The Rights of Creditors of Affiliated Corporations

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In a recent article in the *Review*, Jonathan Landers attempts an ambitious rethinking of legal policy toward the creditors of affiliated corporations.[1] He organizes his discussion around three specific questions:

> (1) The parent company has advanced funds to its subsidiary in the form of a loan; if the subsidiary does not have enough assets to satisfy all of its creditors, should the parent be treated differently from other creditors?
>
> (2) If a subsidiary is unable to satisfy a creditor's claim out of its own assets, should the creditor be entitled to satisfy his claim out of the assets of the corporate parent (*i.e.*, to "pierce the corporate veil")?
>
> (3) If two affiliated corporations become bankrupt, should the assets of, and the claims against, the two corporations be pooled?

Landers believes that a group of affiliated corporations is a single economic enterprise in reality and should be treated as such by the law. This belief leads him to answer all of the above questions affirmatively, with two major qualifications.

First, Landers does not think that existing law—reflecting as it does a settled if perhaps questionable legislative policy in favor of limited shareholder liability—is sufficiently flexible to accommodate a general rule of piercing the corporate veil. The furthest that judicial reform can go in this area, in his opinion, is to allow the veil to be pierced whenever the parent of the bankrupt corporation has

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[1] Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975). Landers limits his analysis and recommendations to the case where the parent corporation owns 100 percent of the stock of each subsidiary so that there are no minority shareholders. *Id.* at 590 n.4.

failed either (1) to endow the subsidiary with sufficient resources to make it economically viable or (2) to observe the formalities prescribed by state law for creating a separate corporation.[2] Second, Landers recognizes that consolidation of bankrupt affiliates may be unfair to a creditor who has relied on the separate character of the affiliate to which he extended credit; forcing him to compete with the creditors of another corporation for access to the debtor's assets would undermine his reliance. Landers therefore proposes to protect a creditor's specific reliance where proved.[3] Subject to these qualifications, Landers would greatly reduce the respect accorded corporate forms when they are invoked by a corporation to defeat the claims of creditors of an affiliate.

Landers's analysis appears to be shaped by a conception of the credit process as one in which scheming entrepreneurs manipulate hapless creditors. The entrepreneur creates multiple corporations in order to avoid the legitimate claims of creditors and others, such as the Internal Revenue Service; he juggles the assets of the enterprise among the corporations to thwart these claimants; and all this occurs against the background of a law of corporations that, in Landers's view, fails to accord adequate protection to creditors even when they are dealing with a nonaffiliated corporation. "Through low capitalization requirements and the uncertain prospect of veil piercing, the law has, to a large extent, placed the cost of promoting new businesses on the creditors of the corporation and, through them, on the public as a whole."[4] Corporation law, Landers believes, has externalized the risks of business failure from the shareholders to the creditors; his proposed reforms would shift some of these risks back to the shareholders, where they belong.

Landers writes persuasively and his legal scholarship is meticulous. But his neglect of economic principles vital to an understanding of credit transactions, limited liability, and corporate affiliation undermines both his general approach and his specific conclusions. I shall attempt to elucidate these economic principles in the first part of the paper and apply them to the three specific questions examined in Landers's article in the second. Part I is also designed to stand by itself as a general introduction to the economic analysis of problems in corporation law and related fields.

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[2] *Id.* at 621.
[3] *Id.* at 632.
[4] *Id.* at 593.

I. The Simple Economics of Corporate Finance

A. Credit Transactions and Limited Liability

Mr. A. Smith wants to borrow $1 million to invest in a mining venture together with $2 million of his own money. He wants the loan for only a year since by the end of the year it will be apparent whether the venture has succeeded; if it has, he would then want to obtain longer-term financing. Since Smith is a man of means, if he gives his personal note to the lender the latter would regard a one-year loan of $1 million as riskless and would offer Smith the riskless short-term interest rate, say six percent. But Smith is reluctant to stake more than $2 million on the outcome of the mining venture. He proposes to the lender a different arrangement, whereby the lender will agree to look for repayment of the loan exclusively to the assets of the mining venture, if any exist, a year hence. Under this arrangement, Smith will be able to limit his liability to his investment in the venture.

The lender estimates that there is an 80 percent probability that the venture will be sufficiently successful to enable repayment of the loan and interest on the due date, and a 20 percent probability that the venture will fail so badly that there will be insufficient assets to repay even a part of the loan.[5] On these assumptions[6] the solution to the lender's problem is purely mechanical; he must calculate the amount, payable at the end of a year, that when multiplied by 80 percent (the probability that payment will in fact be made) will equal $1,060,000, the repayment he would have received at the end of the year had he made the riskless loan. That amount is $1,325,000.[7] Accordingly, the lender will charge Smith 32.5 percent interest for the loan if Smith's obligation to repay is limited to the assets of the venture. At this rate of interest the lender is indifferent as between the riskless and the risky loan.

This example illustrates the fundamental point that the interest rate on a loan is payment not only for renting capital but also for the risk that the borrower will fail to return it. It may be wondered why the borrower might want to shift a part of the risk of business failure to the lender, given that he must compensate him for bearing added risk. There are two reasons why the lender might be the superior risk bearer. First, the lender may be in a better

[5] To simplify exposition, I ignore the intermediate possibilities.

[6] Plus the additional assumption that the lender is "risk neutral." This term is explained in note 8 *infra*.

[7] Calculated by solving .8x = $106 for x.

position than the borrower to appraise the risk. Compare the positions of the individual shareholder in a publicly held corporation and the banks that lend the corporation its working capital. It may be easier and hence cheaper for the bank to appraise the risk of a default and the resulting liability than it would be for the shareholder, who may know little or nothing about the business in which he has invested. Second, the borrower may be risk averse and the lender less so (or risk neutral, or even risk preferring).[8] Thus, unlimited liability would discourage investment in business ventures by individuals who wanted to make small, passive investments in such ventures. It would also discourage even substantial entrepreneurial investments by risk-averse individuals—and most individuals are risk averse.[9]

A borrower could in principle negotiate with the lender for an express limited-liability provision. The more usual course, however, is to incorporate and have the corporation borrow the money. The basic principle of corporation law is that the shareholders of a corporation are not personally liable for the corporation's debts unless they agree to assume such liability. Corporate borrowing therefore automatically limits the borrower's liability to his investment in the corporation. The fact that the law permits Smith to limit his liabil-

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[8] An individual is risk averse if he prefers the certain equivalent of an expected value to the expectation—the certainty of receiving $1 to a 10 percent chance of receiving $10. A risk preferrer would have the opposite preference, and a risk-neutral individual would be indifferent. A corporation is less likely to be risk averse than an individual because the shareholders of the corporation can offset any risks incurred by that corporation by holding a diversified portfolio of securities. Moreover, a large lender can eliminate or greatly reduce the risk of loss on a particular loan by holding a diversified portfolio of loans. On both counts it seems likely that individual investors would often be more averse to bearing unlimited personal liability for the failure of an enterprise in which they had invested than lenders would be to bearing the risk of that failure to the extent of their loan to the enterprise.

[9] Risk aversion is implied by the principle of the diminishing marginal utility of (money) income. The principle of diminishing marginal utility is easiest to grasp in the case of a tangible commodity like hats: the more hats one has, the less each additional hat contributes to one's utility. Although money is a much more versatile good than hats, the principle of diminishing marginal utility should hold: as people obtain more dollars, the increment to their utility contributed by each additional dollar should become progressively smaller. Suppose that an individual derives 50 utiles (an arbitrary nonmonetary measure of welfare) from the last dollar that he possesses, but would derive only 40 utiles from having another dollar. Then he would not pay a dollar for a 50 percent chance of obtaining two dollars (even though the dollar cost and expected dollar gain of the wager are the same—$1), for the disutility to him of the transaction—50 utiles—would exceed the expected utility—45 utiles (50 percent of 90 utiles, the payoff if the wager is successful). Since some people do gamble, it is plain that not all people are consistently risk averse. But there is considerable empirical evidence that most *investors*, at least, are risk averse, as the theory of diminishing marginal utility would imply. The evidence is summarized in J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 198-227 (1973).

ity by conducting his mining venture in the corporate form does not imply, however, that the law is somehow tilted against creditors or enables venturers to externalize the risks of business failure, as Landers argues.[10] Although incorporation permits Smith to shift a part of the risk of failure to the lender, there is no externality; the lender is fully compensated by the higher interest rate that the corporation must pay by virtue of enjoying limited liability. Moreover, the lender is free to insist as a condition of making the loan that Smith guarantee the debts of the corporation personally or that he consent to including in the loan agreement other provisions that will limit the lender's risk—though any reduction in the risk will reduce the interest rate the lender can charge since a portion of that rate is, as we have seen, compensation to the lender for agreeing to bear a part of the risk of the venture.

There is an instructive parallel here to a fundamental principle of bankruptcy law: the discharge of the bankrupt from his debts. This principle, which was originally developed for the protection of business rather than individual bankrupts,[11] enables the venturer to limit his risk of loss to his current assets; he is not forced to hazard his entire earning capacity on the venture. Incorporation performs the same function of encouraging investment by enabling the risk averse to limit their risk of loss to their investment.

Far from externalizing the risks of business ventures, the principle of limited liability in corporation law facilitates a form of transaction advantageous to both investors and creditors; in its absence the supply of investment and the demand for credit might be much smaller than they are. Landers overlooks this essential point because he is unsure of the basis for limited liability.[12]

In discussing the reciprocal relationship of risk and interest rates, I have concentrated on the risk of default that is anticipated when the loan is first made. During the period that the loan is outstanding, however, the risk of default may change. To the extent that the change can be foreseen, it will be reflected in the interest rate negotiated at the outset. To the extent that it cannot be foreseen, the lender may seek to protect himself by offering an amortized loan (which is repaid continuously rather than in a single payment at the end of the term), even if the assets available to repay the loan are not expected to depreciate physically. Since the balance outstanding on the loan declines as a function of time and hence of

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[10] Landers, *supra* note 1, at 619-20.

[11] See 2 W. BLACKSTONE, COMMENTARIES *473-74.

[12] See Landers, *supra* note 1, at 617-19.

the probability of unforeseen changes in the risk of default, the lender is protected in part against those changes. Nor is the borrower prejudiced. Should no unforeseen increases in risk materialize, the borrower will be able to negotiate a reduction in the interest rate as the outstanding balance of the loan declines.[13] If the lender refuses to renegotiate the interest rate, the borrower can replace the loan at a lower rate from another lender; if there is a penalty in the loan agreement for prepayment, the borrower was presumably compensated for agreeing to it and cannot complain.

The parties will find it difficult, however, to adjust the interest rate or other terms of the loan to reflect the possibility of the borrower's deliberately increasing the lender's risk. After the interest rate has been agreed upon and the loan agreement signed, the borrower may increase the risk of defaulting on the loan by, for example, obtaining additional loans not subordinated to the first or transferring assets to its shareholders or others without adequate consideration.[14] In effect the borrower has unilaterally reduced the interest rate he is paying for the loan. That rate was negotiated with reference to a lower anticipated level of risk than has come to pass. Given the actual level of risk, the borrower is being allowed to borrow money at less than its true cost.

To protect himself against such dangers the lender may insist that the borrower agree to limit his total indebtedness or the amount of dividends payable during the term of the loan, where "dividend" is broadly defined to include any disposition of corporate assets for less than full market value. Or the lender may insist on some minimum capitalization, impose other restrictions, or require collateral. Alternatively he may decide to forgo protection and demand a higher interest rate. It may be difficult, however, to quan-

[13] This will be true unless he has in the meantime assumed other liabilities as a result of which the risk of defaulting on the loan may be unchanged or even increased. *See* text and note at note 14 *infra*.

[14] Anything that increases the borrower's debt-equity ratio will increase the likelihood of default, because debt charges are fixed costs to the firm and cannot be reduced if there are adverse business developments, such as a decline in demand for the firm's product, that lead to a reduction in its earnings.

It might be asked why a firm would deliberately increase the risk of its defaulting on the loan, since any short-run gains will usually be outweighed by the long-run loss of creditor confidence, resulting in much higher interest rates when the firm next wants to borrow. This is true for the firm that expects to remain in business for the indefinite future. But the firm that expects to be bankrupt and is trying to minimize the impact of bankruptcy on its shareholders will discount, perhaps to zero, the loss of creditor confidence, and firms of this sort presumably account for a substantial fraction of the actual defaults. The danger that a firm which has in fact defaulted will, prior to default, have taken various measures that increased the risk of default to some of its creditors is thus a substantial one.

tify the probability that the borrower will deliberately attempt to increase the riskiness of the loan.

Although the analysis to this point has focused on the explicit loan, it also applies to extensions of credit in other forms. For example, the merchant who does not insist on payment in cash and the employee who is not paid until the end of the week are creditors, and their estimation of the risk of default will determine the amount of credit extended, the length of time for which it is extended, and the interest rate (which, of course, need not be stated separately from the sale price or wage rate). The major difference between the trade creditor and the financial creditor is that the latter, because he is a specialist in credit and because the amount of credit that he extends to each creditor is apt to be larger, is much more likely to negotiate the terms of credit explicitly. This means, as we are about to see, that the provisions of corporation law will have a greater impact on credit transactions with trade creditors than on those with financial creditors.

B. The Economic Effects of Corporation Law

An important implication of the foregoing analysis is that the specific doctrines of corporation law should not be expected, in general, to have a profound impact on the credit system or to alter the balance of advantage between debtor and creditor.[15] If corporation law did not provide for limited shareholder liability, then in situations where the parties desired to limit that liability in exchange for a higher interest rate the loan agreement would contain an express provision limiting liability. Conversely, under existing law a firm asked to lend money to a corporation in which it lacks confidence can insist as a condition of making the loan that the shareholders agree to guarantee repayment personally; of course, the interest rate will be lower than it would have been without such a guarantee.

Similarly, if the rules of corporation law limiting the payment of dividends to the amount of "earned surplus" shown on the corporation's books effectively protect creditors against attempts by firms to increase the risk of default after the loan has been made, well and good. But if corporation laws were amended to drop all limitations on the payment of dividends, the major consequence would be that those creditors who wanted dividend limitations would have to ask that they be written into the loan agreement.

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[15] *Cf.* Coase, *The Problem of Social Cost,* 3 J. LAW & ECON. 1 (1960).

There are, however, exceptions to the proposition that corporation law does not affect the allocation of resources. One is the involuntary extension of credit. A pedestrian is struck by a moving van in circumstances making the moving company liable to him for a tort. Pre-existing negotiations, explicit or implicit, between the parties with respect to the moving company's ability to make good on the pedestrian's claim are simply not feasible. Since the parties have no opportunity to transact around the provisions of corporation law, the provisions governing limited liability may alter the relative position of debtor and creditor.

A more common exception occurs where, although the context is one of voluntary transacting, the costs of explicitly negotiating the question of extent of liability are high in relation to the stakes involved. The slight probability that an employee will be seriously injured on the job, when multiplied by the probability that the employer will have insufficient assets to satisfy his claim for workmen's compensation, may be too small to warrant inclusion of an express term in the employment contract to cover that contingency. In this case, too, whatever term is implied as a matter of corporate or bankruptcy law will control the parties' relations even if it is contrary to what the parties would have negotiated in a world of zero transaction costs. But there is an important difference: the wage rate can adjust to compensate the worker for the risk of nonpayment of any compensation claim that he may some day have against his employer. Such compensation for bearing an added risk of nonpayment is precluded in the case where the parties have no contractual or potentially contractual relationship at all—the usual situation in an accident between strangers.

These exceptions to one side, the primary utility of corporation law lies in providing a set of standard, implied contract terms, for example, governing credit, so that business firms do not have to stipulate these terms anew every time they transact, although they could do so if necessary. To the extent that the terms implied by corporation law accurately reflect the normal desires of transacting parties, they reduce the cost of transactions. The criterion of an efficient corporation law is therefore whether the terms do in fact reflect commercial realities, so that transacting parties are generally content with them. A corporation law that is out of step with those realities, and so induces contracting parties to draft waivers of the contract terms supplied by the law, is inefficient because it imposes unnecessary transaction costs.

Thus a corporation law is inefficient if it fails to provide standard implied contract terms that afford creditors the sorts of protections against default that they would normally insist upon in an express negotiation. Such a law can be criticized for creating avoidable costs of explicit negotiation. In some cases it can also be criticized for leading creditors to forgo desired protective provisions and to settle instead for a higher interest rate as a second-best alternative to the desired protection.

Landers's criticisms, however, are of an entirely different nature. His complaint against a corporation or bankruptcy law that fails to give creditors adequate protection against default is that it shifts the costs of entrepreneurship from shareholders to creditors. Except in the special case of the tort creditor,[16] this is a serious overstatement. At the worst, such a law may lead to somewhat higher interest rates as compensation for the absence of protective provisions that would reduce the risk of default; more probably it will lead simply to lengthier credit agreements. Transacting parties will negotiate explicitly the inclusion of protective provisions that a proper corporation law would read automatically into the credit transaction. The additional transaction costs, to the extent that they are borne in the first instance by the lender, will be passed on in whole or part to the borrower in the form of a (slightly) higher interest rate,[17] thereby reducing the amount of credit extended, presumably also slightly. But this will be the only allocative effect of a corporation law that fails to give the creditors the protections they would normally demand. And observe that such a law hurts borrowers as well as lenders, by raising interest rates.[18]

C. Creditor Protection: The Problems of Information and Supervision

Let us take a closer look at the types of protection that creditors would normally insist upon and that would therefore be found in an efficient corporation or bankruptcy statute. It is convenient to divide the sources of risk faced by the creditor into two types along the lines of the earlier analysis. The first is the risk of default based on circumstances known or anticipated when the loan is made. The

[16] And even this case must be qualified. Where the tort occurs between the parties to a pre-existing contractual relationship (*e.g.*, a bus passenger injured by the bus driver's negligence), the costs of the accident are not externalized.

[17] Thus the interest rate may be viewed as having three components: the cost of riskless capital (which includes any anticipated inflation), the cost of the risk assumed by the lender, and the administrative costs of the credit transaction incurred by the lender.

[18] The analysis of the economic effects of corporation law is, of course, merely a special case of the economic analysis of contract law, *i.e.*, the law governing voluntary transactions. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 41-65 (1973).

creditor's interest is not necessarily in minimizing this risk; since it is compensated risk any measures taken to reduce it will also reduce the interest rate. The creditor's interest lies rather in forming an accurate idea of the risk, for otherwise he cannot determine what interest rate to charge. Assessment of the risk of default requires accurate information about the existing and expected assets and liabilities of the borrowing corporation and of anyone else who may be liable for the corporation's debts, insofar as those assets and liabilities effect the creditor's ability to obtain repayment. Coping with this risk presents the problem of *information*. Measures that increase the creditor's costs of information are prima facie undesirable. A good example of such a measure would be misrepresentation by the borrower of his solvency.

The second source of risk to the creditor is the possibility that the corporation will take steps to increase the riskiness of the loan after the terms have been set. The problem of coping with this risk is the problem of *supervision*; the creditor must supervise or regulate the corporation's disposition of its assets to the extent necessary to prevent any deliberate attempts to reduce the assets available to repay the loan. Dividend limitations are an illustration of the supervision type of credit term.

Obtaining information and supervising a corporation's internal affairs are costly undertakings. Economizing on these costs is one objective, social as well as private, of the provisions in a credit instrument. The first question to ask about any existing or proposed creditor's right under corporation or other laws is whether it actually reduces the creditor's information or supervision costs. It is often a difficult question to answer, because of differences in the costs of information and supervision to financial, trade, and nonbusiness[19] creditors, because of the debtor's ability to increase those costs by various acts and omissions, and because of differences in the nature of the collateral put up by different debtors (*e.g.*, land versus inventory).

The analysis, moreover, cannot stop with a consideration of the creditor's costs. The goal is to minimize not just the administrative costs of the credit transaction but its total social costs. Even if a rule abrogating the limited liability of corporate shareholders would lower the costs of credit administration by reducing the risk of defaulting on a loan and thereby decreasing the optimal level of expenditures on supervision and information,[20] it would probably be

[19] See pp. 522-23 *infra*.

[20] It is not certain that it would reduce those costs overall, however, since creditors of

an uneconomical rule because it would prevent a type of risk shifting (from shareholders to creditors) that is apparently highly efficient, judging by its prevalence. To the extent that—paradoxical as it may seem—risk can often be borne more cheaply by creditors than by shareholders, a rule that prevented the shifting of risk from the latter to the former would impose costs in undesired risk that might be much greater than the savings in reduced costs of credit administration. Similarly, a rule that forbade any payment of dividends to corporate shareholders would reduce supervision costs by increasing the assets available for the payment of creditors' claims, but it would also reduce the attractiveness of owning stock to those investors who do not consider appreciation a perfect substitute for periodic income.[21] It would probably not be an optimal rule considering all the relevant costs and benefits of corporate activity.

The ultimate objective of the credit process is to minimize the overall social costs of capital through a complex allocation of costs, including the disutility of risk, between borrower and lender. Measures that minimize the risk borne by the creditor will lower interest rates both directly and by reducing the creditor's optimum expenditure on obtaining information and supervising the debtor's business.[22] But beyond a certain point the cost to the investors of the added risk they are made to bear may well exceed the reduction in interest rates. It is of no benefit to a corporation to be able to borrow at six percent on condition that its shareholders personally guarantee repayment of the loan, if the expected earnings of the corporation are insufficient to compensate the shareholders for giving such a guarantee. An efficient corporation law is not one that maximizes creditor protection on the one hand or corporate freedom on the other, but one that mediates between these goals in a fashion that minimizes the costs of raising money for investment.

D. The Reasons for and Consequences of Corporate Affiliation

Landers is interested in the special case of the creditor of a corporation wholly owned by, or otherwise 100 percent affiliated

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individuals exposed to unlimited liability for the debts of corporations in which they had invested might, in consequence, have to make a more extensive investigation of such individuals' creditworthiness.

[21] The transaction costs involved in selling stock in order to convert appreciation into cash income may make periodic income preferable to appreciation for some investors.

[22] Capital requirements imposed by the lender on the borrower are to be understood in this light: the more heavily capitalized the borrower is, the less likely he is to dissipate assets necessary to repay the loan by withdrawing capital from the enterprise in the form of dividends or otherwise.

with, another corporation. To understand this case it is necessary to consider how it might come about that one corporation was owned by or in common with another corporation. Landers's implicit explanation is that an entrepreneur will decide, typically in order to avoid taxes or limit other liabilities, to divide a unitary enterprise—a single business in economic terms—into a series of formally separate but commonly owned and controlled corporations. Under this view of how corporate affiliation arises, the separate corporate status of the different parts of the enterprise is indeed fictional (whether it is harmful is a separate question). But the view is seriously incomplete.

To begin with, often a group of affiliated corporations is not a single enterprise at all. Even before the vogue of the "conglomerate," there were many highly diversified enterprises, comprising a number of distinct businesses, often separately incorporated and related only in the integration of a few headquarters functions such as legal counseling and securities issuance. How might the common ownership of seemingly unrelated businesses come about? There are a number of possibilities. First, there may be managerial or financial economies (the businesses aren't really unrelated). Second, the owners may be trying to reduce risk through diversification. Third, an enterprise may decide to expand internally (through a separate corporation) into an unrelated line of business because it perceives opportunities for greater profits than its shareholders could earn if the funds employed in entering the new line were instead distributed to the shareholders as dividends.[23] A related point is that a firm which is not well managed is an attractive target for a takeover bid, normally by another corporation rather than by an individual or a group of individuals. The bidder may not be in the same or even in a related line of business. It may instead be a specialist in identifying undervalued firms. But the takeover bid is only the most dramatic illustration of the operation of the market for corporate assets. The existence of such a market implies that corporations are frequently in the market for other corporations, sometimes in different lines of business.

Where a commonly controlled pool of capital is employed in a number of different lines of business, it is not at all obvious that the owners of the pool should be treated differently from other venturers. It is especially doubtful in the case of "lateral piercing," which

[23] Transaction costs would be lower if the corporation invested directly and there would also be tax savings to the shareholders.

Landers appears to regard as indistinguishable in principle from piercing the subsidiary's corporate veil to reach the parent's assets.[24] Suppose that individuals who in the aggregate own 100 percent of *X* Corporation's stock create a new corporation, *Y*, to engage in an unrelated business. *X* and *Y* are affiliates, and Landers I take it would like the creditors of *Y* to be able to reach the assets of *X*. But why should a group of investors be treated differently by the law just because they own a corporation engaged in an unrelated business? And if they should *not* be treated differently, then why, if *X*, acting as an agent of its shareholders, forms *Y* in order to engage in an unrelated business, should *X*'s liabilities (and therefore those of its shareholders) be greater than those borne by other entrants into *Y*'s market?

Landers's implicit answer is that *X* may take steps to increase the risks borne by creditors of *Y*. *X* may, for example, cast its equity investment in *Y* in the form of a loan, thus reducing the assets available to satisfy claims of *Y*'s genuine creditors, without disclosure to those creditors. But the same danger is present in the case of two corporations owned by the same individuals. Indeed, it is present in the case of an unaffiliated corporation. There is a conflict of interest between the personal shareholder and the creditor as well as between the corporate shareholder and the creditor; in both cases management has an incentive to try to shift uncompensated risk to the creditor. Is the danger greater when the shareholder is a corporation? Probably it is greatest in the closely held corporation whether the dominant shareholder is an individual or a corporation. Arguably, therefore, if a shareholder that is a corporation should not be permitted to hide behind limited liability when the subsidiary corporation is unable to pay a creditor's claims, neither should the shareholder who is an individual be permitted to invoke limited liability when the corporation in which he owns stock is unable to satisfy the corporation's debts. The logic of Landers's arguments would seem to require the abolition of limited liability across the board.

To this it may be objected that there is a greater social interest in according limited liability to personal shareholders than to corporations, in order to make investment in enterprises attractive to individuals who would be deterred from investing by the prospect of potentially unlimited personal liability for the debts of the enterprise. A partial answer to this objection is that when a corporation

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[24] *See* Landers, *supra* note 1, at 590, 606, 628.

undertakes a new venture, it simply cuts short the process by which corporate assets are first distributed to shareholders in the form of dividends and then reinvested by those shareholders in a new corporation that undertakes the venture. The corporation's liabilities should therefore be no greater than those of its shareholders, who might have made the investment directly (though at a higher cost), without subjecting their interest in the old corporation to liability on account of the new corporation's debts. But this argument overlooks a difference between individual and corporate investment. If a parent corporation is made liable for its subsidiary's debts, the exposure of the parent's shareholders to liability, although greater than if the subsidiary enjoyed limited liability, is still limited to their investment in the parent. Making a parent liable for the subsidiary's debts will not result in unlimited personal liability for the parent's shareholders, whereas making a personal shareholder liable for corporate debts would have this effect.

However, the implication of this point—which is that unlimited corporate-shareholder liability would have a less dampening effect on individual investment than unlimited personal-shareholder liability—is applicable primarily to the large publicly held corporation, where, as we shall see, the objections to limited liability in the affiliation context are weak. The investor in the large corporation is ordinarily in a position to minimize the risk that is transmitted to him through the ventures undertaken and liabilities incurred by a corporation in which he owns stock simply by holding a diversified portfolio of corporate securities. Unlimited corporate-shareholder liability would threaten such an investor far less than unlimited personal-shareholder liability. But the investor in a small corporation frequently does not enjoy the same opportunities for diversification. He cannot protect himself against the consequences of unlimited liability of corporate shareholders as effectively as the investor in the large corporation.

To understand this important point, suppose in our example of the Smith mining venture that the Smith fortune (other than that which Mr. Smith plans to commit to the mining venture) is invested in a radio station owned by a corporation of which Smith is the sole stockholder. If he forms a new corporation to conduct the mining venture, and if "lateral piercing" is permitted as Landers would like, then Smith has hazarded his entire fortune on the outcome of the mining venture. This may be an unacceptable risk to him. In this case there is in fact no difference between piercing the corporate veil to reach the assets of an affiliated corporation and piercing it to reach an individual shareholder's assets. The case is extreme, but approximations to it are not uncommon in the world of small business. This example is to me a decisive objection to a general rule of piercing the corporate veil to reach the assets of an affiliated corporation. And the case is no different if, instead of Smith's forming a new corporation to conduct the mining venture, he invests $2 million more in the radio station which then forms a subsidiary to conduct the venture.

Landers's only reason why the case for limited liability is weaker for corporate than for personal shareholders is that affiliated corporations, even if engaged in totally unrelated lines of business, will be managed differently from independent firms because the owners will seek to maximize the profits of the enterprise as a whole rather than the profits of any individual corporation.[25] This argument is unconvincing. Normally the profits of the group will be maximized by maximizing the profits of each constituent corporation. Indeed, if the corporations are engaged in truly unrelated lines of business, the profits of each will be completely independent.

It is true that the common owner can take measures that conceal or distort the relative profitability of his different enterprises, as by allocating capital among them at arbitrary interest rates. But it is not true, as Landers implies, that owners invariably or typically adopt such measures. For one thing, such measures are costly because they reduce the information available to the common owner about the efficiency with which his various corporations are being managed. The costs rise rapidly with the size of the overall enterprise. That is why large corporations typically treat their major divisions and subsidiaries as "profit centers," which are expected to conduct themselves as if they were independent firms.[26] For similar reasons, divisional managers are compensated on the basis of the profitability of the subsidiary or division rather than of the enterprise as a whole.[27]

Even when the activities of affiliated corporations are closely related—when they produce substitute or complementary goods—normally each corporation will be operated as a separate profit center in order to assure that the profits of the group will be maximized. It is only in the exceptional case that maximizing the

[25] *See, e.g., id.* at 624-25.

[26] In some cases, however, the profit center may not coincide with divisional or corporate boundary lines.

[27] *See, e.g.*, United States v. International Tel. & Tel. Corp., 306 F. Supp. 766, 782-83 (D. Conn. 1969); O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR 109-81 (1970).

profits of a group of related corporations will involve different behavior from what could be expected of separately owned corporations.[28] To be sure, where there are genuine cost savings from common ownership, as in some cases where the affiliated corporations operate at successive stages in the production of a good, the two corporations will be managed differently from separately owned corporations in the same line of business in the sense that their operations will be integrated in a way independent corporations' are not. But that would not mean that either corporation was, in any sense relevant to the reasonable expectations of creditors, something other than a bona fide profit-maximizing firm. Rather, each corporation would simply be more profitable than its nonintegrated competitors because its costs were lower. It would be perverse to penalize such a corporation for its superior efficiency by withdrawing the privilege of limited liability enjoyed by its nonintegrated competitors. Moreover, in this case as well, the common owner has a strong incentive to avoid intercorporate transfers that, by distorting the profitability of each corporation, make it more difficult for the common owner to evaluate their performance. That is why the price at which one division of a vertically integrated firm will "sell" its output to another division is normally the market price for the good in question (less any savings in cost attributable to making an intrafirm transfer compared to a market transaction), rather than an arbitrary transfer price designed artificially to enhance the profits of one division at the expense of the other.

The important difference between a group of affiliates engaged in related businesses and one engaged in a number of unrelated businesses is not that the conduct of corporations in the first group will differ from that of nonaffiliated corporations in the same businesses, but that the creditor dealing with a group of affiliates in related businesses is more likely to be misled into thinking that he is dealing with a single corporation.[29] The mere possibility of deception in some affiliation cases does not in logic justify disregarding

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[28] For example, if one affiliate had a monopoly of business machines, and the other sold the punch cards used in the machines, the common owners might decide to lease the machines at cost and charge a high price for each card as a method of price discrimination that would generate higher profits for the enterprise as a whole than if each corporation maximized its profits separately. However, as this example suggests, most of the cases in which the common owners will not seek to maximize the profits of each corporation separately are cases in which one or more of the corporations has monopoly power; and many such attempts to exercise monopoly power, as in the "tie-in" example given above, would violate the antitrust laws. *See generally* Posner, *Exclusionary Practices and the Antitrust Laws*, 41 U. CHI. L. REV. 506 (1974).

[29] *See* text and notes at notes 38-43 *infra*.

the corporate form in *all* such cases. Deception is rather one of the factors to be considered in applying a rule of creditor protection properly based on the creditor's information costs. Such a rule will be described later in this paper.

In sum, Landers's "single enterprise" approach exaggerates the degree to which we can expect affiliated corporations to be operated differently from separately owned corporations. A more reasonable presumption, especially in the case of large publicly owned firms, is that whether a corporation is owned by individuals or by another corporation will in general not affect the way in which the corporation is managed, and so in general should not be a matter of concern to creditors. It may be true that the social interest in limited liability is somewhat attenuated in the case where the shareholder is a large publicly held corporation. But that is scarcely a strong argument for abrogating the limited liability of corporations owned by such shareholders, given that affiliates managed by a large publicly held corporation are not likely to be managed differently from how they would be managed if they were independent firms. The danger of abuse of the corporate form is greater in the case of the small business, where operation of the constituent corporations as separate profit centers is less necessary to assure efficient management. But an offsetting factor is that individual investors' interest in the limited liability of corporate affiliates approaches, in the context of small business, their interest in preserving the limited liability of unaffiliated corporations.[30]

I conclude that the case for eliminating the limited liability of affiliated corporations has not been made. To this it may be replied that Landers does not want to eliminate their limited liability but simply to require them, if they want it, to negotiate expressly for it with their creditors. Although Landers does not discuss the possibility of contracting around a general rule of unlimited liability, I assume he would permit such contracts. However, if I am correct that in the case of large companies creditors normally have little reason to seek to be able to reach the assets of parent or affiliated corporations, and that in the case of small companies the debtor would normally insist on expressly limiting the liability of parent and affiliated corporations, contracting around unlimited liability would occur frequently and would therefore be a source of substantial, and avoidable, transaction costs. Moreover, as we have seen, contracting around unlimited liability for tort debts would be in-

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[30] *See* pp. 506-07 *supra*.

feasible; and, as we shall see, methods other than corporate limited liability for limiting tort liability are inadequate.[31] Furthermore, while outside the tort area the costs of expressly contracting around unlimited liability would probably be small in the case of the financial creditor (bank, etc.), with whom the debtor would have an express written contract anyway, those costs might be considerable where the debtor wished to disclaim liability to a trade or nonbusiness creditor—a materials supplier, employee, etc.—especially since the courts may refuse to enforce simple disclaimers.[32] The consequences of eliminating the limited liability of affiliated corporations would thus not be trivial.

II. Specific Policy Questions

A. Landers's Proposals

1. Landers would like the creditor of a subsidiary corporation to be able always to pierce the corporate veil and reach the assets of the parent (or an affiliated) corporation, though in deference to the policy of limited liability he confines his specific proposal to piercing the corporate veil to cases where the subsidiary either lacks "viability" or has failed to observe the procedural formalities required under the applicable state law for setting up a corporation. I have already suggested that a rule of indiscriminate piercing would often impose unacceptable risks on the personal owners of a small corporation that owned or was otherwise affiliated with the corporation whose veil was pierced. Risk, however, is only one factor to be considered. Another is the creditor's information and supervision costs. Landers believes those costs would be lower under a rule allowing the subsidiary's creditors to pierce the corporate veil. I disagree.

Take the case of unrelated businesses—the parent is engaged in the production of steel, the subsidiary in the production of cornflakes. The costs of supervision to a creditor of the subsidiary may be smaller if he knows that he can pierce the corporate veil and reach the parent's assets; he need not worry that the parent might strip the subsidiary of the assets necessary to satisfy creditors' claims. But the creditor's information costs may now be greater. Evaluating the risk that he will not be repaid will now require an investigation of the creditworthiness of the parent. The creditor

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[31] *See* text at note 35 *infra*.

[32] As urged by, for example, Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. Cal. L. Rev. 1 (1974).

unable to pierce the corporate veil would normally forgo such an investigation.[33]

More important, a complete analysis of the effect of piercing the corporate veil on information and supervision costs must consider the creditors of the subsidiary as well as those of the parent. If piercing the veil is allowed, the parent's creditors are exposed to an additional risk—that the parent's assets may be diverted to satisfy the claims of the subsidiary's creditors. To determine the parent's creditworthiness, therefore, prospective creditors of the parent must also investigate the subsidiary's creditworthiness. Acquiring the necessary information will become even more complicated if we allow not only the subsidiary's creditors to reach the assets of the parent, but the parent's creditors to reach the assets of the subsidiary, an extension implicit in the unitary-enterprise approach proposed by Landers.

The basic point, however, is a simpler one: there is no basis for believing that a general rule permitting the piercing of the corporate veil in order to reach the assets of an affiliated corporation would minimize the costs of credit transactions, and therefore result in lower interest rates at any given level of risk, even if it did not impose unacceptable risks on the personal owners of affiliated corporations. Stated otherwise, it has not been established that a general rule allowing the piercing of the corporate veil in the case of affiliated corporations would approximate the normal desires of the transacting parties.

2. Landers's proposal to subordinate a parent's loan to a subsidiary to the claims of the subsidiary's independent creditors is also objectionable, but mainly on different grounds. Like veil piercing, the prospect of subordination would increase the risk of nonpayment to the parent and thereby induce the parent's creditors to take account of that prospect in appraising the parent's creditworthiness. This might in turn lead those creditors to investigate the subsidiary's creditworthiness more carefully than if the parent were merely another creditor of the subsidiary. But the extent and therefore cost of the additional credit inquiry would be less than in the veil-piercing case since the potential liability of the parent would be limited to the amount of the loan.

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[33] Even in that case, the parent's creditworthiness might affect the appropriate interest rate on a loan to the subsidiary because the parent might voluntarily mount a rescue operation if the subsidiary became insolvent. Should such rescue operations be limited in order to protect the parent's creditors? The general answer is probably "no" since failure to rescue would often impair creditor confidence in the parent, which might increase the risk of default by the parent. *See* p. 518 *infra*.

In effect, Landers is proposing that the only kind of investment that a corporation may make in an affiliated corporation is an equity investment. This is less objectionable than the piercing rule from the standpoint of burdening creditors of the parent, but it is independently objectionable as undermining the overall efficiency of the investment process. Parent corporations are sometimes the most efficient lenders to their affiliates because the enterprise relationship may enable the parent to evaluate the risk of a default at a lower cost than an outsider would have to incur. A rule that placed heavier liabilities on a parent lender than on an outside lender might thus distort the comparative advantages of these two sources of credit.

The proposed rule is a dubious one even from the excessively narrow standpoint of protecting creditors of the affiliate receiving the loan. The parent may extend credit to its subsidiary on terms more advantageous to the latter than an independent creditor would offer because the parent fears that its own creditworthiness would suffer if the subsidiary became insolvent. The availability of such loans thus reduces the risk that the subsidiary will in fact default. If the parent is not allowed to make a "real" loan to a subsidiary—if in effect the only permitted method of rescue is a contribution of equity capital—the added risks of this method of rescue may deter the parent from trying to salvage the subsidiary. If so, the creditors of the subsidiary will be hurt. There is, to be sure, another side to the coin. The parent may make the loan merely to conceal the subsidiary's precarious state and thereby attract new creditors who, but for the loan, would have been warned away by slow payment or other symptoms of financial distress that the loan may mask. But this possibility indicates only that parent-subsidiary lending is susceptible of abuse, and not that creditors in general would be benefited by a rule of automatic subordination of the parent's loan to the rights of independent creditors.

3. In the case of consolidation in bankruptcy of affiliated corporations, Landers recognizes that the interests of two groups of creditors are in conflict. To the extent that one of the bankrupts has greater assets relative to the claims of its own creditors than the other has, consolidation harms those creditors and helps the affiliate's creditors. The prospect of consolidation means that a creditor can make a total evaluation of the risks that he faces only by considering the risk of insolvency of the borrower's affiliates as well as the risk of insolvency of the borrower itself. Consolidation is thus analytically similar to veil piercing. Landers urges consolidation as the general rule but would recognize an exception where the creditors

of one of the corporations have specifically relied on the corporate separateness of the borrower.

The recognition of this exception is inconsistent with Landers's treatment of the veil-piercing case. The problem of reliance on the corporate form arises in the context of attempts to pierce the corporate veil as well as in the consolidation context. Landers assumes it away in the former context by expressly confining his discussion to cases where the parent's assets are so great that it cannot be made insolvent by having to answer for the debts of its subsidiaries.[34] He reasons that in such cases the parent's creditors cannot be harmed by a change in law that would reduce the risks borne by the subsidiary's creditors relative to those borne by the parent's creditors. But this reasoning is unsound. It erroneously treats solvency and insolvency as dichotomous states. As stressed in Part I, the interest rate on a loan is determined by the estimated risk of default and that estimate will always fall somewhere in between zero and 100 percent; it will not be zero *or* 100 percent. Since anything that increases the estimated risk will lead a creditor to insist on a higher interest rate, creditors will not be indifferent to changes in law that increase the risk of a default, even though, ex post, the default does not materialize. Ex ante they will incur costs to ascertain the change in the risk of default brought about by an expansion in the rights of competing creditors. To assume that the parent corporation will still be solvent after being made liable for the debts of a subsidiary is to assume away the principal policy issue concerning piercing the veil—its impact on the costs of credit.

B. Limited Liability and Creditors' Rights: An Alternative Approach

Having criticized Landers's approach, I am obliged to suggest a superior alternative. Unlike Landers, I do not start from the premise that the limited liability of affiliated corporations has an inherent tendency to externalize the costs of new business ventures, disadvantage creditors, or increase the costs of credit transactions. Limited liability can be abused but the law should focus on the abuses and preserve the principle.

To this end, it is first necessary to make a distinction between the involuntary (normally tort) creditor and the voluntary creditor. In a series of cases in New York, the courts have wrestled with the

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[34] Landers, *supra* note 1, at 606-07.

problem of the taxi company that incorporates each taxicab separately in order to limit its tort liability to accident victims.[35] In terms of the analysis in this paper, the separate incorporation of the taxicabs increases the risk that the taxi company will default on its tort obligations. If this were a negotiated obligation the creditor-victim would charge a higher interest rate to reflect the increased risk, but it is not, negotiations between the taxi company and the accident victims before the accident being infeasible. The result of separate incorporation is therefore to externalize the costs of taxi service. But although this result is socially inefficient, the analysis cannot stop here. Permitting the corporate veil to be pierced would create an inefficiency of another sort: investment in taxi service would be discouraged because investors would be unable to limit their liability, and the information costs of creditors of affiliated corporations (or for that matter of creditors of noncorporate shareholders) would be increased. To be sure, the enterprise could insure itself against tort liability. But this would not be a satisfactory alternative to limited liability. The managers might fail to take out adequate insurance; the insurance company might for a variety of reasons refuse or be unable to pay a tort judgment against the insured (the insurance company might for example become insolvent); the particular tort might be excluded from the coverage of the insurance policy. An alternative would be to preserve limited liability but require every company engaged in dangerous activity to post a bond equal to the highest reasonable estimate of the probable extent of its tort liability. Shareholders would be protected; accident costs would be internalized; and the information costs of the creditors of the affiliated corporations would be minimized.

The other and more important case in which piercing the corporate veil may be warranted is where separate incorporation is misleading to creditors. In this case pooling the assets of the affiliated corporations for purposes of meeting creditors' claims would reduce the creditors' information and regulation costs. If corporations are permitted to represent that they have greater assets to pay creditors than they actually have, the result will be to increase the costs that creditors must incur to ascertain the true creditworthiness of the corporations with which they deal. Misrepresentation is a way of increasing a creditor's information costs, and the added costs are

[35] For a summary of the cases, see H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 252 n.25 (2d ed. 1970). I am assuming that the victim has no pre-existing contractual relationship with the taxi company—*i.e.*, that he is a pedestrian, or a driver or occupant of another vehicle, rather than a passenger in the taxi. *See* note 16 *supra*.

wasted from a social standpoint to the extent that the misrepresentation could be prevented at lower cost by an appropriate sanction against it.[36]

Suppose for example that a bank holding company establishes a subsidiary to invest in real estate. The holding company gives the subsidiary a name confusingly similar to that of the holding company's banking subsidiary, and the real estate corporation leases office space in the bank so that its offices appear to be bank offices. Unsophisticated creditors extend generous terms to the real estate subsidiary on the reasonable belief that they are dealing with the bank itself.[37] In these circumstances it would seem appropriate to "estop" (*i.e.*, forbid) the bank holding company—or even the bank itself—to deny that it is the entity to which the creditors have extended credit. To protect the legal separateness of affiliated corporations in this case would lead creditors as a class to invest a socially excessive amount of resources in determining the true corporate status of the entity to which they were asked to extend credit.[38]

In general, a corporation's creditors should be allowed to reach a shareholder's assets when the shareholder, whether an individual or another corporation, has represented to the creditor that those assets are in fact available to satisfy any claim that the creditor may assert against the debtor corporation. Misrepresentation is a familiar and widely used concept in the law, with strong intuitive appeal, and its use in the present context is firmly grounded in the economics of credit and information. Moreover, it is the dominant approach in fact used by the courts in deciding whether to pierce the corporate veil. True, they often describe the criterion for piercing as whether the debtor corporation is merely an "agent," "alter ego," or "instrumentality" of the shareholder, which as Landers points out is a confusing test.[39] A careful reading of these decisions suggests, however, that in applying the "agent-alter ego-instrumentality" test the courts commonly ask whether the parent engaged in conduct or

[36] On the simple economics of fraud, see R. POSNER, REGULATION OF ADVERTISING BY THE FTC 3-9 (1973); for a more technical treatment, see Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. LAW & ECON. 67 (1973); and on the underlying economics of information, see G. STIGLER, THE ORGANIZATION OF INDUSTRY 171 (1968).

[37] By an "unsophisticated" creditor, I mean one to whom the costs of ascertaining the true corporate status of the real estate company would be substantial. A "reasonable belief" means simply a belief based upon an optimal investigation of that corporate status.

[38] See F. Black, M. Miller, & R. Posner, *supra* note †, at 28-31 (for a detailed discussion of this example).

[39] *See* Landers, *supra* note 1, at 626.

made representations likely to deceive the creditor into thinking that the debtor had more assets than it really had or that the parent was the real debtor.[40] And some courts have explicitly adopted a misrepresentation rationale for determining whether to pierce the corporate veil.[41]

Because a misrepresentation test requires weighing the individual facts and circumstances in each case and somehow discovering what the creditor thought and whether he was reasonable in so thinking, it is more difficult to apply than a rule simply abolishing the limited liability of shareholders that are corporations. But it is no more difficult to apply than Landers's interim test of "viability" (whatever that means) plus procedural observances,[42] and it could be made more precise in a number of ways.

One way would be to make clear that the test is an "objective" one; the issue should be not what the creditor in fact thought but what a reasonable person in the creditor's situation would have thought. Another way would be to differentiate among types of creditors in terms of their information costs. A financial creditor, such as a consortium of banks, can discover the true financial situation

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[40] *See, e.g.*, Weisser v. Mursam Shoe Corp., 127 F.2d 344, 345-47 (2d Cir. 1942); Stone v. Eacho, 127 F.2d 284, 287-88 (4th Cir. 1942); Darling Stores Corp. v. Young Realty Co., 121 F.2d 112, 113 (8th Cir. 1941); Arnold v. Phillips, 117 F.2d 497, 501 (5th Cir. 1941); Stark Elec. R.R. v. M'Ginty Contracting Co., 238 F. 657, 661-62 (6th Cir. 1917); Bartle v. Home Owners Co-Operative, Inc., 309 N.Y. 103, 106, 127 N.E.2d 832, 833 (1955); North v. Higbee Co., 131 Ohio St. 507, 514-18, 527, 3 N.E.2d 391, 394-95, 399 (1936); *cf.* Hospes v. Northwestern Mfg. & Car. Co., 48 Minn. 174, 198, 50 N.W. 1117, 1121 (1892). A particularly good example of the approach is Gledkill v. Fisher & Co., 272 Mich. 353, 388-89, 262 N.W. 371, 372-73 (1935), where the court states:

> In the case at bar I am unable to find that any control exercised over the Westbrook-Lane Properties Corp. by Fisher & Co. [the parent] was exercised in such a manner as to defraud or wrong the plaintiffs, or that such domination was in any way injurious to them. In entering into the land contract, plaintiffs relied entirely upon the Westbrook-Lane Corporation as the sole and actual purchaser. There was no representation by Fisher & Co. that it was the real party in interest or that its responsibility was in back of the Westbrook-Lane Corporation. In fact, plaintiffs did not know at that time that their vendee was a subsidiary of the New Center Corporation or of Fisher & Co.

[41] *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Co., 483 F.2d 1098, 1102 (5th Cir. 1973); *cf.* Fisser v. International Bank, 282 F.2d 231, 238, 240 n.18 (2d Cir. 1960). *See also* H. HENN, *supra* note 35, at 259; Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1123, 1125 (1958).

[42] *See* Landers, *supra* note 1, at 621-22, 625-26. Landers's test is actually more complicated than this since he would allow as a defense to the creditor's attempt to pierce the veil a showing that the creditor knew or should have known what the assets of the corporation to which he extended credit really were. *Id.* at 625-26. Here and elsewhere Landers's article suggests that his interim test for veil piercing, at least, is based on a misrepresentation rational. *See, e.g.*, *id.* at 623. But this interpretation is weakened by his emphatic rejection of fraud as a basis for veil piercing. *Id.* at 626.

of the debtor at lower cost than the trade creditor, and the latter in turn at lower cost than the nonbusiness creditor. (The financial creditor generally extends the greatest amount of credit to each debtor and therefore has the greatest incentive to investigate the debtor's creditworthiness; he also has the greatest degree of specialization in appraising credit risk). Perhaps the courts should raise a presumption against piercing the veil in the case of the financial creditor and a presumption in favor of piercing in the case of the non-business creditor.

The courts might also develop rules for treating creditors on an aggregated basis, the usual approach in bankruptcy proceedings, rather than adjudicating the question of each creditor's relative knowledge. An entire class of creditors might be granted a right to recover on the basis of evidence that a significant fraction of their number was or was likely to have been misled. For example, were there evidence that some trade creditors had actually or probably been misled, trade creditors as a class might be permitted to invoke the misrepresentation rationale as a basis for recovery against the affiliate that had engaged in the misrepresentation. My conclusion is that a misrepresentation approach, which seems clearly sounder than Landers's "single enterprise" approach as a matter of principle, is susceptible of practical application.

The misrepresentation approach can also be used to answer the other two specific questions discussed by Landers—subordination of the parent's loans and consolidation of bankrupt affiliates. Although a rule of automatic subordination would be inappropriate, a creditor should be permitted to show that the parent's loan misled him regarding the amount of assets the corporation had available for repayment of his loan. He may have reasonably believed that the corporation had the usual equity capitalization for a corporation of its size and line of business.[43] If these reasonable expectations were defeated because the parent supplied capital to the corporation in the form of a loan rather than equity, the parent should be estopped to deny that the loan is actually a part of the subsidiary's equity capital. Similarly, consolidation of bankrupt affiliates should be permitted where the creditor of one of the affiliates reasonably relied

[43] "Usual" capitalization could be determined by an examination of the capital structures of a representative sample of the debtor's competitors, excluding any firm that was an affiliate of another firm. The examination might, however, disclose a variance in the amount of capital among these firms large enough to negative the creditor's claim that he had relied on the debtor's having the amount of capital that was "normal" for firms in its line of business; that is, there might be no norm.

on an appearance of greater capitalization than in fact existed.

In all cases in which estoppel is successfully invoked some competing group of creditors will be disadvantaged whose expectations may have been just as reasonable as those of the creditors invoking estoppel. But to the extent that enforcing the estoppel or misrepresentation principle will discourage borrowers from using the corporate form to mislead creditors, creditors in general will benefit—as will society since the costs of credit transactions will be lower, and hence interest rates will be lower for any given level of risk.

The suggested approach deals automatically with the problem especially troubling to Landers of the entrepreneur who, in order to avoid creditor and other claims, divides a truly unitary business into a number of separate corporations. Insofar as creditors are misled by the proliferation of affiliated corporations, the misrepresentation principle affords them a remedy. If they are not misled, the proliferation of corporations is harmless and should be ignored.

C. A Summary Comparison of the Suggested Approaches

The basic difference between Landers and me over the question of the limited liability of affiliated corporations is that he thinks that the abuses of limited liability are so prevalent in this context as to warrant a rule dispensing with the need to prove that an abuse occurred. I reject this approach because the principle of limited liability has considerable merits even in the affiliation context, when all relevant costs and benefits are considered. Moreover, I conjecture that Landers has exaggerated the prevalence of abuses by limiting his data source to reported bankruptcy cases. Cases in which the debtor actually becomes bankrupt are not likely to constitute a representative sample of credit transactions generally.[44] This is especially so because under current law proof of misrepresentation is usually necessary for the corporate veil to be pierced. This means that someone who just reads cases on veil piercing will come away with an impression that the usual purpose and effect of corporate affiliation is to mislead creditors. But any rule allowing the piercing of the corporate veil will affect business behavior across the entire range of credit transactions rather than just the limited and unrepresentative sample of behavior of the defendants in reported veil-piercing cases.

It is also possible to exaggerate the virtues of simple legal rules,

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[44] *Cf.* D. STANLEY & M. GIRTH, BANKRUPTCY: PROBLEMS, PROCESS, REFORM 107-17 (1971).

such as a rule abolishing the limited liability of shareholders that are corporations. There are two points to be made here. The first is that the simple, flat rule opens up loopholes. Landers limits his analysis to the 100 percent affiliate. He does not discuss the case where some of the shares of the affiliate are owned by others. That case is apparently to be taken care of by some other rule; or perhaps limited liability is to remain sacrosanct whenever there is less than 100 percent ownership by the parent or affiliate. But to draw so sharp a legal distinction between the case where the parent owns 100 percent of the common stock of its subsidiary and the case where it owns 99.9 percent is not only arbitrary; it invites the creation of tiny minority stock interests for the precise purpose of escaping Landers's rules. In a complete analysis, Landers would be forced to propose additional rules to close up this loophole.[45] A misrepresentation approach does not have this defect because it is unaffected by the presence of minority shareholders save insofar as their presence might, in a rare case, affect creditors' reasonable expectations.

The second point is that a rule abolishing the limited liability of separate corporations, while simpler than one that makes veil piercing contingent on proof of misrepresentation, is not necessarily cheaper to administer than the latter rule. The question whether simple rules really reduce the net costs of legal administration has been extensively discussed in the context of whether to supplant negligence by strict liability in tort cases. Proponents of strict liability point out, correctly, that it simplifies the trial of the individual case by eliminating one of the issues in the trial—the issue of fault—and that by simplifying the trial, and thereby facilitating prediction of its outcome, it also reduces the fraction of disputes likely to be litigated. However, the proponents typically ignore the fact that strict liability would expand the universe of potential claims by increasing the scope of liability for injury-creating conduct. Each case might be cheaper to try, and the fraction of claims actually tried might be smaller, but the absolute number of claims tried would be larger, and the total administrative costs—which are the product of the cost per case litigated, the fraction of claims litigated, and the total number of claims—might actually rise.[46]

It is the same with piercing the corporate veil. If the veil may

[45] A similar problem is created by his proposal for subordinating parents' loans. Parents would have an incentive to contribute capital in forms (*e.g.*, equipment leases) that might escape being classified as "loans" for purposes of the rule.

[46] *See* Posner, *Strict Liability: A Comment*, 2 J. LEGAL STUDIES 205, 209 (1973).

always be pierced to reach an affiliated corporation's assets, then the litigation of each veil-piercing case will be simpler, and the fraction of creditors' claims against affiliated corporations that are litigated will therefore be smaller; but the *number* of potential claims by creditors against parent or other affiliated corporations will be much greater than under a rule that entitles the creditor to pierce the corporate veil only if he has been misled. Thus, if the incidence of abuse of the corporate form in the affiliation setting is in fact small—if most creditors of affiliated corporations are not misled into thinking that they are dealing with the debtor's parent or affiliated corporation—the expansion of liability implicit in Landers's suggested approach could result in greatly increased administrative costs by allowing a large number of claims to be pressed that would be frivolous under existing law.

The most serious objection to Landers's suggested approach, however, is that it would impair a socially valuable principle, that of limited corporate liability, which I have argued retains much of its importance in the context of affiliated corporations. The risks of small business might be materially enhanced if small venturers could not limit their risk in undertaking a new venture to their investment in that venture. Although Landers appears to be willing to allow affiliated corporations expressly to negotiate for limited liability, this would not take care of the investor's exposure to tort liability; and disclaiming liability to the many small trade and non-business creditors with which a corporation deals could be quite costly—even prohibitively so if the courts refused to honor simple disclaimers of unlimited liability.