-26. Leebron’s proposal is hence more similar to a corporate veil claim.
1. Punishment for Improper Conduct

What remains to be determined is the precise nature of these objectives. There are a number of possibilities, including punishment, deterrence, compensation, and avoiding unjust enrichment. There is evidence that veil piercing has produced punitive effects in some cases. In some of the inadequate capitalization cases, the defendant was subject to a liability that significantly exceeded the shortfall in capitalization identified by the court.\textsuperscript{85} The defendant shareholder can be said to have been punished for his failure to capitalize the corporation adequately. There have been other corporate veil cases in which the courts expressed strong disapproval of the defendant’s conduct and imposed personal liability as a punishment. For example, in \textit{Bair v. Purcell}, after describing the defendant’s conduct as “outrageous and reprehensible,” the court pierced the veil to impose hefty personal liability.\textsuperscript{86} And of course when pled in a criminal case, veil piercing may further the punitive objectives of the underlying criminal law. However, this is very rare. Of the 1,600 or so cases surveyed by Thompson, only fifteen of them were criminal cases.\textsuperscript{87} Therefore, the focus of the discussion will be on the pursuit of punitive objectives in the civil veil piercing cases.

To further a punitive objective in civil cases, a veil piercing court must impose civil damages additional to and far exceeding what is necessary for compensation. The case law shows that this is rarely done by the courts. This can be illustrated with a comparison between the concentration of liability under veil piercing and punitive damages. In civil


\textsuperscript{86} Bair v. Purcell, No. 1:04-CV-1357, 2009 WL 772828, at *15 (M.D. Pa. Mar. 17, 2009). The court’s punitive intent was corroborated by its imposition of punitive damages on the defendants. Id. at *17 (“Francis Purcell and Norma Purcell intentionally engaged in outrageous, reprehensible conduct and that punitive damages are necessary to punish and deter them and others from engaging in this behavior in the future.”).

\textsuperscript{87} Thompson II, \textit{supra} note 11, at 1058.
cases, the courts punish the defendant by imposing punitive damages, which are often multiples of the compensatory award. In corporate veil cases, the same effect can only be achieved if the liability imposed on a shareholder is a multiple of its proportionate share. This concentration effect increases as a particular shareholder’s ownership stake decreases in size. For a shareholder with 100% ownership, there will be no concentration effect. For a shareholder with a 20% ownership stake, the liability multiple will be five. A review of the case law shows that veil piercing is most often only applied to shareholders with a controlling stake, which allow the courts to hold those shareholders responsible for the corporation’s improper conduct. It is rarely applied to shareholders whose stake is small enough so that the liability multiple will approach that under punitive damages. In other words, veil piercing alone almost never concentrates liability sufficiently to achieve punitive effects. Absent the concurrent imposition of punitive damages, veil piercing is unlikely to achieve significant punitive effects.

A punitive objective is unsuitable for the corporate veil doctrine for other reasons. First, the class of conduct that justifies veil piercing encompasses a variety of commercial practices. While some cases implicate conduct such as fraud that may justify punitive action, the conduct featured in other cases is often less reprehensible. Punishment will not be an appropriate response in these cases. The ascertainment of a punitive objective is also inconsistent with the altruistic underpinning of the doctrine, which emphasizes sharing and sacrifice between members of society. Punishment that aims to deter undesirable conduct is a distinctly individualistic response. For these reasons, a punitive rationale is an inappropriate objective of the corporate veil doctrine.

88 For instance, in Pacific Mutual Life Insurance Co. v. Haslip, 499 U.S. 1 (1991), the Supreme Court upheld the constitutionality of a punitive damage award which was more than four times the size of the compensatory damages, despite noting that it might be “close to the line.” Id. at 23. In BMW of North America, Inc. v. Gore, 517 U.S. 559 (1996), the Supreme Court struck down as unconstitutionally excessive a punitive damage award that was 500 times the compensatory damages awarded to the plaintiff.

89 HOK Sport, Inc. v. FC Des Moines, L.C., 495 F.3d 927, 936 (8th Cir. 2007) ("[F]raud is a sufficient, but not necessary, condition for piercing the corporate veil.").
2. Compensation for the Corporate Creditors

The corporate veil doctrine performs a compensatory function. In particular, it helps to restore the full compensatory effects of the underlying contractual or tort damages that otherwise would have been curtailed by limited liability. For example, a contractual creditor whose breach of contract claim is worth $1 million against a corporation with $500,000 assets would have been denied half of its compensation if limited liability were strictly adhered to. The same applies for tort claims. Operation of the limited liability rule would have confined maximum recovery to the sum of the corporation’s assets. To the extent that the main function of contractual and tort liabilities is compensatory, the corporate veil doctrine preserves this function.

This picture is incomplete, however, as it ignores the possibility that compensation from a corporation is intended to be subject to an implicit cap under limited liability. Take contractual liabilities as an example. The argument is the well-rehearsed one that when a contractual creditor enters into a transaction with the corporation, it implicitly accepts the fact that its maximum recovery is limited to the corporate assets. If such a creditor desires extra credit protection, perhaps in the form of shareholder personal guarantees, it should negotiate for it. Failure to undertake such negotiation is an implied acceptance of the cap on its maximum recovery imposed by limited liability. This bargain argument has little application for tort victims, who usually do not have the opportunity to negotiate with the tortfeasor *ex ante*. Even then, one may argue that by adopting limited liability, the legislature has made a policy determination that tort damages be subject to a similar cap as well. Potential tort victims are expected to take out insurance to make up for the shortfall. To the extent that these assertions are true, the corporate veil doctrine goes beyond mere restoration of the compensatory function of civil damages by upsetting the tacit bargain that the creditor has

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90 Tort law, of course, is widely understood to perform a deterrent function as well. See generally STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 177-256 (2004).
made with the corporation and overturning the policy choice made by the legislature.

At least with respect to contractual creditors, it is possible to reconcile veil piercing with the bargain theory proposed above. The reconciliation is premised on the argument that when a contractual creditor transacts with a corporation, one of the implied terms in the contract is that the integrity and autonomy of the corporation will be respected and that the corporation will not be used for improper purposes. In this sense, veil piercing can be viewed as judicial enforcement of the implied terms of the contract. For example, veil piercing based on asset stripping or shareholder misappropriation of corporate assets can be understood as enforcing the implied contractual term that the shareholders will not engage in *ex post* opportunistic conduct. The obvious question is why the parties rely on the courts to fill in the implied terms for them, as opposed to writing them explicitly into the contract themselves. One possible answer is the difficulty with delineating the varieties of *ex post* shareholder opportunism and designing the appropriate protection against them. Instead, the parties choose to rely on the courts to supplement their contracts. This helps to explain why the courts often refuse to pierce the veil when there is evidence suggesting that

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91 United States v. Golden Acres, Inc., 702 F. Supp. 1097, 1107 (D. Del. 1988) (“When it agreed to insure the loan to Golden Acres, HUD naturally assumed that Golden Acres would be managed like a normal corporation, with sufficient regard for solvency, corporate formalities, and corporate obligations. Refusal to pierce the corporate veil in this case would be unfair in that it would punish HUD for its misplaced trust and reward defendants for their abuse of the corporate form.”); Taylor Steel, Inc. v. Keeton, 417 F.3d 598, 610 (6th Cir. 2005) (noting that even though breaches of contract happen regularly, contractual parties are entitled to expect to have recourse to corporate assets and not to have those assets siphoned off to avoid liability); Laya v. Erin Homes, Inc., 352 S.E.2d 93, 100 (W. Va. 1986) (“[I]n entering into such [contractual] relationships with corporate entities the parties are [generally] entitled to rely upon certain assumptions, one being that the corporation is more than a mere shell—that it has substance as well as form.”).

92 This can also be viewed as an embodiment of the principles of truth and respect proposed by Dean Clark for the dealing between a corporation and its creditors. Clark, *supra* note 24, at 511.
the contractual creditor foresaw the problem but failed to take any action to protect itself.93

This implied contract explanation for veil piercing, however, suffers from a number of limitations. First, while some courts have refused to pierce the veil in light of evidence that the creditor failed to take precautions against known sources of risk, just as many courts have imposed shareholder liability despite such evidence.94 If the creditor has expressly considered a potential default risk and has resolved to do nothing about it, judicial intervention cannot be understood as enforcement of implied contractual terms. Instead, what the court does is override the parties’ contractual understanding.

Second, not every ground for veil piercing can be plausibly characterized as an implied contractual term which the parties would have incorporated in their contract but for the prohibitive transaction costs. For example, a contractual creditor is unlikely to be concerned about the overlap in personnel between a parent corporation and its subsidiary so long as the subsidiary remains profitable and its liabilities are backed up by ample assets. Nor is this creditor likely to negotiate for contractual terms governing the observance of corporate formalities, such as whether shareholder and board meetings are properly convened. This explains why veil piercing criteria such as non-observance of corporate formalities and shareholder domination are usually justified not so much on creditor protection grounds as on an estoppel theory. The theory is that if the shareholder himself does not treat the corporation as one, he cannot be heard to complain when the court sets aside the corporate entity.95

Third, this implied contract explanation obviously does not apply to tort claims. There is almost never any ex ante

95 Barber, supra note 11, at 400; Landers, supra note 68, at 621-22.
negotiation of risk allocation between the corporation and the tort victim. The lack of such negotiation means that veil piercing cannot be explained as judicial fulfillment of the parties’ implicit wishes. The conclusion is probably unavoidable that by piercing the veil in tort cases, the courts have overridden the legislature’s policy choice. In fact, it is not entirely clear that this explanation applies to contractual creditors of all kinds.\textsuperscript{96} One of the basic premises of the explanation is that a contractual creditor can bargain for extra credit protection beyond the background rule of limited liability if it so desires. By piercing the veil, the courts are merely filling in the gaps in the contract and inserting terms that the parties would have wanted to include. However, if the creditor at issue does not have the bargaining power or the incentive to negotiate for additional protection, the function performed by veil piercing is more than gap filling. For instance, an employee is unlikely to have the bargaining power to ask for a personal guarantee for his wages by the shareholders of his employer, let alone to demand contractual protection against \textit{ex post} shareholder opportunism or other kinds of misconduct.\textsuperscript{97} It therefore makes little sense to characterize veil piercing on behalf of unpaid employees as enforcement of implied contractual terms. The more plausible explanation is judicial recognition of the employee’s inability to protect himself and intervention on his behalf to override the harsh effects of limited liability. The implied contract explanation is arguably only apt for financial creditors and some trade creditors.

To sum up, the extent to which the corporate veil doctrine performs a compensatory function depends on the nature of the underlying claim and the identity of the creditor. For a tort

\textsuperscript{96} There are generally three kinds of contractual creditors: financial creditors, trade creditors, and employees. Easterbrook & Fischel, \textit{supra} note 34, at 104-05. Professors Easterbrook and Fischel include consumers as contractual creditors of a corporation as well. There are disagreements regarding the correct classification of consumers as voluntary or involuntary creditors. Blumberg, \textit{supra} note 37, at 618. For the purpose of this article, consumers will be excluded from contractual creditors.

\textsuperscript{97} Blumberg, \textit{supra} note 37, at 619-20; Halpern et al., \textit{supra} note 34, at 149-50. Dean Clark has similarly noted that as compared to bank creditors, trade creditors are likely to have less bargaining power and wherewithal to conduct a thorough credit check and negotiate for adequate protection. Clark, \textit{supra} note 24, at 543-45.
victim, to the extent that the legislature has made a conscious policy choice under limited liability to cap tort damages against corporations, the doctrine’s effect goes beyond mere compensation.\footnote{98} For a contractual creditor, the compensatory effects vary with the type of contractual creditor at issue. For sophisticated financial creditors, one can postulate veil piercing as a compensatory tool by characterizing the judicially imposed requirements as what the parties themselves would have contracted for. These creditors realistically could have bargained for many of the protections mandated by the courts. For many trade creditors and employees, this explanation loses its persuasiveness as most of them would have been unable to obtain those protections through contractual negotiations. Veil piercing performs more than a mere compensatory function for them. In short, while the corporate veil doctrine no doubt performs a compensatory function, compensation is not its principal objective.

3. Deterrence of Future Improper Conduct

Deterrence is another possible objective of veil piercing. It is a particularly fitting one in light of the requirement of improper conduct in the various formulations of the doctrine. In Powell’s formulation of the instrumentality doctrine, the types of conduct that qualify as improper conduct include fraud, circumvention of a statutory prohibition, asset stripping, misrepresentation, estoppel, torts, and other cases of wrong or injustice.\footnote{99} This is conduct that the law would like to deter.\footnote{100} There have been cases in which the courts combined veil piercing with punitive damages with the express purpose to achieve deterrence.\footnote{101} In In re Amberjack Interests, the court

\footnote{98} The corporate veil doctrine will also restore the deterrent effects of the tort judgment.\footnote{99} Powell, supra note 14, at §§ 6, 13.\footnote{100} With respect to tort liabilities, the corporate veil doctrine helps to preserve the inherent deterrent functions of tort damages. Of course, preservation of the functions of the underlying contractual or tort damages is not the main focus of our inquiry; the focus is whether the doctrine pursues any independent objectives of its own.\footnote{101} In a previous section, there was discussion of courts using punitive damages to punish. Punitive damages of course can both punish and deter. Some courts have
imposed personal liability and punitive damages on the defendants to “deter future conduct of this deplorable nature,” which consisted of misappropriation of corporate funds.\textsuperscript{102} Similarly, in In re Fox, the court combined both personal liability and punitive damages “to deter the defendant from engaging in similar conduct in the future.”\textsuperscript{103} However, the need to combine shareholder liability with punitive damages to achieve deterrent effects seems to suggest that veil piercing alone does not suffice for deterrence purposes. Moreover, attributing deterrence as the principal objective of the doctrine is complicated by the general judicial consensus that the doctrine is an equitable one whose goal is to prevent injustices.\textsuperscript{104} The courts seldom describe the corporate veil doctrine in deterrence terms. Yet the importance of this dearth of references should not be overstated. The courts seldom explicitly acknowledge deterrence as a goal of tort law, but that has not stopped commentators from analyzing and theorizing about the deterrent effects of tort liabilities. What matters is not whether the courts themselves perceive their veil piercing decisions in deterrence terms, but whether these decisions do in fact achieve those effects.

Examination of the possible deterrent effects of the corporate veil doctrine requires a more nuanced understanding of how liability creates deterrence and how this inducement works in the context of the corporate veil doctrine. For the law to have a deterrent effect on undesirable conduct, the penalty must be greater than the benefits the defendant obtains from such conduct. Otherwise, the defendant would be always

\textsuperscript{103} In re Fox, 232 B.R. 229, 231 (Bankr. D. Kan. 1999). The court noted that the defendants debtor,

[I]ntentionally concealed his misconduct over several years. He filed fraudulent registrations with the Patent and Trademark Office, deliberately sold inferior aluminum phosphide as Quick-Phos, provided erroneous deposition testimony, falsified multiple invoices, and submitted fraudulent information to both plaintiffs and the court. Further, his trial testimony was hardly the hallmark of truthfulness.

\textsuperscript{104} See supra text accompanying note 8.
willing to take a chance with the hope that the conduct will not be detected. If the penalty is the same as the benefit from the undesirable conduct, the defendant will have nothing to lose if it gets caught. In fact, theoretically, the penalty or damages should be set as the benefit multiplied by the reciprocal of the probability of apprehension. For example, if the shareholder’s dissipation of corporate assets has a 20% chance of detection, and the dissipated assets are worth $1 million, the penalty on the defendant should be set at $5 million to achieve full deterrent effect.

The question of how the corporate veil doctrine achieves deterrence needs to be analyzed differently for intentional improper conduct and non-intentional, probabilistic improper conduct such as negligence-based torts. This is because as far as intentional conduct is concerned, the perpetrator has control over whether the conduct is undertaken. In order to deter such conduct, the law needs to impose an expected penalty on the perpetrator that is equal to the benefit multiplied by the reciprocal of the probability of apprehension. For probabilistic conduct, the tort may take place despite the precautions undertaken by the tortfeasor. Thus the law needs to ensure that the tortfeasor is liable for the full damages it causes so that it internalizes the full costs of its negligent conduct. In that case, the tortfeasor will take precautions up to the socially efficient level. As the ensuing discussion will show, the corporate veil doctrine is at best only an imperfect tool for achieving deterrence.

The discussion begins with intentional conduct. Shareholder liability resulting from veil piercing falls short of the theoretical requirements of effective deterrence in two important ways. First, the corporate veil doctrine does not impose penalties nor does it directly take into account the shareholder’s gains from his improper conduct. The doctrine merely holds shareholders responsible for unpaid corporate liabilities. The outstanding liabilities may have little to do with the perpetrator’s ill-gotten gains. If the gains exceed the outstanding liabilities, merely holding the culpable shareholder

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105 Shavell, supra note 90, at 236-38.
liable for the latter will not achieve effective deterrence. In some cases, there may be a close correspondence between the ill-gotten gains and the outstanding liabilities. To the extent that the unpaid liabilities are the direct consequence of shareholder misconduct, those liabilities can be used as a gauge of the shareholder’s gains. For instance, if a shareholder removes $1 million of corporate assets and the corporation is unable to repay $1 million of debts as a result, these outstanding liabilities would reflect the shareholder’s ill-gotten gains. If the outstanding liabilities were then adjusted for the probability of detection, imposition of shareholder liability would be consistent with the theoretical requirements of deterrence.

Second, and more importantly, achieving effective deterrence of intentional conduct requires the unpaid liabilities to be adjusted for the probability of detection. The case law shows that this is not done by the courts. Without such an adjustment, the corporate veil doctrine will not effectively deter intentional shareholder misconduct. One mitigating factor for this deficiency is that the probability of detecting shareholder misconduct is likely to be high given that the consequence of such misconduct is corporate failure and default. There should be little difficulty with detection because the creditors will surely become aware of a default, after which shareholder misconduct will be uncovered. In the event that the shareholder misconduct does not result in a default, detection will not be as straightforward. However, one may argue that the corporate veil doctrine should not be concerned with shareholder misconduct if it does not result in failure to meet corporate liabilities. Deterrence of such conduct is the responsibility of other areas of corporation law. As long as the creditors are fully paid off, the doctrine should have no application.

Deterrence of probabilistic conduct is relatively straightforward. The main type of such conduct as far as the corporate veil doctrine is concerned is negligence-based torts committed by the corporation. As mentioned earlier, to the extent that the underlying tort damages were already set to achieve deterrence, preservation of the deterrent effect only
requires that the corporation and its shareholders fully internalize the harm caused by the tort. In other words, the corporate veil doctrine only needs to shift unmet liabilities to the shareholders, which is precisely what the doctrine does. However, the courts have almost never held the shareholders personally liable for a corporate tort absent misconduct on their part. The courts have repeatedly affirmed that the corporate entity can be legitimately employed to limit future tort liabilities. The misconduct required to pierce the veil is always intentional. Absent such misconduct, the full deterrent effect of a tort judgment against a judgment-proof corporation will be curtailed. What would be needed to preserve the full deterrent effect of the judgment is a general rule of unlimited liability. In light of the requirement of intentional misconduct for veil piercing, one may even say that the corporate veil doctrine is never concerned with deterrence against probabilistic torts.

An interesting observation about using the corporate veil doctrine to achieve deterrence is that the deterrent effect is inversely proportional to the defendant’s shareholding in the corporation. This can be illustrated with another numerical example. Assume that there are five shareholders in a corporation, only one of whom has dominated the corporation and was found to have committed improper conduct, the detection of which has a probability of 20%. A tort victim files a veil piercing claim against this shareholder, seeking to hold him personally liable for $5 million of unmet liability award. If the claim prevails, personal liability for this shareholder would be $5 million, as opposed to the $1 million which would have been allocated to him had the additional liability been apportioned equally among the five shareholders. Thus the liability multiple is five, which is the reciprocal of his 20%

107 See generally Hansmann & Kraakman II, supra note 38, at 1882-94; Leebron, supra note 38, at 1584-85.
shareholding. Assuming that the outstanding liability reflects the ill-gotten gains, the shareholder’s 20% share ownership inadvertently helps to achieve full deterrent effect. In fact, to the extent that the other shareholders have shared the benefits of the improper conduct, this deterrent effect will be further enhanced. The benefit received by the culpable shareholder will be smaller than the outstanding liability (as it has been shared by other shareholders), while his share of the corporate liability remains unchanged.

Whether this deterrence enhancement effect is desirable is of course a different issue. The smaller a shareholder’s ownership interest, the less likely it is that the shareholder has control over corporate affairs and should be held responsible for the corporation’s default. In fact, one may argue that the deterrent effect should be made greater the larger a shareholder’s ownership stake. The irony is that, as mentioned earlier, veil piercing will achieve no deterrent effect in a single-shareholder corporation. There is no concentration of liability and no dilution of ill-gotten gains. Yet there is no more convincing case for deterrence than a single-shareholder corporation, where the sole shareholder’s responsibility for the corporation’s conduct is beyond dispute. This is another reason why the corporate veil doctrine is a blunt instrument of deterrence.

Aside from its ineffectiveness as a deterrence tool, the altruistic nature of the corporate veil doctrine means that deterrence is unlikely to be a fitting objective for it. As Kennedy said, altruism calls for sharing and mercy, not punishment and deterrence. Deterrence of undesirable conduct that harms the economic interest of other members of society facilitates self-reliance and private initiatives. It allows individuals to rely on their own effort to pursue their goals without the fear that the fruits of their labor will be compromised. Profiteering through fraud, misrepresentation, and other improper conduct that justifies veil piercing violates

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108 In reality, such a high multiple is highly unlikely because in most of the corporate veil cases, the defendant shareholder owns at least a majority of the corporation’s shares. Oftentimes the shareholder owns all or almost all of the shares. Therefore, the liability multiple is rarely greater than two.
the individualistic ideal of self-reliance. Deterrence of such conduct is an essentially individualistic enterprise. The foregoing discussion demonstrates that while deterrence no doubt plays a role in veil piercing, it is ill-suited as the principal objective of the corporate veil doctrine. With punishment, compensation, and deterrence rejected as the principal objective of the corporate veil doctrine, the remaining alternative is the prevention of unjust enrichment.

4. Prevention of Unjust Enrichment of the Shareholders

Prevention of unjust enrichment of the shareholders is the most apposite principal objective of the corporate veil doctrine. Before an attempt is made to explain the corporate veil cases in terms of unjust enrichment, it is important to explain what the term means. As it turns out, a clear definition of unjust enrichment, and its companion concept of restitution, has eluded scholars for generations since the field was first created by the Restatement of the Law of Restitution in 1937.

Scholars cannot even seem to agree on what constitutes unjust enrichment and restitution. One commentator compares unjust enrichment to contracts and torts and posits that it refers to a range of physical events that give rise to liability.109 Another asserts that unjust enrichment is the single guiding jurisprudential principle that unifies and underpins the law of restitution.110 Yet another suggests two alternative characterizations of unjust enrichment: an equitable principle that justifies judicially crafted exceptions to rigid legal rules or a descriptive and organizational principle for the wide range of restitution cases.111 In fact, unjust enrichment is also a cause of

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109 Peter Birks, *Unjust Enrichment and Wrongful Enrichment*, 79 Tex. L. Rev. 1767, 1778 (2001) (“Unjust enrichment has to be understood as an event and, more specifically, a causative event.”).

110 Andrew Kull, *Rationalizing Restitution*, 83 Cal. L. Rev. 1191, 1196 (1995) (“My proposition is that the law of restitution be defined exclusively in terms of its core idea, the law of unjust enrichment.”).

111 Emily Sherwin, *Restitution and Equity: An Analysis of the Principle of Unjust Enrichment*, 79 Tex. L. Rev. 2083, 2084 (2001). In fact, Professor Sherwin rejects the suggestion that unjust enrichment is a principle that justifies judicially crafted exceptions to rigid legal rules. While her rejection of this characterization of unjust enrichment may be valid for the law of restitution, it will be argued that unjust
action that allows a plaintiff to recover a benefit it has bestowed upon the defendant, where allowing the defendant to keep that benefit would offend notions of justice.\textsuperscript{112} The definition of restitution, especially as it relates to unjust enrichment, is even more controversial. One commentator believes that restitution is exclusively concerned with the rectification of unjust enrichment,\textsuperscript{113} while another has attributed both a substantive and a remedial component to restitution.\textsuperscript{114} Yet another commentator describes restitution as a goal of the law alongside compensation, punishment, and deterrence.\textsuperscript{115} The focus of this article is not to resolve the debate about the proper characterization of unjust enrichment and restitution. It is in fact not necessary to resolve it in order to explain the corporate veil cases in terms of unjust enrichment.\textsuperscript{116} As applied to the corporate veil cases, this article treats unjust enrichment as the consequence that may result if separate corporate personality is strictly adhered to, and the prevention of unjust enrichment as a principle that allows judges to create narrow exceptions to limited liability.\textsuperscript{117}

\textsuperscript{112}See, e.g., Spires v. Hosp. Corp. of Am., 289 F. App’x 269, 272-73 (10th Cir. 2008) (“Under Kansas law, the elements of an unjust enrichment claim are (1) plaintiff conferred a benefit on defendant; (2) defendant knew and received a benefit; and (3) defendant retained the benefit under circumstances that make it unjust.”).

\textsuperscript{113}Kull, supra note 110, at 1196.


\textsuperscript{115}Birks, supra note 109, at 1772. Professor Birks’ characterization of restitution perhaps suggests that restitution would be a more appropriate term than prevention of unjust enrichment as a description of the goal of the corporate veil doctrine. In his view, restitution, compensation, deterrence, and punishment are comparable concepts. However, given the seemingly endless controversy and misunderstanding surrounding the definition and scope of restitution, this article will use prevention of unjust enrichment instead. Despite disagreements about whether unjust enrichment is a liability-creating event or a principle, there seems to be a relative consensus of what the term means.

\textsuperscript{116}The proper characterization of unjust enrichment is mostly pertinent to disentangling the relationship between unjust enrichment and restitution.

\textsuperscript{117}Professor Sherwin argues that unjust enrichment should not be treated as a principle allowing judges to create exceptions to clearly defined legal rules which would otherwise apply in restitution cases. She observes that there is nothing inherent in the field of restitution that renders it particularly suitable for individualized decision making. Sherwin, supra note 111, at 2096-2101. Her arguments, of course, are
It is important to clarify that by attempting to explain the corporate veil cases in terms of unjust enrichment, this article does not characterize veil piercing as restitution claims.\textsuperscript{118} While there are cases in which one can analogize the imposition of shareholder liability to the disgorgement of the benefit received by the defendant, there are cases in which the analogy is inapt.\textsuperscript{119} Instead, the focus will be on how veil piercing prevents the unjust enrichment of shareholders that follows from a strict adherence to limited liability.

To demonstrate that unjust enrichment provides a fitting rationale for the corporate veil cases requires a clearer definition of the term. While the concept has great intuitive appeal, even the draft Restatement of Restitution and Unjust Enrichment itself does not seem able to define unjust enrichment in a concrete manner. Section 1 of the draft Restatement asserts that “[a] person who is unjustly enriched at the expense of another is liable in restitution to the other.”\textsuperscript{120} It has also been said that unjust enrichment is “the equitable principle by which one who has been enriched at the expense of another, whether by mistake, or otherwise, is under a duty to return what he has received or its value to the other.”\textsuperscript{121} These merely state the legal consequence of an instance of unjust enrichment. The appending comment on Section 1 proceeds to provide a number of examples of unjust enrichment without attempting to offer a formal definition of the term. In a 1938

\textsuperscript{118} Laycock points out that in fact, restitution need not be the only possible remedy for unjust enrichment. There are cases in which damages will be the more appropriate remedy. Laycock, supra note 114, at 1285 (“In some cases, unjust enrichment best explains substantive liability, but plaintiff's loss is the most appropriate measure of recovery.”).

\textsuperscript{119} \textsc{Restatement (Third) of the Law of Restitution and Unjust Enrichment} § 2 (Discussion Draft, March 31, 2000) (“Liability in restitution is based on and measured by the receipt of a benefit, but the receipt of a benefit does not of itself make [the] recipient liable in restitution.”).

\textsuperscript{120} Id. at § 1.

article that explained the then-emerging field of restitution to a skeptical British audience, the reporters of the First Restatement provided a more concrete formulation of the concept. They wrote that “[a] person has a right to have restored to him a benefit gained at his expense by another, if the retention of the benefit by the other would be unjust.”

This statement at least explains what constitutes enrichment. As for the meaning of unjust, the comment on Section 1 of the draft Third Restatement suggests that it entails “a direct appeal to standards of equitable and conscientious behavior.” This appeal is in many ways reminiscent of the determination of improper conduct under the corporate veil doctrine. There is no single uniform standard for deciding what constitutes improper conduct that justifies veil piercing. The courts make a determination based on notions of fundamental fairness and justice on a case-by-case basis. The draft Restatement similarly highlights the open-ended nature of unjust enrichment by characterizing it as “the embodiment of natural justice and equity [that] gives the subject an undoubted versatility, an adaptability to new situations.” The parallel between this characterization of unjust enrichment and the corporate veil doctrine is unmistakable. Integrating these various observations, unjust enrichment can be defined as an equitable principle under which natural justice and equity require the recipient of a benefit to return that benefit to the plaintiff when allowing the recipient to keep it would result in injustice.

How then are shareholders of a corporation unjustly enriched at the expense of the creditors? The benefit

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123 RESTATEMENT (THIRD), supra note 119, at § 1.
124 Id.
125 Sea-Land Servs., Inc. v. Pepper Source, 993 F.2d 1309 (7th Cir. 1993). In that case, the court defined unjust enrichment as “the receipt of money or its equivalent under circumstances that, in equity and good conscience, suggest that it ought not to be retained because it belongs to someone else.” Id. at 1312. Based on this definition, the court proceeded to pierce the veil because the shareholder at issue was unjustly enriched.
126 In contractual corporate veil cases, the contract is between the corporation and the creditor. The creditor, who is trying to recover from the shareholders, does not have a direct contractual relationship with them. This is similar to most unjust enrichment cases in which the plaintiff and the defendant do not share a contractual relationship.
conferred depends on the creditor at issue. For a financial creditor, the benefit will be the proceeds of a loan or purchase money for corporate bonds. For a trade creditor, the benefit will be the goods or services supplied to the corporation. For an employee, the benefit will be the labor services rendered. To the extent that the corporation, and by extension the shareholders, receive these benefits without making full payment for them and the default risks have not been fully compensated for, the shareholders can be said to have been enriched. It is obvious how shareholders are enriched if these benefits have not been fully paid for. However, there will be no enrichment if the default risk has been fully compensated. Given adequate compensation, the transaction would simply be a fully bargained-for exchange, and there would be no shareholder enrichment. This means that given that financial creditors are usually in a position to negotiate for a higher rate of return for the default risk, it will be difficult for such a creditor to argue that the shareholders have been unjustly enriched at its expense. Meanwhile, trade creditors and employees, which are in a much weaker position to do the same, should have less difficulty demonstrating enrichment.

For a tort victim, the main benefit will be the unpaid tort liability that would have compensated the victim. One further benefit conferred by the tort victim on the corporation is reduced accident prevention costs, the incurrence of which would have prevented the tort at issue. As a result of limited liability, the corporation does not fully internalize its accident costs and loses the incentive to undertake adequate precautions.\textsuperscript{127} The corporation will lower the level of prevention as a result and achieve savings in prevention costs. The shareholders are enriched to the extent that such savings are shared with them through dividend distribution and other means.

\textsuperscript{127} Hansmann & Kraakman II, supra note 38, at 1882-94.
Mere enrichment is of course different from unjust enrichment. Shareholder enrichment only becomes unjust if the circumstances under which it arises can be considered unjust under notions of natural justice or equity. This means that absent impropriety on the part of the shareholders, mere non-satisfaction of corporate liabilities would not constitute unjust enrichment. The law has made a policy choice that under limited liability, shareholders may be enriched at the outside creditors’ expense in order to encourage entrepreneurship and capital flow to corporations. If limited liability is to be upheld, the corporate veil doctrine cannot deem non-payment of corporate liabilities absent shareholder impropriety to be unjust. Otherwise, limited liability would be practically overturned. It is only when the enrichment results under unjust circumstances, such as when the shareholders have misappropriated corporate assets, hence leaving insufficient assets to satisfy the outside creditors, that veil piercing is justified. In this instance, the unjust enrichment equals the amount of assets misappropriated by the shareholders that would have been available to the creditors.

Recasting the corporate veil doctrine in terms of unjust enrichment means that conduct that unjustly enriches shareholders should carry more weight in the analysis. For example, among the seven types of improper conduct enumerated by Powell, fraud, asset stripping, and uncompensated torts are the most likely to result in unjust enrichment. The courts should be more ready to pierce the veil in the presence of such conduct. Unjust enrichment is also relevant to the analysis under the formalities prong of the doctrine. A variety of factors have been identified as indicia of the lack of formal integrity of the corporation. However, not all of them result in unjust enrichment of the shareholders. For example, non-observance of corporate formalities and overlap in corporate personnel are unlikely to contribute directly to

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128 Laycock points out that not all instances of enrichment are considered unjust under the law of restitution. He gives as examples duress and the conferment of benefit in the absence of mistake, coercion, request, or emergency. Laycock, supra note 114, at 1284.
shareholder enrichment. These factors should receive less emphasis in the analysis.

While explaining the corporate veil doctrine in terms of unjust enrichment may seem surprising at first glance, there is substantial support for it. As mentioned earlier, the draft Restatement states that unjust enrichment is premised on notions of natural justice and equity. This echoes the courts’ repeated assertions that the corporate veil doctrine is ultimately about preventing injustices. The characterization of unjust enrichment as an equitable principle that allows the courts to create individualized exceptions to general legal rules also aptly describes the role of the corporate veil doctrine as a standard-based exception to the general rule of limited liability. The courts have in fact used unjust enrichment of the shareholders as a basis for veil piercing in some cases. Moreover, prevention of unjust enrichment as the main purpose of contractual remedies has long been affirmed. In his seminal article on contractual damages, Professor Fuller declared that “it would seem that the fundamental purpose of the law is the prevention of unjust enrichment, since

129 Sea-Land Servs., 993 F.2d at 1309; Liberty Mut. Ins. Corp. v. M & O Springfield Co., No. 97-4146, 1998 WL 894654, at *4 (7th Cir. Dec. 17, 1998) (“As we previously observed, absent a showing of fraud or unjust enrichment, the fact that there is an unsatisfied judgment is an insufficient ground to compel the extraordinary remedy of piercing the corporate veil.”); Tr. of Chi. Painters v. Destiny Decorators, Inc., No. 07-C-4236, 2009 WL 3188687, at *11 (N.D. Ill. Sept. 30, 2009) ("This deprivation, and McDuffie's consequential unjust enrichment, is the sort of fraudulent wrong beyond the creditor's inability to collect sufficient to satisfy the second condition needed to pierce the corporate veil." (internal quotation marks omitted)); Langston v. Rizza Chevrolet, Inc., No. 07-CV-5965, 2008 WL 5083111, at *6 (N.D. Nov. 24, 2008) (citing unfair enrichment as one ground for veil piercing); United States ex rel. Purcell v. MWI Corp., 520 F. Supp. 2d 158, 173 (D.D.C. 2007) ("Here, the defendant is a stockholder of a corporation that received a benefit from the plaintiff. The plaintiff may only rely on an inference that a stockholder by means of his corporate equity received a benefit if the plaintiff shows that the stockholder abused the corporate form, using it as his own alter ego to perpetrate fraud—in which case, the corporate veil should be pierced."); Robertson-Ceco Corp. v. Cornelius, No. 3:03cv175/RV/EMT, 2007 WL 1020326, at *5 n.6 (N.D. Fla. Mar. 30, 2007) ("[U]njust enrichment is relevant to the analysis insofar as it represents one way of determining whether the corporate veil should be pierced."); Munder v. Circle One Condo., Inc., 596 So. 2d 144, 145 (Fla. Dist. Ct. App. 1992) ("Fraud, self-dealing, unjust enrichment and betrayal of trust, may well result in individual [shareholder] liability."); Taylor v. Wellington Station Condo. Ass'n, 633 So. 2d 43, 45 (Fla. Dist. Ct. App. 1994) (stating same).
enrichment of the promisor at the expense of the promisee is the "sine qua non" of judicial interference. Unjust enrichment of the tortfeasor at the expense of the tort victim is equally deserving of judicial interference, if not even more so. Lastly, attributing prevention of unjust enrichment as the principal objective of the corporate veil doctrine is consistent with its altruistic nature. While deterrence and punishment no doubt play a significant role in some corporate veil cases, they cannot be the principal focus of an altruistic legal doctrine. They have little to do with the primary altruistic concerns of sharing and sacrifice. Meanwhile, unjust enrichment compels the recipient of an ill-gotten benefit to return it to the rightful beneficiary. It requires those who were unduly advantaged by the existing legal regime to share what they not ought to keep. This is in keeping with Kennedy’s statement that “[i]f altruism is the sharing and sacrifice of advantages that one might have kept for oneself, then the state forces the strong to behave altruistically.” Here, the strong are the shareholders who have unjustly benefited from the protection of limited liability. The corporate veil doctrine compels them to return the benefit to the creditors on grounds of fairness. Unjust enrichment hence reinforces the altruistic tendencies of the doctrine.

5. Summing Up

The foregoing analysis of the formal and substantive dichotomies of the corporate veil doctrine has provided a number of important conclusions and observations. First, it demonstrates the relationship between limited liability and the corporate veil doctrine as one between a rule and a standard-based exception to the rule. In particular, it confirms the open-ended nature of the doctrine, which is an essential characteristic of a standard. This means that a certain degree

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131 As mentioned earlier, many commentators have argued that there are more persuasive arguments for applying unlimited liability to tort victims. Halpern et al., supra note 34, at 145-47; Leebron, supra note 38, at 1574-87; Hansmann & Kraakman II, supra note 38, at 1882-94.
132 Kennedy, supra note 18, at 1717.
133 Id. at 1919.
of non-conclusiveness and open-endedness in application is inherent in the doctrine. Effort to enhance its formal realizability beyond a certain point is likely to be futile if not counterproductive. One may argue that this relative lack of formal realizability will hamper the ability of the doctrine to deter undesirable conduct. If the corporate veil cases cannot even inform potential perpetrators in advance precisely what conduct will result in shareholder liability, these perpetrators will find it difficult to adjust their conduct accordingly. This argument, however, should not be overstated for a number of reasons. As has been conclusively argued in this section, the principal objective of the corporate veil doctrine is not deterrence, but prevention of unjust enrichment. If the achievement of the latter entails reduced efficacy in attaining the former, this is a price that has to be paid. Moreover, even though the corporate veil doctrine is a standard of considerable open-endedness, there are some clearly identifiable trends. As Thompson’s survey shows, misrepresentation is a highly predictive factor in the veil piercing decisions. Similarly, the courts have repeatedly said that a finding of fraud justifies veil piercing. Some commentators have created lists of do’s and don’t’s for shareholders to avoid veil piercing. There is hence sufficient guidance to potential perpetrators on what conduct to avoid. Lastly, the vagueness of the doctrine may actually enhance its ability to deter by encouraging potential perpetrators to steer clear of the boundary of permissible conduct. In contrast, bright-line rules will allow potential

134 Thompson II, supra note 11, at 1063.
135 Dole Food Co. v. Patrickson, 538 U.S. 468, 475 (2003) (“The doctrine of piercing the corporate veil, however, is the rare exception, applied in the case of fraud or certain other exceptional circumstances . . . .”); United States v. Bestfoods, 524 U.S. 51, 62 (1998) (“[T]he corporate veil may be pierced and the shareholder held liable for the corporation’s conduct when, inter alia, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder’s behalf.”); Ill. Bell Tel. Co. v. Global NAPs Ill., Inc., 551 F.3d 587, 597 (7th Cir. 2008) (“What is true is that in a contractual veil-piercing case, such as this case, Delaware permits piercing the veil only upon proof either of fraud or that the corporation simply functioned as a façade for the dominant shareholder.”); Dusharm v. Elegant Custom Homes, Inc., 302 F. App’x 571, 572 (9th Cir. 2008); Belvedere Condo. Unit Owners’ Ass’n v. R. E. Roark Cos., 617 N.E.2d 1075, 1086 (Ohio 1993).
136 Krendl & Krendl, supra note 11, at 52-55.
137 Kennedy, supra note 18, at 1696.
perpetrators to tailor their conduct to the precise scope of the rule. They will make sure that their actions lie just outside the scope of prohibition. What seems at first glance to be a weakness of the doctrine as an instrument of deterrence turns out to be a strength.

Second, the analysis shows that the corporate veil doctrine is a hybrid formalities-conduct directive. This should not come as a surprise, given the structure of some of the prevailing formulations of the corporate veil doctrine. Kennedy’s assertion about the lawmaker’s neutrality toward compliance with formalities affirms the general judicial approach that veil piercing will not be granted merely on the grounds of non-observance of corporate formalities, broadly understood to include factors such as inadequate capitalization and others. Impropriety is needed to substantiate a veil piercing claim. Third, the analysis affirms the doctrine’s altruistic underpinning. The doctrine is meant to alleviate the harshness that may result from an unyielding adherence to the general rule of limited liability. Some have argued that application of the doctrine should be confined to exceptional circumstances because veil piercing discourages entrepreneurship and investment in corporations. However, as explained above, the argument that veil piercing undermines the benefits of limited liability has been overstated. The corporate veil doctrine, as it is currently formulated and applied, does not undermine these benefits. In particular, this is due to the fact that veil piercing requires a showing of impropriety or injustice and generally only results in liability for the culpable shareholder. Bona fide entrepreneurs and investors should not be deterred by the doctrine.

Efforts to identify the principal objective of the corporate veil doctrine sheds further light on the application of the doctrine. The discussion about the circumstances under which shareholders are unjustly enriched suggests that veil piercing should be rarely available for financial creditors, who are most likely to be able to negotiate for an adequate compensation for the default risk borne by them. The same is not true for many trade creditors and employees, whose veil piercing claims should thus be adjudged more leniently. As has been argued
previously by other commentators, tort victims’ inability to negotiate for *ex ante* protection means that they are almost never adequately compensated for the accident costs they are made to bear. Shareholders are thus unjustly enriched at the expense of these victims. This again confirms that the courts should be more willing to pierce the veil in tort cases.

Making prevention of unjust enrichment the principal objective of the doctrine means that the courts should attach greater importance to conduct and breach of formalities that are more likely to result in shareholder enrichment. These include conduct such as asset stripping and fraud and formalities such as commingling of assets and inadequate capitalization. In particular, formalities requirements that are justified on estoppel grounds should be given less emphasis. This is a helpful insight because the courts tend to adopt a totality-of-circumstances approach to the question of whether formal integrity of the corporation has been compromised, without giving much explanation of the relative importance of the different factors. Lastly, if the goal is to prevent unjust enrichment, the corporate veil doctrine should expand the scope of the plaintiff’s recovery beyond the unpaid liability to include other forms of enrichment of the shareholder. This last point is probably the most radical departure from the prevailing approaches to the doctrine.

III. REFORMULATION OF THE CORPORATE VEIL DOCTRINE BASED ON AN UNJUST ENRICHMENT RATIONALE

The conclusions drawn above provide a basis upon which the doctrine can be reconceptualized and reprioritized. Many commentators have remarked on the lack of clarity in the doctrine and the difficulty with predicting the outcome of a veil piercing case.\textsuperscript{138} The totality-of-circumstances approach

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\textsuperscript{138} Krendl & Krendl, supra note 11, at 22 (“We know, however, of no successful effort to integrate all of these issues into a single simple rule which incorporates the proper considerations with sufficient specificity to ensure uniformity and predictability of application.”); Thompson II, supra note 11, at 1036 (“Piercing the corporate veil is the most litigated issue in corporate law and yet it remains among the least understood.”); Barber, supra note 8, at 374-75 (providing list of nineteen factors which courts deem relevant for veil piercing); Landers, supra note 68, at 620 (describing corporate veil doctrine as “[d]evoid of any consistent doctrinal basis, the cases
adopted by many courts requires them to weigh the myriad factors in an indeterminate manner. The altruistic nature and the inherent open-endedness of the doctrine as a standard mean that some degree of unpredictability is inevitable. Greater clarity nonetheless can be attained with an improved understanding of the formal and substantive nature of the doctrine. The various factors considered by the courts to determine the formal integrity of the corporation are not equally relevant to the veil piercing analysis. In fact, viewed in light of its shareholder unjust enrichment rationale, it will be argued below that most of them do not serve a useful purpose and should be de-emphasized. Our improved understanding of the form and substance of the doctrine will also shed light on the impropriety prong. The guidance provided by the courts and the analysis by the commentators on this prong is scant. What follows is an application of the conclusions from the previous section to fill these gaps and to reformulate the doctrine.

A. The Formalities Prong

1. Non-observance of Corporate Formalities

One inherent contradiction in the corporate veil doctrine is that the doctrine determines an issue of substance with reference to form. Liability is an issue of substance. It is about the allocation of economic loss between private parties. Yet much of the analysis under the doctrine focuses on the form of the corporation. This is in some ways understandable because a corporation is a legal fiction. It is an artificial entity that is constituted through a formal process of incorporation. With the abolition of the minimum capital requirement in almost all the states, the incorporation process has been reduced largely to a set of procedures. Once these procedures have been complied with, a corporation comes into being and its separate legal personality is recognized in the eyes of law. However, legal
form does not determine economic substance. Compliance with the formalities of a corporation does not endow the corporation with economic substance. Conversely, non-observance of those formalities does not deprive the corporation of its economic existence.

Given this disconnect between form and substance, one may legitimately question whether observance of corporate formalities has any place in the corporate veil doctrine. A number of commentators have downplayed the importance of corporate formalities. Similarly, some courts have upheld separate corporate personality despite failure to observe them. In fact, there are instances in which these formalities serve little practical purpose as far as the protection of outside creditors is concerned. The single-shareholder corporation aptly illustrates this. In such a corporation, the requirement of board approval of important corporate decisions is meaningless because the single shareholder will mostly likely control the board. Any proposal from him is assured of approval regardless of the required procedures. Formalistic distinctions do not alter the fact that the sole shareholder has complete substantive control over the corporation. Every corporate act is essentially his act. Therefore, whether this shareholder has complied with corporate formalities should not determine the outcome of the veil piercing analysis.

This is not to say that the form of a corporation does not matter. Corporate procedures and formalities clearly serve important purposes. The purpose they serve often depends on the formality at issue. As Kennedy suggested, formalities directives serve evidentiary and cautionary functions. Some corporate formalities serve a cautionary function by conveying to the parties involved in a particular transaction their intentions to each other. They may also serve an evidentiary function by conveying to the judge what the parties intended with the transaction. In fact, the cautionary function served by

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139 Clark, supra note 24, at 553; Hamilton, supra note 1, at 990-91; Barber, supra note 8, at 381.

140 Zubik v. Zubik, 384 F.2d 267 (3d Cir. 1967); Barlow v. Budge, 127 F.2d 440 (8th Cir. 1942).

141 Kennedy, supra note 18, at 1691.
formalities in corporation law goes beyond that served by contractual formalities in that they also provide parties not immediately involved in the transaction with useful information. This is perhaps more appropriately called an informational function. This makes intuitive sense because a contract generally only affects the contractual parties. Therefore, the cautionary function need not go beyond them. Meanwhile, the impact of a corporate transaction will be felt by those not immediately involved in it. Corporate claimants such as shareholders and outside creditors may have an interest in the outcome of the transaction, in particular to ensure that their claims against the corporation are not compromised. Some corporate formalities also perform a more substantive function. They ensure that important corporate decisions are well considered and interests of the various corporate claimants are taken into account. This can be called a protective function in the sense that these formalities protect the interests of corporate claimants.

Whether the observance of corporate formalities has any place in the corporate veil doctrine (outside of single-shareholder corporations) arguably depends on the type of formalities at issue. There seems to be no reason for the doctrine to be concerned with formalities that serve a cautionary or an informational function. The doctrine determines whether shareholder liability should be imposed. Apart from the case where the plaintiff argues that non-compliance with formalities leads to confusion on its part as to whether it is dealing with an individual or a corporation, corporate formalities that serve a cautionary or an informational function should have few implications for shareholder liability. There seems to be a stronger case for formalities that serve a protective function to be incorporated in the doctrine. Observance of these formalities will help to protect the interests of the corporate claimants. Here the problem is that while the doctrine aims to prevent shareholders from unjustly enriching themselves at the expense of outside creditors, many corporate formalities are chiefly designed to
It is unclear why failure to accord the protection required by law to minority shareholders should lead to judicial intervention on behalf of the outside creditors. Conversely, compliance with a formality that protects minority shareholders does not mean that creditor interest has been upheld and veil piercing is unwarranted. If the entire body of shareholders decides to siphon off corporate assets for their own personal benefits, a requirement that the removal of assets be approved by a shareholder vote will not protect the creditors. Therefore, even formalities that serve a protective function are not necessarily relevant to the veil piercing analysis.

Even if non-observance of corporate formalities is deemed important enough to warrant judicial intervention, it is not clear that the sanction should be shareholder liability. Kennedy observes that the common legal sanction for non-compliance with a formalities directive is non-enforcement of the transaction. For example, if an important corporate transaction that is required by law to be approved by the board has not received board approval, the law can invalidate the transaction and refuse to enforce it. Perhaps fines can be imposed to encourage compliance. However, if the objective of the sanction is to encourage compliance, shareholder liability seems to be an excessive judicial response, especially when most of these formalities have little to do with harm to the creditors.

The misfit between observance of corporate formalities and veil piercing becomes even more apparent when one considers that estoppel is the most convincing justification that has been put forward for the inclusion of this criterion in the doctrine. As mentioned earlier, the estoppel theory holds that if the shareholders themselves have not treated the corporation as one, they cannot be heard to complain if the court does the

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142 E. R. Latty, A Conceptualistic Tangle and the One- or Two-Man Corporation, 34 N.C. L. Rev. 471, 474 (1956). Professor Latty argues that corporate formalities, such as the rule that the corporation must act through its board, are often meant to protect the minority shareholders. They do not offer much protection to outside creditors.

143 Kennedy, supra note 18, at 1691.

144 Hamilton, supra note 1, at 990.
same.\textsuperscript{145} The validity of this argument, however, depends on the extent of non-compliance. It would be a stretch to say that the shareholders have ignored the existence of the corporation and should be penalized with shareholder liability simply because a shareholder meeting was not convened or a consent was not properly signed. The extent of non-compliance must be extensive for the estoppel argument to hold. A review of the case law suggests that when the courts find that extensive non-compliance justifies veil piercing, it is almost always accompanied by more flagrant shareholder abuses that directly undermine the economic substance of the corporation. An example would be commingling of corporate and personal assets by the shareholders. This inevitably leads one to question the independent significance of non-observance of corporate formalities and wonder whether the courts mention this factor merely to corroborate the lack of economic substance of the corporation.

The best way to fit non-observance of corporate formalities with the prevention of shareholder unjust enrichment rationale of veil piercing is that observance of these formalities will reduce the likelihood of shareholder abuses and unjust enrichment. While that may be true in some instances, if the concern under the corporate veil doctrine is shareholder unjust enrichment, the analysis should focus on the fact of enrichment itself rather than factors indicating the likelihood of enrichment. These factors are arguably irrelevant if there was in fact no enrichment. The corporate veil doctrine does not intervene merely on the grounds of a heightened probability of shareholder unjust enrichment. It requires actual enrichment. And if there was shareholder unjust enrichment, consideration of these factors would be redundant. There are already criteria in the veil piercing analysis that focus on the fact of enrichment, which means that consideration of non-observance of corporate formalities is largely redundant.

\textsuperscript{145} Barber, supra note 8, at 379.
2. Lack of Substantive Separation

The foregoing discussion suggests that a sound veil piercing analysis should emphasize factors that focus on economic substance rather than form. In light of the principal objective of the doctrine, economic substance should be understood as unjust enrichment of shareholders. Factors that focus on unjust enrichment of shareholders should be given greater weight. Apart from observance of corporate formalities, the courts have considered, under the formalities prong, substantive separation between the shareholders and the corporation, shareholder domination, and overlap of corporate personnel. The ensuing analysis will determine the extent to which these factors are concerned with shareholder unjust enrichment, and hence the weight they should be accorded in the doctrine.

Substantive separation between the shareholders and the corporation refers to the degree of financial independence enjoyed by the corporation. This is determined in light of a range of factors, including whether the corporation maintains its own separate account, whether the salaries of the corporation’s employees are paid for by the corporation itself, whether the corporation maintains its own financial records and financial unit, whether the shareholder has advanced loans to the corporation or guaranteed the corporation’s loans, and whether the financial transactions between the

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146 Each of these criteria can be further broken down into more detailed sub-criteria. Many of these sub-criteria are contained on the nineteen-point list developed by Barber and the thirty-one point list developed by the Krendls. Barber, supra note 8, at 374-75; Krendl & Krendl, supra note 11, at 52-55.
148 This factor has been emphasized by the courts since the early days of the doctrine. Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 63 (N.Y. 1926) (noting that wages of employees such as motormen and conductors were paid by subsidiary itself).
149 State v. Swift & Co., 187 S.W.2d 127, 134 (Tex. Civ. App. 1945); Fischbach & Moore, 311 F. Supp. at 414. This factor may also be considered under observance of corporate formalities.
shareholders and the corporation were well documented and conducted at arm’s length.\textsuperscript{151}

What is most curious and surprising is that some courts have actually held that a shareholder’s payment of the corporation’s debts may be held against the shareholder and justify veil piercing. In \textit{Ampex Corp. v. Office Electronics, Inc.}, the court cited the parent corporation’s continual payment of the subsidiary’s debts as a reason for imposing shareholder liability.\textsuperscript{152} From a shareholder unjust enrichment perspective, it is not at all clear why shareholder payment of the corporation’s debts should result in veil piercing. The corporate parent certainly has not enriched itself by doing so. In fact, it has suffered a financial detriment. One may attempt to defend the court’s reasoning on the grounds that the outside creditor may have relied on the fact of shareholder payments when extending credit to the corporation. If that were the argument, however, the plaintiff should be required to provide clear evidence of reliance. In \textit{Ampex Corp.}, there was no reliance on the part of the plaintiff whatsoever because the parent corporation had explicitly informed the plaintiff that it would not take responsibility for the subsidiary’s debts.\textsuperscript{153} The \textit{Ampex} court’s decision would discourage shareholders from shouldering responsibility for corporate debts in the first place. From a shareholder unjust enrichment perspective, there is certainly nothing objectionable about shareholder payment of corporate debts. There is no policy reason to discourage it. If anything, it is beneficial to the outside creditors.

The same argument can be made for shareholder guarantees of corporate debts. Again, the grant of such guarantees in no way results in shareholder unjust enrichment; shareholders in fact suffer a detriment. There is hence no reason to view such guarantees with suspicion. Moreover, shareholders of small close corporations are often required by contractual creditors, especially financial creditors, to provide personal guarantees. If the provision of such guarantees may result in shareholder liability, a narrow carve-

\textsuperscript{151} \textit{Fischbach} & \textit{Moore}, 311 F. Supp. at 414.
\textsuperscript{153} \textit{Id.} at 23.
out from limited liability given to one creditor may effectively result in general shareholder liability. Shareholders would become doubly reluctant to grant personal guarantees, which may impair access to capital by close corporations. The reliance argument should have no application to personal guarantees of debts because a creditor cannot logically assume from the fact that such a guarantee has been given to another creditor, or the same creditor for a previous debt for that matter, that the shareholder will bear personal liability for other debts. From a shareholder unjust enrichment perspective, shareholder payment of the salaries of the corporation’s employees is no different from shareholder payment of corporate debts or grant of personal guarantees. Again, there is no reason that payment of salaries should result in shareholder liability. These three considerations should be left out of the determination of the financial independence of the corporation, and should not be considered in the veil piercing analysis.

As for the remaining factors of whether the corporation maintains its own separate account, whether the corporation maintains its own financial records and financial unit, and whether the financial transactions between the shareholders and the corporation were well documented and conducted at arm’s length, they tend to focus on formalities and structure that guard against shareholder abuses. In other words, similar to observance of corporate formalities, they do not go to the substantive issue of shareholder unjust enrichment, but only to the likelihood of enrichment. If a shareholder has misappropriated corporate assets for personal use, it should matter little for the purpose of shareholder liability whether the corporation has in place a state-of-the-art accounting system or whether other legitimate corporate transactions were well documented. In short, lack of substantive separation between the corporation and the shareholders should be pared down to shareholder misappropriation of corporate assets. The remaining considerations do not focus on shareholder unjust enrichment and are not helpful to the veil piercing analysis.
3. Shareholder Domination and Overlap in Corporate Personnel

Shareholder domination refers to excessive shareholder control of the corporation. Excessiveness can be understood as going beyond what is acceptable commercial practice. From early on, the courts have held that shareholder domination must be more than complete share ownership. This is to be expected because to hold otherwise would amount to a wholesale repeal of limited liability between a corporation and its wholly owned subsidiaries, which the courts are understandably reluctant to do without legislative intervention. There is, however, no clear threshold for excessive control. No courts have articulated how much more control than complete share ownership would suffice to establish domination. Instead, the courts have come up with vague formulations such as “[w]hen a parent corporation dominates a subsidiary so that the subsidiary is an instrumentality or agent of the parent corporation” or “a domination and control so complete that the corporation may be said to have no will, mind, or existence of its own.” These formulations are long on metaphors but short on clarity. Instrumentality and agency are labels rather than operative standards and cannot be used to decide concrete cases. Given that a corporation is an inanimate entity, it cannot have a will or mind of its own, and its existence is derived from its legal

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154 Craig v. Lake Asbestos of Que., Ltd., 843 F.2d 145, 150 (3d Cir. 1988) (“The control which a parent must exercise over a subsidiary so as to warrant piercing the veil between them is more than ‘mere majority or complete stock control’. . . .”); Lowendahl v. Balt. & Ohio R.R. Co., 287 N.Y.S. 62, 72-73 (N.Y. App. Div. 1936) (“Control through mere ownership of a majority or of even all the capital stock and the use of the power incident thereto to elect officers and directors will not in and of itself predicate liability.”).

155 Some commentators have in fact argued for this. See generally Landers, supra note 68. Regardless of the theoretical merit of this view, the sweeping scope of such a repeal means that it should not be implemented judicially. It should be left to the state legislatures to decide.

156 Fitzpatrick v. Commonwealth Oil Co., 285 F.2d 726, 730 (5th Cir. 1960).

157 Lowendahl, 287 N.Y.S. at 73.

158 Thompson II, supra note 11, at 1037 (“A common refrain in the literature is an attack on the use of conclusory terms, such as ‘alter ego’ and ‘instrumentality,’ that provide no insight into the nature of the factors considered.’). These terms merely state the courts’ conclusions rather than provide reasons for the result.
recognition. The reference to a corporation’s existence in the determination of shareholder domination is circular reasoning, and the reference to will and mind may qualify as what Professor Felix Cohen would call “transcendental nonsense.”  

The Lake Asbestos court came up with a more concrete formulation for the threshold, stating that domination amounts to shareholder control “not only of finances but of policy and business practice in respect to the transaction attacked so that the corporate entity . . . had at the time no separate mind, will or existence of its own.” Despite the inevitable reference to the lack of a separate mind or existence, the Lake Asbestos court did provide two useful focal points for the analysis. While control of finances can be dealt with under the rubric of lack of substantive separation and has been discussed in the previous section, control of policy and business practice may provide a fruitful line of inquiry. The question is how much control over policy and business practice must there be for the courts to deem it excessive and hence support a finding of shareholder domination. Some courts have suggested that to qualify as excessive, control must extend to the daily operations of the corporation. However, it is unclear why day-to-day control over the corporation’s affairs should raise greater judicial concerns. In a single-shareholder corporation, the shareholder is for all intents and purposes the corporation itself. He controls every aspect of it, from the election of directors to daily operations. There is no reason to attach particular importance to control over daily operation. The conclusions are largely the same for close corporations with individual shareholders. In most closely held corporations, the shareholders, at least the active ones, exercise extensive control over the firm’s operations. They may at the same time function as directors and officers. They make important corporate decisions as

160 Craig v. Lake Asbestos of Que., Ltd., 843 F.2d 145, 150 (3d. Cir. 1988).
161 Id. at 152 (“The involvement in Cape’s [subsidiary] financial and managerial affairs fails to rise to the high standard of domination necessary to pierce the corporate veil . . . . In this case, there is no evidence that Charter’s [corporate parent] intrusion into Cape’s affairs is even ‘constant’ or day-to-day.”); State v. Swift & Co., 187 S.W.2d 127, 134 (Tex. Civ. App. 1945).
directors and decide daily operational issues as officers. Again, the control of daily operations should not be accorded independent significance.

The situation is slightly different for a corporate parent and its subsidiary. The parent as a shareholder owns a majority, or perhaps the entirety, of the subsidiary’s shares, but it does not run the subsidiary itself. It must do so through directors and officers whom it may appoint. A parent may be deemed to have exercised excessive control over a subsidiary by appointing its own employees or directors as the subsidiary’s directors and officers, who then manage the subsidiary’s daily operations on the parent’s behalf. This is what the courts have called overlap in corporate personnel. In this sense, overlap in corporate personnel is merely a manifestation of shareholder domination in the parent-subsidiary context. The fact that the corporate parent can and did nominate its own personnel as the subsidiary’s directors and officers is evidence that the parent exercised a high degree of control over the subsidiary. However, one wonders why such appointments are objectionable. After all, the power to appoint directors is a right that inheres in share ownership. There is generally no restriction on what kind of directors a shareholder may appoint. By piercing the veil on the grounds of overlap in corporate personnel, the courts are implicitly requiring a corporate parent to appoint individuals not under its direct control to run its subsidiary. In other words, the courts are mandating independent directors and officers through the corporate veil doctrine.

This requirement does not serve any immediate purpose from a shareholder unjust enrichment perspective. It would only help to prevent enrichment if the number of independent directors and officers required is sufficiently high to allow these directors and officers to make a difference in the corporate decision making. The courts by and large have not articulated the extent of overlap of corporate personnel necessary to trigger veil piercing. In most of the corporate veil cases, the

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162 Overlap in corporate personnel, as a criterion, is only relevant if the shareholder is a corporation. Only a parent corporation can share the same officers with its subsidiary. An individual shareholder obviously does not have officers of his own.
overlap is rather complete. This suggests that a less-than-complete overlap would most probably not result in shareholder liability. Overlap in corporate personnel as a veil piercing criterion would amount to a mere formality that the parent appoint a handful of non-employees as directors and officers. This would be a lamentable case of form over substance and would be inconsistent with the focus of the corporate veil doctrine on economic substance.

It is not even clear that shareholder domination and overlap in corporate personnel advance the prevention of shareholder unjust enrichment rationale of the doctrine in any significant way. Shareholder domination and overlap in corporate personnel on their own do not confer financial benefit on the shareholders. A shareholder may own all the shares of a corporation and may have chosen every single board member and officer. It may even require every corporate decision to be personally approved by itself. Again, all this only indicates the likelihood, but not the fact, of shareholder unjust enrichment. The importance of these two criteria should thus be downplayed.

This conclusion can be illustrated by some cases that highlight the interplay between these two criteria and shareholder unjust enrichment. In Consolidated Sun Ray, Inc. v. Oppenstein, the parent corporation incorporated a subsidiary for the purpose of leasing a premise for a retail business. The subsidiary was practically an empty shell created for the sole purpose of holding the lease. The court pierced the veil of the subsidiary and held the parent liable for the rent owed by the subsidiary. Despite its remarks on the complete overlap in the directors and officers of the two corporations and the degree of shareholder domination, it was obvious that what the court found objectionable was the blatant attempt to insulate the parent from liability through the use of the subsidiary. After the parent had decided to close down the retail business, the parent made no attempt to settle the outstanding rent, even though the retail business received funds from the sale of its

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163 335 F.2d 801 (8th Cir. 1964).
164 Id. at 804.
inventory.\(^\text{165}\) By exploiting the corporate entity, the corporate parent was unjustly enriched at the expense of the landlord through the avoidance of the rent payment.

In *Luckenbach S.S. Co. v. W.R. Grace & Co.*, one of the well-known early corporate veil cases, the Luckenbach Company incorporated a subsidiary, the Luckenbach Steamship Company, for the purpose of entering into freight contracts with counterparties.\(^\text{166}\) The parent owned all of the ships in the group, which were leased to the subsidiary to allow it to carry out the freight contracts. The subsidiary was in breach of one particular freight contract and the counterparty sued the parent corporation to recover the damages, which the subsidiary did not have sufficient assets to cover. The court pierced the veil of the subsidiary to hold the parent liable, emphasizing, among other things, the fact that the two corporations had the same directors and officers and were controlled by the same shareholders. Again, despite references to shareholder domination and overlap in corporate personnel, the court’s ultimate reason for piercing the veil was shareholder unjust enrichment. The court declared that “it would be unconscionable to allow the owner of this fleet of steamers, worth millions of dollars, to escape liability because it had turn them over a year before to a $10,000 corporation.”\(^\text{167}\) The corporate parent was unjustly enriched in the amount of the contractual damages it would have been able to avoid under limited liability.

More cases can be provided to illustrate the basic point that criteria such as shareholder domination, overlap in corporate personnel, and observance of corporate formalities do not focus on shareholder unjust enrichment—the paramount concern of the corporate veil doctrine—and could be done away with by focusing on the fact of enrichment itself. Their usefulness as criteria is further undermined by their highly malleable nature. The lack of clear thresholds for determining the degree of shareholder domination, overlap in corporate personnel, or non-observance of corporate formalities that

\(^{165}\) *Id.* at 805.
\(^{166}\) 267 F. 676 (4th Cir. 1920).
\(^{167}\) *Id.* at 681.
justifies veil piercing means that the courts sometimes play fast and loose with them to suit the result they want to achieve.

The famous early corporate veil case of Berkey v. Third Avenue Railway aptly illustrates this.\textsuperscript{168} It was apparent early in the opinion that Justice Cardozo, then sitting on the New York Court of Appeals, was minded to uphold the separate corporate personality of the subsidiary, probably because a contrary holding would have resulted in criminal liability for the corporations involved.\textsuperscript{169} There was evidence of overlap in corporate personnel, shareholder domination, and lack of substantive separation in the case. In deflecting this evidence, Justice Cardozo focused on a few details of minor importance. First, he pointed out that the boards of the two corporations “were nearly, though not quite the same.”\textsuperscript{170} It is difficult to appreciate the importance of this difference given that they shared the same “president, treasurer, general manager, paymaster and counsel.”\textsuperscript{171} Second, even though the salaries of the executive officers were paid with temporary advances from the parent corporation, wages for the motormen and conductors were covered by the subsidiary's own funds.\textsuperscript{172} Again, there seems to be no principled basis to distinguish the relative importance of the payment of executive salaries as opposed to workmen's wages for the purpose of veil piercing.

In Zubik v. Zubik, the court refused to impose liability on the controlling shareholder of the corporation despite copious evidence of lack of substantive separation and non-observance of corporate formalities.\textsuperscript{173} The case involved the imposition of shareholder liability for a corporate tort resulting from an accident in a river. The bulk of the assets of the corporation were owned by the shareholder who leased them back to the corporation through very informal leasing arrangements that

\textsuperscript{168} 155 N.E. 58 (N.Y. 1926).
\textsuperscript{169} Id. at 91 (“We feel assured that no such inference is to be drawn from acts so uncertain in their suggestions, where the inference is also one of the commission of a crime.”).
\textsuperscript{170} Id. at 88.
\textsuperscript{171} Id.
\textsuperscript{172} Id. at 89.
\textsuperscript{173} 384 F.2d 267 (3d Cir. 1967).
suggested “a possible lack of arm’s-length dealing.” The court noted that the lack of formalities extended to other important aspects of the corporation’s operations, such as meetings, expenses, and oral renewal of leases. However, the court dismissed the relevance of all this evidence by arguing that “[a] person who travels on the river, like a person who travels on the highway, does not evaluate the financial responsibility or structure of each person who may collide with him.” While that is no doubt a valid observation, one can say the same about contractual creditors, most of whom do not check whether the corporation has been holding regular board and shareholders’ meetings or whether the employees’ salaries are paid by the corporation as opposed to shareholder funds prior to entering into a contract with the corporation. What ultimately drove the Zubik court’s decision was not the degree of observance of corporate formalities or substantive separation between the controlling shareholder and the corporation, but the fact that the shareholder was an “old (71 at the time of trial), illiterate, [and] ill man.”

It should be obvious from these two cases that absent complete identity between two corporations, complete disregard of corporate formalities or other extreme circumstances, judges can probably draw contrary conclusions from the same facts applying the same set of criteria of substantive separation, shareholder domination, observance of corporate formalities, and overlap in corporate personnel. These criteria not only have failed to provide clarity to the analysis, they can be said to have obfuscated it. The corporate veil doctrine would be better off if it simply refocused on the ultimate issue of shareholder unjust enrichment.

B. The Impropriety Prong

In contrast to the formalities prong, the impropriety prong of the corporate veil doctrine has received relatively less attention from commentators. This lack of attention is both

\[174\] Id. at 271.
\[175\] Id.
\[176\] Id. at 274 n.17.
\[177\] Id. at 274.
unfortunate and understandable. It is unfortunate because, as the previous section showed, the formalities prong in most instances only focuses on the manifestations rather than the crux of the issue in corporate veil cases. This lack of attention is also understandable in light of the courts’ open-ended formulations of what is required under the impropriety prong. The courts have often said that limited liability would not be upheld if doing so would produce an inequitable result,\textsuperscript{178} sanction a fraud,\textsuperscript{179} or promote injustice.\textsuperscript{180} The courts have not articulated clear standards for determining what constitutes an inequitable result, a fraud, or injustice in the veil piercing context. These formulations are left intentionally vague to capture the wide variety of facts that arise in corporate veil cases. But this factual diversity has also rendered it very difficult to undertake a systematic categorization or analysis.

One exception from the lack of scholarly attention in the recent literature is Krendl & Krendl, who listed the following five categories of conduct as satisfying the impropriety prong: (1) violations of public policy, (2) misrepresentation, (3) lack of economic substance,\textsuperscript{181} (4) shareholder domination or direct participation in the wrongful conduct, and (5) evasion of legal obligations through the use of a corporate entity.\textsuperscript{182} In his original formulation of the instrumentality doctrine, Powell enumerated seven instances of impropriety.\textsuperscript{183} What is striking, but also unsurprising about these categories is that many of them explicitly or tacitly focus on shareholder unjust

\textsuperscript{178} Williamson v. Recovery Ltd. P’ship, 542 F.3d 43, 53 (2d Cir. 2008).
\textsuperscript{179} Laborers’ Pension Fund v. Lay-Com, Inc., 580 F.3d 602, 610 (7th Cir. 2009).
\textsuperscript{180} Id.
\textsuperscript{181} Krendl & Krendl further divided this into deliberate unprofitable operation and under-capitalization. Deliberate unprofitable operation refers to a situation in which the corporation, usually a subsidiary, was set up in such a way that it was never given the opportunity to be viable on its own. Krendl & Krendl, supra note 11, at 36-38. These corporations are usually set up with the sole purpose of supplying the parent corporation with raw materials or other inputs of production. United States v. Reserve Mining Co., 380 F. Supp. 11 (D. Minn. 1971); Int’l Tel. & Tel., Corp. v. Holton, 247 F.2d 178 (4th Cir. 1957).
\textsuperscript{182} Krendl & Krendl, supra note 11, at 28-29.
\textsuperscript{183} The seven instances are (1) actual fraud; (2) violation of a statute; (3) stripping the subsidiary of its assets; (4) misrepresentation; (5) estoppel; (6) torts; and (7) other cases of wrong or injustice. F. Powell, Parent and Subsidiary Corporations, §13 (1931).
enrichment. Among Powell’s categories, fraud, asset stripping, torts, and possibly other cases of wrong or injustice all exhibit such a focus.\textsuperscript{184} How torts unjustly enrich shareholders was explained in Section 0. Shareholder unjust enrichment clearly follows from fraud and asset stripping, through which shareholders remove corporate assets for their personal benefit. Among Krendls' categories, lack of economic substance and evasion of legal obligations are also premised on shareholder unjust enrichment. The discussion below will focus on inadequate capitalization, asset stripping, and deliberate unprofitable operation. It will be demonstrated that they are all best explained as instances of shareholder unjust enrichment.

1. Inadequate Capitalization

Among all the grounds for veil piercing, inadequate capitalization has probably received the most scholarly attention.\textsuperscript{185} Some commentators have called it one of the most important grounds for veil piercing.\textsuperscript{186} This attention

\textsuperscript{184} Violation of a statute under Powell’s categorization and violation of public policy under Krendls’ classification both mainly refer to circumvention of statutory prohibitions. Neither is concerned with contractual or tort corporate veil cases, which are the focus of this article. Statutory corporate veil cases implicate the policy rationale of the statute at issue and do not concern the prevention of unjust enrichment rationale of the corporate veil doctrine. The rationale of misrepresentation is not shareholder enrichment, but is premised on reliance by the outside creditor on the shareholders' representation. Veil piercing under misrepresentation is justified on either of these two lines of reasoning: first, that the shareholder who has made a representation to the creditor is estopped from repudiating it, and second, given the shareholder representation, the creditor can be deemed to have entered into the contract directly with the shareholders. Black & White, Inc. v. Love, 367 S.W.2d 427 (Ark. 1963); Zaist v. Olson, 227 A.2d 552 (Conn. 1967).


\textsuperscript{186} Inadequate capitalization was determinative in many early corporate veil cases. See Douglas & Shanks, \textit{supra} note 75, at 214. It continues to be viewed as an important ground for veil piercing. Leebron, \textit{supra} note 38, at 1634. However, the results from Professor Thompson’s survey show that inadequate capitalization is not as outcome-predictive as commentators believe. Thompson II, \textit{supra} note 11, at 1065-67.
notwithstanding, there remains much confusion about the scope and the application of the factor. A number of commentators have remarked on the failure on the part of the courts to articulate a clear standard for determining adequacy of capitalization.\textsuperscript{187} There is not even an academic consensus on whether inadequate capitalization should result in shareholder liability.\textsuperscript{188} Beyond issues of measurement, some commentators have posited that inadequate capitalization should be accorded varying weights in different cases. Their view is that inadequate capitalization is a more important consideration in tort cases than in contract cases.\textsuperscript{189} In fact, some courts have argued that in tort cases, inadequate capitalization is more than mere indicia for the formal integrity of the corporation. It is a proxy for improper motive.\textsuperscript{190} This reflects confusion regarding the proper place for inadequate capitalization in the doctrine. While the general view seems to be that inadequate capitalization pertains to the formal integrity of the corporation,\textsuperscript{191} some commentators have characterized it as an instance of improper conduct.\textsuperscript{192} It will be argued below that,

\begin{footnotesize}
\textsuperscript{187} Barber, \textit{supra} note 8, at 391 (“No general rule has been articulated by the courts for determining adequate capital.”); Hackney & Benson, \textit{supra} note 182, at 890 (“In virtually no cases have the courts clearly enunciated what they mean by inadequate capital when it is said to be a major factor in the imposition of shareholder liability.”); Hamilton, \textit{supra} note 1, at 1001 (“There is no easy way to determine when a corporation is in fact undercapitalized . . . .”); Roger E. Meiners, James S. Mofsky & Robert D. Tollison, \textit{Piercing the Veil of Limited Liability}, 4 Del. J. Corp. L. 351, 354 (1979) (“No court has formulated a set of concrete criteria for determining adequate capitalization . . . .”).

\textsuperscript{188} See Clark, \textit{supra} note 24, at 535-36 (inadequate capitalization without deception does not compromise creditor interest so long as creditors have opportunity to negotiate for adequate compensation). \textit{But see} Easterbrook & Fischel, \textit{supra} note 34, at 115 (veil piercing based on inadequate capitalization will encourage firms to divulge unusually low capitalization to potential creditors).

\textsuperscript{189} Hamilton, \textit{supra} note 1, at 988.

\textsuperscript{190} Radaszewski v. Telecom Corp., 981 F.2d 305, 308 (8th Cir. 1992) (“The reason, we think, is not because undercapitalization, in and of itself, is unlawful (though it may be for some purposes), but rather because the creation of an undercapitalized subsidiary justifies an inference that the parent is either deliberately or recklessly creating a business that will not be able to pay its bills or satisfy judgments against it.”).

\textsuperscript{191} Barber, \textit{supra} note 8, at 386-90.

\textsuperscript{192} Krendl & Krendl, \textit{supra} note 11, at 37-38.
\end{footnotesize}
properly understood, inadequate capitalization should be considered under the impropriety prong.

The ensuing discussion will address the following issues raised by the commentators and the courts concerning inadequate capitalization: first, whether inadequate capitalization is a relevant consideration under the corporate veil doctrine at all; second, what is the appropriate standard for determining adequacy of capitalization; and third, whether inadequate capitalization should be accorded different treatment and weight in contract and tort cases.

(i) Whether Inadequate Capitalization Should be a Relevant Factor

The first and foremost issue to be addressed is whether inadequate capitalization should be a relevant consideration in veil piercing cases at all. One forceful objection to inadequate capitalization as a veil piercing criterion is based on the incongruity between the wrong and the remedy. It has been argued that if the wrong is inadequate capitalization, the shareholders should only be held liable for the shortfall in capitalization as opposed to the full share of the outstanding liability.\footnote{Philippe M. Salomon, \textit{Limited Limited Liability: A Definitive Judicial Standard for the Inadequate Capitalization Problem}, 47 Temp. L.Q. 321 (1974).} This can be illustrated by a numerical example. Assume that a court would consider $40,000 to be adequate capital for a business of a certain size and risk profile, and the actual initial capitalization was $20,000. The liability at issue in the case is $200,000 owed to a trade creditor, who is the only creditor of the corporation. With its capital base, the corporation only manages to pay off $20,000 of the liability. The creditor attempts to hold the shareholders liable for the unpaid liability of $180,000. Should the court pierce the veil for a shortfall of $20,000 in capitalization, the shareholders end up bearing a liability that is nine times larger. If the shareholders had adequately capitalized the corporation, and there were no other independent grounds for veil piercing, the creditor would have received $40,000 as opposed to the full amount of
$200,000 (assuming that the shareholders are not judgment proof).\(^{194}\)

The inclusion of inadequate capitalization as a veil piercing criterion is fully consistent with the shareholder unjust enrichment rationale of the corporate veil doctrine. By inadequately capitalizing the corporation, the shareholders have unjustly enriched themselves by the amount of the capital shortfall, which would have been available to satisfy the outside creditors. If the shareholders had invested an adequate amount of capital in the corporation, the creditors would have had more assets to satisfy their liabilities. This of course does not address the incongruity objection. In fact, this objection is not confined to inadequate capitalization. It could be equally made against shareholder fraud and misappropriation of corporate assets. One may similarly contend that if the shareholders have deprived the creditors of funds available to satisfy their debts in the amount of the misappropriated assets, the shareholders should not be made fully liable for the unmet liability but should only be made to return the misappropriated assets. After all, to the extent that the outstanding liability exceeds the pilfered assets, imposing shareholder liability increases the amount of assets available for creditor recovery beyond what would have been available absent misappropriation. These related objections will be addressed in the remedies section below. For now, suffice it to say that plaintiff recovery under an unjust enrichment claim may exceed the defendant’s gain. Therefore, it would be consistent with the doctrine’s shareholder unjust enrichment rationale to

\(^{194}\) Another example would be the imposition of unlimited shareholder liability for failure to observe corporate formalities. Assume that a corporate loan from a bank was not properly authorized by the board because the controlling shareholder and director of a corporation has not convened a board meeting for five years. Moreover, the shareholder has failed to keep proper corporate records. The business has failed because the shareholder has misjudged the market, and the corporation is now unable to repay the loan. The bank attempts to pierce the corporate veil because the loan was not properly authorized by the board. If the court pierces the veil for the shareholder’s failure to observe corporate formalities, one may similarly think that the remedy is punitive in the sense that it far exceeds the harm caused by the shareholder’s failure. In fact, given that the business failure and the consequent inability to repay the loan has nothing to do with the absence of board approval, one may argue that the non-observance of corporate formalities has caused the bank no harm.
allow a veil piercing plaintiff to recover more than what the defendant shareholder has gained from its improper conduct.

Dean Clark asserted that at least with respect to contractual creditors, inadequate capitalization is only unfair and warrants legal intervention if the corporation did not disclose the fact and the creditor did not have the opportunity to negotiate for adequate compensation. Similarly focusing on the importance of disclosure but reaching a contrary conclusion, Professors Easterbrook and Fischel argued that veil piercing based on inadequate capitalization will encourage firms to divulge an unusually low level of capitalization to creditors. While Dean Clark’s argument seems to question the relevance of inadequate capitalization for veil piercing, his argument is in fact consistent with the shareholder unjust enrichment rationale of the doctrine. The emphasis on prior opportunity to negotiate highlights the importance of whether the creditor has been adequately compensated for the heightened default risk resulting from inadequate capitalization. As suggested earlier, shareholders are only unjustly enriched at the expense of outside creditors if the latter has not been adequately compensated for the default risk. The lack of a prior opportunity to negotiate suggests shareholder unjust enrichment.

Where the shareholder unjust enrichment analysis diverges from Dean Clark’s argument is the extent to which one can assume that disclosure to creditors necessarily permits negotiation for a higher compensation. This assumption most likely holds for a financial creditor, which means that veil piercing on the grounds of inadequate capitalization should be...

195 Clark, supra note 24, at 535-36. Although this point was made in the context of a discussion about equitable subordination, Dean Clark explicitly analogizes equitable subordination to veil piercing. He observes that “equitable subordination is a functional substitute for, though not an equivalent of, a trustee action to ‘pierce the corporate veil’ under state law.” Id. at 535. Therefore, his assertion about the unfairness of inadequate capitalization to creditors presumably also applies in the veil piercing context.

196 Easterbrook & Fischel, supra note 34, at 113. Their argument is clearly premised on a deterrence rationale for the corporate veil doctrine, which has been rejected already. Moreover, this deterrence-based argument would only be valid if there is a clear benchmark for inadequate capitalization, which, as will be suggested below, is sorely lacking.
rarely made available to a financial creditor who received full
disclosure in advance. However, this assumption is unlikely to
be valid for employees and for at least some trade creditors.
This means that even with *ex ante* disclosure, inadequate
capitalization should still be considered in veil piercing claims
brought by trade creditors and employees. At the very least,
the courts should undertake a detailed inquiry into whether
the employee or trade creditor at issue had the opportunity or
bargaining power to negotiate for higher compensation before
deciding the weight that should be attached to inadequate
capitalization. This kind of circumstance-specific inquiry can be
easily accommodated in the corporate veil doctrine.

(ii) The Appropriate Test for Capital Adequacy

The issue of the appropriate test for capital adequacy has
long befuddled the courts. Commentators have remarked on
this judicial inability to articulate a clear-cut standard for
capital adequacy.197 Yet they have been unable to offer
anything more than vague formulations such as “capital
sufficient to meet the reasonable requirements of the business
in question”198 or “an amount of equity that is within the
ordinary range for the business in question.”199 One slightly
more concrete suggestion is to compare the level of
capitalization of the corporation at issue with other
corporations with a similar size and scope of business.200 This
comparative approach, however, is fraught with difficulty. To
begin with, it is not always easy to locate suitable comparators
for the kind of close corporations that feature in corporate veil
cases.201 Even if these firms can be located, the court must
know that the level of capitalization of the comparator firm is
itself adequate before a valid comparison can be made. That
entails comparing that comparator firm with yet another firm.

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197 See *supra* text accompanying note 184.
198 Meiners et al., *supra* note 184, at 354.
200 Barber, *supra* note 8, at 392; Cataldo, *supra* note 182, at 496 n.90. See *In re
Lumber Inc.*, 124 F. Supp. 302 (D. Or. 1954) (court determined adequacy of
capitalization with reference to industry norm).
201 Recall Professor Thompson’s finding that no public corporation has had its veil
This iterative process, which presumably would have to go on \textit{ad infinitum}, can be avoided if the court could somehow ascertain the average level of capitalization of all the comparable firms. Yet it is not immediately obvious how any court can undertake this potentially enormous undertaking. Even if this could be done, there is no guarantee that the result obtained represents adequate capitalization. If a majority of the comparable firms in the market are inadequately capitalized, the result of this survey will likely yield a deficient result.

According to Professor Barber, the starting point for most courts in formulating a standard for adequate capitalization is the idea that “capitalization must be adequate to cover the reasonably foreseeable risks of the business.”\textsuperscript{202} Dean Clark has attempted to put this idea in more concrete application by adapting the famous B<PL formula proposed by Judge Learned Hand in \textit{Carroll Towing}.\textsuperscript{203} Under this modified B<PL formula, the veil would be pierced if PL is greater than B, or in other words, if the probability-adjusted loss to the creditor is greater than the cost of an additional increment of equity capital.\textsuperscript{204}

One fundamental misconception behind this modified B<PL formula is that the provision of additional shareholder capital will materially reduce the probability of default, or to put it differently, that there will be a significant effect on the default risk after a change in capitalization. In most corporations, the equity capital base is insufficient to cover outstanding liabilities. The equity capital of a corporation was never meant to be large enough to cover all liabilities. It was only meant to

\textsuperscript{202} Barber, \textit{supra} note 8, at 390.
\textsuperscript{203} Clark, \textit{supra} note 24, at 545 n.107. According to Dean Clark’s adaptation of the B<PL formula to the determination of capital adequacy,

B can represent the discounted present value of the cost of an additional increment of equity capital; L, the losses that would be suffered by contract and tort creditors if the corporation were to fail; P, that portion of the probability of failure that would be eliminated by supplying the additional increment of equity capital to the corporation; and PL would be discounted to present value.

\textit{Id.} at 546.

\textsuperscript{204} Professor Leebron has criticized this test, asserting that “this approach illustrates rather than cures the problems with the adequate capital test.” Leebron, \textit{supra} note 38, at 1634 n.208.
provide a working capital for the corporation and to offer some
minimum level of protection to the creditors. In fact, a
requirement that the stated capital be sufficient to cover all
liabilities would be tantamount to a repeal of limited liability.
Instead, liabilities are usually paid off with the revenue or
assets generated by the corporation’s operation. And it is the
risk that the generated assets fall short of liabilities as they
come due that causes a corporation to default and fail. This
risk, which is what ultimately concerns creditors, will depend
on a variety of factors such as the conditions of the market in
which the firm operates, fluctuations in the costs of production,
or even weather. A small increase in capitalization is unlikely
to have significant impact on these risks and will only
marginally increase the recovery available to creditors in the
event of a corporate failure. The implication is that an
increment of additional capital will have insignificant impact
on the probability of default, which means that PL is likely to
be small and rarely greater than B. Veil piercing hence will be
rare.

Given that equity capital is not intended to provide full or
even substantial coverage for corporate liabilities, attempts to
formulate a capital adequacy test based on a rigorous
quantitative relationship between this capital and the
corporation’s liability needs is likely to be futile. Moreover, so
long as the realized liability in any kind of quantitative test is
discounted by changes in the probability of default, the test will
only call for an increase in risk-adjusted shareholder capital.  
This risk-adjusted capital will never be sufficient to cover the
realized ability, which of course is not discounted by risk. The
fundamental reason for this disconnect is that shareholder
capital is not insurance for corporate liabilities. The “payout”
from shareholder capital in the event of default is the same as

205 Id. at 1634 n.208.
206 For an interesting discussion of the interplay between shareholder capital and
insurance coverage in providing protection to creditors, see Radaszewski v. Telecom
Corp., 981 F.2d 305 (8th. Cir. 1992). The court acknowledged the protection offered by
insurance coverage to creditors, and proclaimed that “[i]nsurance is unquestionably
relevant on the issue of ‘undercapitalization.”’ Id. at 310. What the court failed to
appreciate was that insurance coverage is in fact much more effective in protecting
creditors for the same amount of outlay by the corporation.
the “insurance premium” put in by the shareholders. The kind of quantitative test suggested by Dean Clark is more appropriately utilized for determining the adequacy of insurance coverage, should the law impose a duty to obtain adequate liability insurance on corporations.\footnote{Leebron, supra note 38, at 1633-35. Professor Leebron in fact suggested such an obligation on corporations with respect to tort liabilities.} It is, however, not suitable for determining capital adequacy.

The nature of the inadequate capitalization inquiry is such that capital adequacy can only be determined in a rough and impressionistic manner.\footnote{Krendl & Krendl, supra note 11, at 37 (arguing that “courts are not totally competent to determine what adequate capitalization should be for a particular business”).} This can be illustrated by a numerical example. If a corporation has outstanding liabilities of $1 million, and its equity capital is only $10,000, few courts would have trouble finding inadequate capitalization. However, if the initial capitalization had been $250,000, the courts would have much greater difficulty reaching the same conclusion, even though $250,000 is clearly insufficient to cover $1 million of liabilities. If the court were to find $250,000 inadequate, the inevitable question would be what about $260,000, or $300,000? Given that equity capital was never intended fully to cover corporate liabilities, an inquiry about capital adequacy probably cannot go much beyond identifying cases of egregious inadequate capitalization.\footnote{It is perhaps due to this inability to increase the rigor with which inadequate capitalization is analyzed that the courts have not attached as much weight to this factor as the commentators have believed. Thompson II, supra note 11, at 1065-67.}

In trying to identify egregious cases, the courts look for evidence of bad faith use of the corporate entity on the part of the shareholders.\footnote{For example, in Automotriz del Golfo v. Resnick, the court concluded that the corporation suffered from inadequate capitalization given an initial capital of $5,000 and a business of $100,000 to $150,000 in sales. 306 P.2d 1 (Cal. 1957). It may be argued that the court focused on the wrong variable. The comparison should not be made with sales, but with outstanding liabilities. However, the amount of sales probably has some correlation with outstanding liabilities.} In particular, the courts have placed great emphasis on evidence tending to show that the shareholders have deliberately exploited the corporate entity to the
detriment of creditors. In fact, it has been suggested that inadequate capitalization is but evidence of shareholder bad faith. In *Radaszewski*, the Eighth Circuit proclaimed that “the creation of an undercapitalized subsidiary justifies an inference that the parent is either deliberately or recklessly creating a business that will not be able to pay its bills or satisfy judgments against it.” Determination of bad faith, deliberateness, or recklessness, entails consideration of evidence of the subjective intent of the shareholders. If the inquiry is meant to be an impressionistic one, and the goal is only to identify cases of shareholder bad faith, there is little need for a clear quantitative rule. Judicial inability to articulate a clear threshold for capital adequacy is less perplexing and troubling than it may have initially seemed. Correctly understood, inadequate capitalization is not an objective criterion entailing a comparison between the corporation’s initial capital and its outstanding liabilities. Instead, it is about ascertaining the good faith of the shareholders in their operation of the corporation, and in particular, in their decisions to incur liabilities.

Not only is this refashioned inadequate capitalization criterion more consistent with judicial practice in reality, it also comports with the formal and substantive nature of the corporate veil doctrine identified in Sections 0 and 0. As demonstrated in Section 0, the corporate veil doctrine is a standard-based exception to limited liability. A standard encapsulates fundamental values of a legal system such as fairness and good faith. A refashioning of the capital adequacy inquiry into a subjective one about the good faith of the shareholders is hence in line with the nature of the doctrine as a standard. It is also consistent with the doctrine’s altruistic

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211 In *Costello v. Fazio*, an equitable subordination case, the court concluded that the corporation was undercapitalized when the initial capital was $6,000 and the current liabilities were $162,162. 256 F.2d 903, 905 (9th Cir. 1958). Moreover, the court attached considerable weight to the fact that the incorporators had withdrawn upon incorporation close to $40,000 of capital from the business, which previously had been operated as a partnership. *Id.* at 909 (“It is therefore certain, contrary to the finding just noted, that, in withdrawing this capital, Fazio and Ambrose did act for their own personal and private benefit.”).

212 *Radaszewski v. Telecom Corp.*, 981 F.2d 305, 308 (8th Cir. 1992).
nature. Requiring shareholders to demonstrate good faith in their operation of the corporation reinforces the altruistic call for sharing and sacrifice and rejects the exclusive concern for one’s self-interest that is the hallmark of individualism. Moreover, shareholders are unjustly enriched only if they have incurred liabilities with deliberate or reckless disregard for creditor interest. As argued earlier, one of the necessary consequences of limited liability is that shareholders generally will not bear responsibility for corporate liabilities beyond their equity investments in the firm. When outside creditors are left unpaid, shareholders are enriched, but not unjustly so. It is only when creditors are unpaid because liabilities were incurred with flagrant disregard for creditor interest that shareholders can be said to have unjustly enriched themselves.

It remains to be set out how shareholder bad faith is to be determined. Even though a precise and quantitative comparison has been rejected as impractical, a determination of bad faith will still need to take into account the amount of initial capital and liabilities incurred by the corporation, which obviously are only known subsequently.\textsuperscript{213} Moreover, if the question is whether the shareholders have demonstrated deliberate or reckless disregard for creditor interest when incurring a legal obligation, the temporal reference point should not be when the corporation fails, but when the obligation is incurred. The court should compare the corporation’s outstanding liabilities with the initial capital when the legal obligation at issue is incurred. To sum up, capital adequacy should be determined by whether, in light of the initial capital, the shareholders incurred a legal obligation with the knowledge that the corporation was unlikely to be able to repay it, or with reckless disregard for the likelihood of repayment.

\textsuperscript{213} For example, there is nothing inherently dishonest or reprehensible about a corporation with an initial capital of $25,000, if the corporation only incurs liabilities up to $50,000. The deliberate disregard for its ability to repay its debts can only be shown if it has taken on liabilities of a much larger amount. This obviously cannot be determined only with reference to the initial capitalization.
(iii) Different Analyses for Contract and Tort Cases

In determining capital adequacy, it is important to distinguish contract cases from tort cases. This is due to a fundamental difference between contractual and tort obligations. The former is incurred on a voluntary basis, whereas the latter is usually involuntary in character. This is of course true for the contractual creditor and the tort victim, but is in fact true for the corporation as well. A corporation voluntarily assumes a contractual obligation by entering into a contract with a lender, a supplier, or an employee. Contractual obligations are not forced upon a corporation against its will. The same cannot be said about tort obligation. Negligence-based tort obligations, which account for most corporate torts, are involuntarily incurred. In fact, they are usually assiduously avoided.

Given the control exercised by a corporation over the incurrence of contractual obligations, the shareholders have an a priori opportunity to evaluate its business operation and assess the likelihood that the corporation will be able to meet a particular contractual obligation. Therefore, a decision to incur a contractual obligation that grossly exceeds the corporation’s capital base and ability to repay should be weighed heavily when assessing capital adequacy. The court may infer from this fact a deliberate disregard for the corporation’s inability to repay its debts on the part of the shareholders. Their involuntary character means that the same inference cannot be hastily drawn about tort obligations. What sort of inference can be drawn instead depends on the foreseeability of risk. If an activity is sufficiently high-risk, one may perhaps argue that the shareholders should have foreseen it. If a corporation is set up with a very small initial capital but is used to operate an ultra-hazardous business and the potential liability arising from it is enormous, then the shareholders can be said to have shown reckless disregard for the likelihood of repayment. In most other tort situations where the risk is relatively low, the

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214 Some commentators have suggested that inadequate capitalization alone should suffice to justify veil piercing in tort cases. In light of the foregoing discussion, it would perhaps seem that this should apply in contract cases and not tort cases.
same inference of recklessness may not be drawn and the mere incurrence of the tort obligation does not conclusively demonstrate inadequacy of capital.

Even for contractual obligations, one should not be too quick to find inadequate capitalization from the mere incurrence of an obligation that grossly exceeds the corporation’s capital base and ability to repay. It is important to recall that default risks are largely determined by the state of a corporation’s business operations, not the size of its shareholder capital. Therefore, a contractual obligation may dwarf the corporation’s capital base, but the shareholders may in good faith believe that the corporation will be able to repay it with the revenue generated from its operations. The corporation may well have been able to meet this obligation but for unforeseen circumstances in its operation that deprived it of substantial revenue. Inadequate capitalization thus should not be found if evidence shows that when the contractual obligation was incurred, there was at least some reasonable basis for the shareholders to believe that the corporation could generate sufficient revenue to cover the liability. This showing need not be high; some reasonable basis for belief would suffice. Otherwise the courts would have to venture into the unfamiliar territory of second-guessing business decisions *ex post*. In sum, a gross disparity between the initial capital of the corporation and its subsequent liabilities should only establish a presumption of inadequate capitalization. The court should then consider whether the shareholders had a reasonable basis to conclude that repayment was likely.

An adjustment needs to be made in order for this mode of analysis to apply to tort obligations. The need for adjustment again arises from the involuntary nature of tort obligations. In determining capital adequacy with respect to the incurrence of a contractual obligation, it makes sense for the courts to direct the inquiry to the time of incurrence of the obligation. This is because that is the time at which the shareholders make a conscious decision to take on the obligation. The situation is different for tort obligations. The shareholders do not make a decision to take on the obligation, but only to undertake an activity that may expose the firm to potential tort liabilities.
Therefore, when applying the foregoing mode of analysis to tort obligations, the courts should compare initial capital with outstanding liabilities at the time the corporation undertakes the activity that eventually gives rise to tort liability. That is the time at which the shareholders resolve to take on the potential exposure to tort liability.

(iv) Summing Up

Reformulation of the criterion of inadequate capitalization into an inquiry about good faith use of the corporate entity may seem surprising to some. Critics may argue that this modification entails a wholesale change in the nature of the criteria from one about the formal integrity of the corporation to one about the propriety of shareholder conduct. While this reformulation clearly shows that the criterion belongs to the impropriety prong rather than the formalities prong, it does not change the nature of the inquiry. Unlike other criteria under the formalities prong such as observance of corporate formalities or overlap in corporate personnel, inadequate capitalization was never truly about the form of the corporation. It was always about economic substance. A proper classification should thus place it under the impropriety prong.

This classification is consistent with the reformulation of the doctrine under a shareholder unjust enrichment rationale. The result is that most of the factors under the formalities prong have been de-emphasized and the main inquiry of the doctrine is shifted to the identification of shareholder unjust enrichment under the impropriety prong. As inadequate capitalization is clearly an instance of enrichment, it rightfully should be included under the impropriety prong. Substantively, an inadequate capitalization inquiry that focuses on the extent to which the shareholders deliberately or recklessly incur legal obligations to the detriment of creditor interest brings it much closer in line with the rationale of the corporate veil doctrine. Unjust enrichment results if the shareholders have incurred a legal obligation with deliberate or reckless disregard for the creditors' interests.

To recap the discussion in this section, inadequate capitalization should be considered under the corporate veil
doctrine, and in particular under the impropriety prong, in light of the doctrine’s shareholder unjust enrichment rationale. Efforts to formulate a quantitative standard for determining capital adequacy is likely to be misguided given that the courts are only likely to intervene in egregious cases and are ultimately more concerned about whether the shareholders have exploited the corporate entity in good faith. Instead, the inquiry should be refashioned explicitly to focus on the shareholders’ good faith in their operation of the corporation. Lastly, contract and tort cases should be treated differently in the analysis. The need for different treatment is largely due to the voluntary nature of contractual obligations and involuntary nature of tort ones.

2. Other Improper Conduct

Given the variety of improper conduct, it is probably impossible to analyze each of them in great detail. The main conclusion from this article is that when deciding what sort of conduct justifies veil piercing, the courts should focus on whether the conduct results in shareholder unjust enrichment at the expense of the corporate creditors. This rationale for the corporate veil doctrine should help to sharpen the analysis and provide greater predictability to future litigants.

This can be illustrated by two examples, asset stripping and deliberate unprofitable operation of a corporation. Similar to inadequate capitalization, shareholder misappropriation of corporate assets clearly results in shareholder unjust enrichment and justifies veil piercing. For example, in *Henderson v. Rounds & Porter Lumber Co.*, the court pierced the veil on the grounds that the corporate parent had pilfered the subsidiary’s assets. The court concluded that such asset stripping was tantamount to inadequate capitalization. Although the court did not spell it out explicitly, the analogous nature of the two is due to the fact that they both result in unjust enrichment of shareholders. Operation of a corporation in a deliberately unprofitable manner similarly results in

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shareholder unjust enrichment.216 One example of such operation is when a parent corporation sets up a subsidiary with the sole purpose of supplying a raw material or an input of production at cost or a loss-making price.217 The profit that the subsidiary could have made if its output was sold at the prevailing market price would have been available to satisfy any outstanding claims it may have against it. Instead, the parent requires the subsidiary to sell the output at cost or even below cost, which means that the subsidiary will never make a profit, thereby unjustly enriching the parent. In unjust enrichment terms, there is little practical difference between this mode of operation, asset stripping, and inadequate capitalization. All three should justify veil piercing.

C. Remedy

One final issue concerning recasting the corporate veil doctrine in terms of shareholder unjust enrichment is the measure of recovery. In a standard unjust enrichment claim, the measure of recovery is the amount of the defendant’s gain from the unjust enrichment.218 Transposing it to the veil piercing context, if the improper conduct involved is inadequate capitalization or asset stripping, the measure of recovery should be the shortfall in capitalization or the amount of the misappropriated assets. This would create obstacles to the doctrine as an exception to limited liability, under which the standard remedy is the corporation’s unpaid liability. This apparent contradiction between shareholder liability under the corporate veil doctrine and its unjust enrichment rationale can be reconciled. While the standard measure of recovery under unjust enrichment is the defendant’s gain, there are circumstances under which the measure of recovery becomes the plaintiff’s loss due to difficulty in quantifying the value of

216 Landers, supra note 68, at 621 (noting that deliberate unprofitable operation of subsidiary justifies veil piercing against parent).
218 Laycock, supra note 114, at 1279.
the defendant’s gain or the fact that the defendant’s conduct has destroyed value.219

The defendant’s gain may be difficult to quantify in some veil piercing situations. In inadequate capitalization cases, the defendant’s gain is the shortfall in capitalization. However, the court’s inability to come up with more precise measures of capital adequacy means that they are unable to determine the amount of capital shortfall with confidence. The refashioning of the criterion into an inquiry about good faith operation of the corporation instead of a quantitative comparison between equity capital and outstanding liabilities also means that capital shortfall is no longer an appropriate measure of recovery. In cases involving commingling of shareholder and corporate assets, the finances of the culpable shareholder and the corporation may become so hopelessly intertwined that the court is unable to determine the precise amount by which the shareholder has benefited from corporate assets. This again means that the court will not be able to quantify the defendant’s gain. Finally, in deliberate unprofitable operation cases, it may be impossible for a variety of reasons to determine the market price for the under-priced input of production, or the subsidiary may have been exploited in other ways that are difficult to quantify. This will again prevent the court from quantifying the defendant’s gain. Given the complex nature of the facts in many corporate veil cases, especially the extent to which the corporation’s and the culpable shareholder’s affairs and finances are intertwined, this difficulty in quantification is likely to be common. This difficulty is compounded by the fact a corporate veil case may involve not one instance but a range of improper conduct by the shareholders. Calculating the defendant’s gain from each of them may be exceedingly complex and time-consuming. Measuring recovery by the plaintiff’s loss will sidestep these myriad problems.

In addition, there are reasons to believe that in many corporate veil cases, shareholder misconduct destroys value in the corporation and results in a loss to the plaintiff that is

219 Id. at 1285, 1287 (“In some cases, unjust enrichment best explains substantive liability, but plaintiff’s loss is the most appropriate measure of recovery.”).
greater than the defendant’s gain from its misconduct. For example, asset stripping harms the corporation not only through the loss of the pilfered assets, but also in other less direct ways. The impact of misappropriation on the corporation’s ability to repay its creditors is likely to be greater than the amount of lost assets. A corporation known to have been a victim of shareholder misconduct is likely to lose its creditworthiness and may become subject to loan recall by its financial creditors. Suppliers may also become unwilling to supply goods or services on credit. Employees may start to leave the firm. Even if the misconduct is not known to the creditors, pillage by the shareholders may leave the firm in such poor financial health that it is unable to pursue otherwise profitable business opportunities. These opportunities would have brought in revenue that could have been used to pay off the creditors. The same scenario may arise under inadequate capitalization. Here, even though the shareholders did not pilfer the firm’s capital, they endowed the firm with such a small starting capital that its ability to borrow or to pursue profitable business opportunities is greatly impeded. In both instances, the improper conduct that results in unjust enrichment inflicts greater loss on the plaintiff than it benefits the defendant. Measuring recovery by the defendant’s gain would under-compensate the plaintiff.

The foregoing discussion hopefully has demonstrated that measuring recovery by the defendant’s gain is likely to be unsatisfactory in most corporate veil cases. One may argue that the measure of recovery can be adjusted on a case-by-case basis depending on the difficulty of quantification of the defendant’s gain in a particular case. This, however, will introduce needless complication to what is already a highly confusing area of law. There are bound to be cases in which the defendant’s gain exceeds the plaintiff’s loss and vice versa. If a uniform approach must be adopted, the choice is between overcompensating the plaintiff in some cases and under-penalizing the defendant in other cases. Given the clear culpability of the defendant in most corporate veil cases, there are compelling policy reasons to choose the former. Therefore, even though the standard measure of recovery in unjust
enrichment cases is the defendant’s gain, the appropriate remedy in corporate veil cases should be the plaintiff’s loss, which is the unmet liability. Imposing shareholder liability in corporate veil cases is hence entirely consistent with its unjust enrichment rationale.

CONCLUSION

The approach taken in this article to the corporate veil doctrine is distinctly more theoretical than is common in the existing literature. Applying the framework from Professor Kennedy’s seminal article on the form and substance of private law adjudication, it established the formal and substantive relationships between the corporate veil doctrine and limited liability and confirmed that the substantive basis of the doctrine is one of altruism. Building on this altruistic foundation, the article demonstrated that the principal objective of the corporate veil doctrine is the prevention of shareholder unjust enrichment at the expense of the corporation’s creditors. It further argued that much of the current confusion in the doctrine can be dispelled if it is reoriented to focus on shareholder unjust enrichment. Tangential considerations under the formalities prong of the doctrine such as observance of corporate formalities, shareholder domination, overlap in corporate personnel, and substantive separation have largely obscured the analysis and should be de-emphasized. Instead, the inquiry should focus on the existence of shareholder unjust enrichment under the impropriety prong. This will bring the doctrine closer to its proper theoretical foundation and help the courts to identify what truly drives veil piercing decisions.