

11-1-2008

## Piercing the Corporate Veil in Regulated Industries

Douglas G. Smith

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### Recommended Citation

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## Piercing the Corporate Veil in Regulated Industries

*Douglas G. Smith\**

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Veil piercing doctrines have been the subject of much scholarly attention in recent years.<sup>1</sup> They have generated diametrically opposing views, with some legal commentators advocating the complete abolition of the doctrines and others advocating a significant relaxation of the standards for piercing the corporate veil.

Those who advocate abolition of these doctrines argue that limited liability for corporations has significant economic benefits.<sup>2</sup> These scholars argue that aside from reducing the costs of equity ownership and facilitating economic growth, limited liability facilitates diversification of investment, reduces monitoring costs, increases liquidity of shares, and encourages managers to undertake beneficial projects that otherwise might be deemed too risky. Allowing plaintiffs to pierce the corporate veil and the shield of limited liability removes these benefits and creates uncertainty for

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1. The scholarly interest in this topic is fueled, in part, by its practical significance. Many commentators have asserted that “the problem is one of the most frequently litigated in all of corporate law.” Stephen B. Presser, *The Bogalusa Explosion, “Single Business Enterprise,” “Alter Ego,” and Other Errors: Academics, Economics, Democracy, and Shareholder Limited Liability: Back Towards a Unitary “Abuse” Theory of Piercing the Corporate Veil*, 100 NW. U. L. REV. 405, 411 (2006); see also Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063, 1065 (2006) (“Veil piercing has been one of the most hotly debated concepts in business law.”); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 81 (1991) (“The limited liability of corporate shareholders is one of the most controversial issues in corporate law.”); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 7 (1997) (“Piercing the corporate veil is the most litigated issue in corporate law.”).

2. See, e.g., Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 495 (2001) (“[T]here is a widely shared view that limited liability was, and remains, essential to attracting the enormous amount of investment capital necessary for industrial corporations to arise and flourish.”); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 90–98 (1985); Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 164 (1992) (“If it is true that the original justification of limited liability was that it encourages investment in the small firm, or investment by entrepreneurs of modest means, and if we are still interested in encouraging individual entrepreneurship through incorporation, this ought to be, perhaps, the most crucial aspect to be considered in veil-piercing doctrine.”).

investors and other corporate stakeholders—particularly in light of the standards applied by courts that are often less than clear.

In contrast, those who seek to relax the requirements for piercing the corporate veil argue that limited liability improperly shifts costs onto innocent creditors.<sup>3</sup> As a result, management may undertake business activities that are harmful to society because they are able to externalize the risk of such projects, resulting in a moral hazard problem. These costs, such commentators assert, outweigh the benefits of limited liability.

However, there may be a middle ground between these two positions. It may be possible to identify certain areas in which all sides agree veil piercing is inappropriate. One such area may exist where the corporations at issue operate within an industry that is subject to regulations that seek to prevent the sorts of conduct that the veil piercing doctrines are designed to remedy. In essence, it may be appropriate to acknowledge a sort of regulatory preemption in such circumstances given that that regulation mitigates the costs associated with limited liability.

Part I of this Article discusses the standards courts apply in determining whether to pierce the corporate veil. The law recognizes a strong presumption in favor of preserving limited liability. Accordingly, the test for piercing the corporate veil is a stringent one. Generally, courts require that the party seeking to overcome limited liability demonstrate that there is significant “domination and control” over the entity whose veil is to be pierced, that there is an element of fraud in the use of the corporate form that warrants disregarding it, and that the fraudulent use of the corporate form has caused plaintiffs some injury. Courts have developed a number of factors to assess whether these conditions have been met, none of which is dispositive. Nonetheless, these factors tend to underscore the high barrier a party must surmount to pierce the corporate veil.

Part II discusses some of the criticisms of the veil piercing doctrines. Some commentators have argued that veil piercing should be eliminated altogether because the standards articulated by courts are so vague that they are unworkable and because the benefits of limited liability clearly outweigh any associated costs. On the other hand, some recent academic literature has proposed expansion of

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3. See, e.g., Henry Hansmann & Renier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1880, 1920 (1991); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 6 (1996).

shareholder liability by eroding the standards for breaching the corporate form. These proposals are often justified on the ground that limited liability improperly allows corporations to shift the costs of their risky activities to innocent third parties and that the benefits associated with limited liability are not as great as some have argued.

Part III discusses examples of existing regulatory frameworks that govern many of the same activities that determine whether courts will pierce the corporate veil. While the principles articulated in this Article may be widely applicable, the Article focuses in particular on regulations governing the insurance and banking industries. Regulatory frameworks, such as those found in these industries, ensure that corporations are not subject to the sort of “domination and control” necessary to pierce the corporate veil and that the corporate form is not misused for some fraudulent purpose. Accordingly, the regulatory framework seeks to prevent the very conduct that the veil piercing doctrines are designed to remedy.

Regulators in multiple states constantly monitor corporate entities operating within the insurance industry, for example, to ensure that they remain adequately capitalized and capable of meeting their obligations to policyholders. Likewise, federal regulators in the banking industry seek to ensure that banks are adequately capitalized and that transactions among entities within a corporate structure do not undermine their financial security. Such regulations construct a series of legal “firewalls” among the companies to prevent any inappropriate transfer of assets from one entity to another. Such regulatory frameworks also preclude the sort of “domination and control” that is necessary to establish alter ego liability. Regulators monitor corporations operating within the industry to ensure that they observe corporate formalities. Accordingly, the rationale behind the veil piercing doctrines simply does not apply.

Finally, Part IV offers a modest proposal for limitation of the veil piercing doctrine that commentators on both ends of the academic spectrum should embrace. Courts should not apply this doctrine to companies that operate within a regulatory framework that essentially precludes alter ego relationships.<sup>4</sup> In such circumstances, the dangers the veil piercing doctrines seek to remedy are already

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4. This article treats the veil piercing and alter ego doctrines as synonymous. *See* Outokumpu Eng'g Enters. v. Kvaerner Enviropower, 685 A.2d 724, 729 (Del. Super. Ct. 1996) (noting that alter ego theory and veil piercing are “analogous”).

mitigated. Moreover, corporations operating within such regulatory frameworks have a legitimate expectation that they will not be subject to such liability.

Accordingly, the rationale for maintaining limited liability under such circumstances is even stronger. Such regulatory frameworks reduce the economic costs of limited liability and preserve the benefits. Conversely, veil piercing in such circumstances only results in additional, and unnecessary, costs given that entities operating within these industries already incur the costs associated with the regulatory framework that mitigates the same dangers that veil piercing is designed to prevent. In these circumstances, the case for veil piercing is substantially weaker.

#### I. STANDARDS FOR PIERCING THE CORPORATE VEIL

The presumption of limited shareholder liability is a “bedrock” principle of corporate law.<sup>5</sup> “[D]istinct corporations, even parent and subsidiary corporations, are presumed separate.”<sup>6</sup> Indeed, this has been the case “since the earliest days of our corporate law.”<sup>7</sup> As a consequence, “[s]hareholder protection through the corporate form is ‘ingrained in our economic and legal systems.’”<sup>8</sup> Moreover, the limited liability associated with the corporate form has played a significant role “in the expansion of industry and in the growth of trade and commerce.”<sup>9</sup> Courts and legislatures have long recognized that “furthering of capital formation could best be accomplished by

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5. Escobedo v. BHM Health Assocs., Inc., 818 N.E.2d 930, 933 (Ind. 2004); WILLIAM MEADE FLETCHER, 1 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 43 (perm. ed., rev. vol. 2006) [hereinafter FLETCHER] (“As a general rule, two separate corporations are regarded as distinct legal entities even if the stock of one is owned wholly or partly by the other. . . . Thus, generally, absent fraud or bad faith, a parent corporation will not be liable for the acts of its subsidiary.”).

6. Greater Hammond Cmty. Servs., Inc. v. Mutka, 735 N.E.2d 780, 784 (Ind. 2000) (citing McQuade v. Draw Tite Inc., 659 N.E.2d 1016, 1020 (Ind. 1995)); see also Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. Ct. App. 1982) (“The general rule is that a corporate entity may not be ignored.”); Hillsborough Holdings Corp. v. Celotex Corp., 166 B.R. 461, 468 (Bankr. M.D. Fla. 1994) (“Delaware courts disregard the corporate entity in only the most extraordinary cases.”).

7. Winkler v. V.G. Reed & Sons, Inc., 638 N.E.2d 1228, 1232 (Ind. 1994).

8. Hambleton Bros. Lumber Co. v. Balkin Enters., Inc., 397 F.3d 1217, 1227 (9th Cir. 2005) (quoting William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 193 (1929)); see also Easterbrook & Fischel, *supra* note 2, at 89 (“Limited liability is a fundamental principle of corporate law.”).

9. *Hambleton Bros.*, 397 F.3d at 1227 (quoting Douglas & Shanks, *supra* note 8, at 193).

encouraging shareholders to invest through limiting their liability.”<sup>10</sup> As a result, “[l]imited liability is the rule not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted.”<sup>11</sup>

Given the critical importance of limited liability in our economic and legal systems, “the burden on a party seeking to ‘pierce the corporate veil’ is severe.”<sup>12</sup> “[C]ourts will pierce the corporate veil only in exceptional circumstances.”<sup>13</sup> Accordingly, disregarding the corporate form and imposing liability on affiliated corporate entities is an “extreme remedy, sparingly used.”<sup>14</sup> A party seeking to disregard the corporate form must show that it was “so ignored, controlled or manipulated” that the subsidiary was “merely the instrumentality of another and that the misuse of the corporate form would constitute a fraud or promote injustice.”<sup>15</sup>

In a breach of contract case, the burden is even *higher* than the normally severe burden imposed upon a plaintiff seeking to pierce the corporate veil.<sup>16</sup> The burden on plaintiffs “must be more

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10. Aronson v. Price, 644 N.E.2d 864, 867 (Ind. 1995) (quoting Presser, *supra* note 2, at 155).

11. Anderson v. Abbott, 321 U.S. 349, 362 (1944); *see also* FLETCHER, *supra* note 5, § 41.10 (“Courts generally apply the alter ego rule with great caution and reluctance. In fact, many courts require exceptional circumstances before disregarding the corporate form.”).

12. Escobedo v. BHM Health Assocs., Inc., 818 N.E.2d 930, 933 (Ind. 2004) (quoting Aronson, 644 N.E.2d at 867); *see also* Mid-Century Ins. Co. v. Gardner, 11 Cal. Rptr. 2d 918, 922 (Cal. Ct. App. 1992) (“It is the plaintiff’s burden to overcome the presumption of the separate existence of the corporate entity.” (citing MacPherson v. Eccleston, 190 Cal. App. 2d 24, 27 (1961))). Several courts have held that an alter ego relationship must be demonstrated by “clear and convincing” evidence. *See, e.g.*, Kaplan v. First Options of Chicago, 19 F.3d 1503, 1522 (3d Cir. 1994) (“Because alter ego is akin to and has elements of fraud, . . . it . . . must be shown by clear and convincing evidence.”).

13. Calvert v. Huckins, 875 F. Supp. 674, 678 (E.D. Cal. 1995) (quoting National Precast Crypt Co. v. Dy-Core of Pa., Inc., 785 F. Supp. 1186, 1192 (W.D. Pa. 1992)).

14. Sonora Diamond Corp. v. Super. Ct., 99 Cal. Rptr. 2d 824, 836 (Cal. Ct. App. 2000) (citing Calvert, 875 F. Supp. at 677); *see also* Bainbridge, *supra* note 2, at 507 (“Control is the common (if sometimes implicit) feature of all the concepts used to describe cases in which veil piercing is appropriate.”).

15. Escobedo, 818 N.E.2d at 933 (quoting Aronson, 644 N.E.2d at 867).

16. Carte Blanche (Singapore) PTE., Ltd. v. Diners Club Int’l, Inc., 758 F. Supp. 908, 913 (S.D.N.Y. 1991) (“[P]resumption [of limited liability] is particularly strong in contract cases, in which plaintiff has chosen the party with which it has contracted, and may negotiate guarantees or other security arrangements.”); Lucas v. Tex. Indus., Inc., 696 S.W.2d 372, 375 (Tex. 1984) (“Courts have generally been less reluctant to disregard the corporate entity in tort cases than in breach of contract cases.”); FLETCHER, *supra* note 5, § 41.85 (“[C]ourts usually apply more stringent standards to piercing the corporate veil in contract cases than they do in tort cases.”).

stringent in contract cases than in tort cases because in contract cases the plaintiff has an opportunity to select the entity with which he deals as opposed to tort cases in which no such choice exists.”<sup>17</sup> As several courts have recognized,

[t]he attempt to hold a parent corporation [liable] where the claim asserted is of contractual origin presents added difficulties. 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 be allowed to look to the parent. As a matter of contract right it is evident he may not. Additional compelling facts must appear.<sup>18</sup>

In assessing whether to pierce the corporate veil, courts generally apply a range of factors, none of which by itself is sufficient to establish liability.<sup>19</sup> These factors, however, tend to be designed to ascertain whether certain, more fundamental, elements are met. In order to pierce the corporate veil or establish alter ego liability, it is generally necessary to show that a parent or affiliated entity exercised domination or control over the entity at issue, that there was an element of fraud or abuse of the corporate form, and that the fraudulent abuse of the corporate form caused a tangible injury.<sup>20</sup>

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17. *Hickman v. Rawls*, 638 S.W.2d 100, 102 (Tex. App. 1982) (citing *Hanson Corp. v. Dal-Mac Constr. Co.*, 554 S.W.2d 712 (Tex. Civ. App. 1977)); *see also* *Edwards Co. v. Monogram Indus., Inc.*, 730 F.2d 977, 981 (5th Cir. 1984); *Cambridge Elecs. Corp. v. MGA Elecs., Inc.*, 227 F.R.D. 313, 331 n.50 (C.D. Cal. 2004) (“Courts are less likely to apply the alter ego doctrine where the party seeking to invoke it . . . voluntarily transacted business with the corporate entity.” (citing *Energy & Metals Corp. v. Banks*, 896 F.2d 1557, 1577 (10th Cir. 1990))).

18. *Edwards Co.*, 730 F.2d at 981 (quoting *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336, 339–40 (Tex. 1968)); *see also* *Mancorp, Inc. v. Culpepper*, 781 S.W.2d 618, 623 (Tex. App. 1989) (“[C]ourts are more likely to disregard the corporate fiction in tort cases than in contract cases, like this one, because the risk of loss in a contract case is apportioned in prior dealings, when the bargain is first struck.” (citing *Lucas*, 696 S.W.2d at 375)), *rev’d on other grounds*, 802 S.W.2d 226 (Tex. 1990).

19. *See, e.g.*, *W. Passalacqua Builders v. Resnick Developers S., Inc.*, 933 F.2d 131, 139 (2d Cir. 1991) (listing factors); *Associated Vendors, Inc. v. Oakland Meat Co.*, 26 Cal. Rptr. 806, 813–15 (Cal. Ct. App. 1962) (listing factors).

20. Fletcher summarizes these requirements as follows:

[C]ourts will disregard the existence of a corporate entity when the plaintiff shows: (1) control, not merely majority or complete stock control, but complete domination, not only of the finances, but of policy and business practice in respect to the transaction so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and (2) that such control was used by the defendant to commit fraud or wrong, to perpetrate the violation of the statutory

*A. Domination and Control*

“Domination and control” means more than the ordinary control that accompanies the normal parent-subsidary relationship. A parent corporation “may be directly involved in financing and macro-management of its subsidiaries . . . without exposing itself to a charge that each subsidiary is merely its alter ego.”<sup>21</sup> Indeed, parent corporations are “almost always ‘active participants’” in the affairs of their subsidiaries, and in most circumstances such participation is “entirely permissible.”<sup>22</sup> “Appropriate parental involvement includes: ‘monitoring of the subsidiary’s performance, supervision of the subsidiary’s finance and capital budget decisions, and articulation of general policies and procedures.’”<sup>23</sup> Accordingly, the standard level of “control” accompanying a parent-subsidary relationship is insufficient in itself to establish this prong of the veil piercing test. For “it is hornbook law that ‘the exercise of the “control” which stock ownership gives to the stockholders . . . will not create liability beyond the assets of the subsidiary.’”<sup>24</sup> Something more is required.

In order to establish alter ego liability or pierce the corporate veil, plaintiffs must show that the parent exercised “exclusive domination and . . . control to the point that [the subsidiary] no longer has legal or independent significance of [its] own.”<sup>25</sup> “The parent’s general executive control over the subsidiary is not enough; rather there must be a strong showing beyond simply facts

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or other positive legal duty, or to commit a dishonest and unjust act in contravention of the plaintiff’s legal rights; and (3) that the aforesaid control and breach of duty proximately caused the injury or unjust loss.

FLETCHER, *supra* note 5, § 41.10; *see also* Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 9 (1994).

21. *Doe v. Unocal Corp.*, 248 F.3d 915, 927 (9th Cir. 2001).

22. *Esmark, Inc. v. NLRB*, 887 F.2d 739, 759 (7th Cir. 1989) (quoting *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 415 (7th Cir. 1988)).

23. *Doe*, 248 F.3d at 926 (quoting *United States v. Bestfoods*, 524 U.S. 51, 69 (1998)).

24. *Bestfoods*, 524 U.S. at 62 (quoting *Douglas & Shanks*, *supra* note 8, at 196).

25. *Outokumpu Eng’g Enters., Inc. v. Kvaerner Enviropower, Inc.*, 685 A.2d 724, 729 n.2 (Del. Super. Ct. 1996) (alterations in original) (quoting *Hart Holding Co. v. Drexel Burnham Lambert, Inc.*, C.A. No. 11514, 1992 WL 127567, at \*11 (Del. Ch. May 28, 1992)); *see also* *Wallace v. Wood*, 752 A.2d 1175, 1183–84 (Del. Ch. 1999) (“[P]laintiffs must allege facts that, if taken as true, demonstrate the Officers’ and/or Parents’ complete domination and control of the [subsidiary].” (citing *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 271 (D. Del. 1989))).

evidencing ‘the broad oversight typically indicated by [the] common ownership and common directorship’ present in a normal parent-subsidary relationship.”<sup>26</sup> “As a practical matter, the parent must be shown to have moved beyond the establishment of general policy and direction for the subsidiary and in effect taken over performance of the subsidiary’s *day-to-day* operations in carrying out that policy.”<sup>27</sup> Even “widespread involvement” in financial and management decisions is not sufficient to establish liability.<sup>28</sup>

### *1. Corporate formalities*

Courts consider a number of factors in determining whether the requisite domination and control exists in a given case. One of the most frequently cited factors in determining whether there has been excessive domination or control is the corporation’s compliance with corporate formalities, such as maintaining separate corporate books, hiring an independent auditor, and maintaining an independent board that holds regular meetings.<sup>29</sup> While this factor is frequently cited, it is not often dispositive given that “mere failure upon occasion to follow all the forms prescribed by law for the conduct of corporate activities will not justify [disregard of the corporate entity].”<sup>30</sup>

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26. *Sonora Diamond Corp. v. Super. Ct.*, 99 Cal. Rptr. 2d 824, 838–39 (Cal. Ct. App. 2000) (brackets in original) (quoting *Calvert v. Huckins*, 875 F. Supp. 674, 679 (E.D. Cal. 1995)).

27. *Id.* (citing *Calvert*, 875 F. Supp. at 679); *see also* *Allen v. Oberdorfer Foundries, Inc.*, 595 N.Y.S.2d 995, 996 (N.Y. App. Div. 1993) (“The parent corporation must exercise complete domination and control of the subsidiary’s everyday operations.” (citing *Pebble Cove Homeowners’ Ass’n v. Fid. N.Y. FSB*, 153 A.D.2d 843 (N.Y. 1989))).

28. *Craig v. Lake Asbestos of Quebec, Ltd.*, 843 F.2d 145, 151 (3d Cir. 1988).

29. *See generally* FLETCHER, *supra* note 5, § 41.31 (noting that when courts determine whether corporate formalities were observed, they examine many factors including whether corporations were separately incorporated, had separate boards of directors, kept separate accounting and tax records, and had separate facilities and operating personnel); *see also In re Silicone Gel Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1128, 1133 (N.D. Ala. 1993) (observing that corporate formalities include corporation’s “maintaining its own books; filing its own tax returns; hiring its own auditor; employing its own officers, management and workers; owning and operating its own plants . . . ; [and] holding its own stockholders’ and directors’ meetings”), *vacated in part on other grounds*, 884 F. Supp. 1455 (N.D. Ala. 1995); *In re Acushnet River & New Bedford Harbor Proceedings*, 675 F. Supp. 22, 35 (D. Mass. 1987).

30. *Curtis v. Feurhelm*, 335 N.W.2d 575, 576–77 (S.D. 1983) (brackets in original) (citing *Larson v. Western Underwriters Inc.*, 77 S.D. 157, 167 (1958)); *see also* *Thompson*, *supra* note 1, at 18 (“The failure to follow corporate formalities has been questioned as a basis

Moreover, the lack of corporate formalities is arguably irrelevant unless it leads to improper “control” or “manipulation” of the subsidiary corporation. Without such manipulation or control, the nexus between the actions of one entity and another required to establish liability is lacking. Accordingly, adherence to corporate formalities is only one element in the analysis.

## 2. Adequate capitalization

A factor that is perhaps more important is whether the corporation has been adequately capitalized. Here too, however, there are appropriately stringent requirements for establishing the sort of inadequate capitalization that may support piercing the veil of limited liability. “Inadequate capitalization means capitalization very small in relation to the nature of the business of the corporation and the risks attendant to such businesses.”<sup>31</sup> To fall below the requisite threshold, the capital “placed in the subordinate” must be “illusory or trifling compared with the business to be done and the risks of loss.”<sup>32</sup>

Moreover, generally one must look to the capitalization of the corporation when it is formed—not during subsequent periods of operation. “A corporation that was adequately capitalized when formed, but which subsequently suffers financial reverses is not undercapitalized.”<sup>33</sup> Accordingly, “undercapitalization, when considered at all, is evaluated with emphasis on the time of

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for piercing in corporations generally and does not seem to have a direct effect on a large percentage of piercing cases.”)

31. *Community Care Centers, Inc. v. Hamilton*, 774 N.E.2d 559, 565 (Ind. Ct. App. 2002) (quoting FLETCHER, *supra* note 5, § 41.33).

32. FLETCHER, *supra* note 5, § 41.33; *see also* *Automotriz Del Golfo De California S.A. de C.V. v. Resnick*, 306 P.2d 1, 4 (Cal. 1957) (explaining that “undercapitalized” means that the amount of capital is “illusory or trifling compared with the business to be done and the risks of loss” (quoting BALLANTINE ON CORPORATIONS 302–03 (rev. ed. 1976))).

33. *Hamilton*, 774 N.E.2d at 565 (quoting FLETCHER, *supra* note 5, § 41.33). While some courts have looked at “siphoning” of funds from one corporate entity to another as one factor in determining whether the veil should be pierced, most courts recognize that such transfers may be perfectly normal:

Alter ego status cannot be inferred whenever a shareholder withdraws some monies from a corporation without formally declaring a dividend or executing a note even if one of the withdrawals is made while the corporation is insolvent. If it did, every payment to a stockholder during insolvency would justify piercing the corporate veil. *Kaplan v. First Options of Chicago*, 19 F.3d 1503, 1522 (3d Cir. 1994).

incorporation rather than thereafter.”<sup>34</sup> In fact, some courts have held that “[t]he filing of articles of incorporation by the secretary of state may be conclusive proof that the incorporators satisfied all conditions precedent to incorporation, including adequate capitalization.”<sup>35</sup>

While courts do not always clearly articulate the standards for assessing the adequacy of capitalization, in the bankruptcy context courts have developed standards for assessing the solvency of corporations entering the bankruptcy system that provide useful guidance. “Foremost among the standards” for determining whether a corporation is “undercapitalized” under this line of authority is “the opinion of a skilled financial analyst” regarding whether the corporation’s capital was “insufficient to support a business of the size and nature . . . in light of the circumstances existing at the time the [company] was capitalized.”<sup>36</sup>

Courts applying these guidelines have made clear that it is improper to judge undercapitalization using hindsight.<sup>37</sup> As these courts recognize, “[t]esting [undercapitalization] by hindsight will . . . turn up too many false positive results of undercapitalization.”<sup>38</sup> This is because “[o]wners owe no duty to recapitalize a failing firm, and courts should not introduce one through the back door by retrospectively finding undercapitalization by proof of ‘eventual failure.’”<sup>39</sup> If such retroactive analysis is applied in judging the adequacy of capitalization, then “every firm that slips into insolvency can be termed undercapitalized.”<sup>40</sup>

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34. *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 416 (7th Cir. 1988) (citing *Consumer’s Co-op of Walworth County v. Olsen*, 419 N.W.2d 211, 218–19 (Wis. 1988); *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976)); *see also In re Hillsborough Holdings Corp.*, 176 B.R. 223, 234 (M.D. Fla. 1994) (“[I]nadequate capitalization refers to the amount of capital provided to a subsidiary upon its formation.” (citing *In re Multiponics, Inc.*, 622 F.2d 709 (5th Cir. 1980))); FLETCHER, *supra* note 5, § 41.33 (“The adequacy of capital is to be measured as of the time of formation of the corporation. A corporation that was adequately capitalized when formed, but which subsequently suffers financial reverses is not undercapitalized.”).

35. FLETCHER, *supra* note 5, § 41.33 (citing *Wilkerson v. Wegner*, 793 P.2d 983 (Wash. Ct. App. 1990)).

36. *In re Mobile Steel Co.*, 563 F.2d 692, 703 (5th Cir. 1977); *see also In re Lifschultz Fast Freight*, 132 F.3d 339, 351 (7th Cir. 1997) (quoting *In re Mobile Steel*, 563 F.2d at 703).

37. *See, e.g., In re Lifschultz*, 132 F.3d at 351–52; *Secon Serv.*, 855 F.2d at 416; *In re Mobile Steel*, 563 F.2d at 703.

38. *In re Lifschultz*, 132 F.3d at 352.

39. *Id.* (quoting *In re Mobile Steel*, 563 F.2d at 703).

40. *Id.* at 351–52.

Even where this factor applies, again, it is generally deemed insufficient by itself to establish alter ego liability.<sup>41</sup> As the Seventh Circuit recently observed: “[W]e are unaware of any decision relying on undercapitalization alone as grounds for disregarding the corporate entity in a contract case . . . . A requirement to provide continuing capitalization, as [plaintiff] urges, probably would injure noncontrolling creditors rather than helping them, by precipitating unnecessary forced sales.”<sup>42</sup>

Courts impose these stringent standards to avoid transforming veil piercing into a mechanism for holding a parent liable whenever the funds of its subsidiary are insufficient to pay a potential judgment.<sup>43</sup> “[T]he mere fact that an entity may or may not have the capital to respond to a potential large award against it does not justify piercing the corporate veil.”<sup>44</sup> Rather, undercapitalization is relevant only when it demonstrates that the corporate form is merely a sham. In a company that was adequately capitalized from the outset, subsequent losses that lead to a lack of adequate capital provide no such evidence.

### *3. Intercompany transactions and commingling of assets*

Another factor courts frequently invoke in conducting a veil piercing analysis is whether there were inappropriate transactions among corporate entities. These intercompany transactions may be cited as evidence of “domination and control” or as a means for siphoning off funds from one corporate entity to another. Nonetheless, courts have been hesitant to place emphasis on this factor in determining whether to impose alter ego liability. As a number of courts have observed, “[t]ransactions between corporations are legitimate and commonplace, and, when between one company and another with a significant or even controlling

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41. See LoPucki, *supra* note 3, at 23 (lamenting the fact that “the strategist nearly always can prevail by undercapitalizing the company and making sure no other factors favoring disregard [of the corporate form] are present”).

42. *Secor Serv. Sys.*, 855 F.2d at 416; see also Bainbridge, *supra* note 2, at 521 (noting “courts’ well-nigh universal refusal to treat undercapitalization, standing alone, as dispositive” when determining whether to pierce the corporate veil).

43. *In re Silicone Gel Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1128, 1138 (N.D. Ala. 1993); see also *Hillsborough Holdings Corp. v. Celotex Corp.*, 166 B.R. 461, 475 (Bankr. M.D. Fla. 1994).

44. *Oriental Commercial and Shipping Co. v. Rosseel, N.V.*, 702 F. Supp. 1005, 1020 (S.D.N.Y. 1988).

stock ownership in the former, do not necessarily suggest improper domination or a failure of the parties to respect their separate corporate identities.”<sup>45</sup>

Indeed, far from suggesting any domination or control of a corporate subsidiary, intercompany transactions may establish the independence of corporate entities. Courts have held, for example, that “[t]he fact that [a parent corporation] requires the subsidiaries to pay a fee” for services actually “supports [the parent’s] argument that it is *not* the alter ego of any of its subsidiaries.”<sup>46</sup> Were corporate formalities ignored, such arms-length transactions would not exist.

In contrast, commingling of assets may present a risk of an inappropriate alter ego relationship.<sup>47</sup> Where a corporation commingles its assets with those of shareholders, courts are more likely to find that the corporation is not separate and distinct from its shareholders. Such commingling is distinct from typical corporate transactions—such as where a parent gives its subsidiary financing to conduct its business operations.<sup>48</sup>

#### *4. Overlap in officers and directors*

Litigants also occasionally point to an overlap in the leadership of corporate entities as evidence in support of piercing the corporate veil. However, as the Supreme Court has made clear, overlap in directors or officers among affiliated corporate entities is not unusual, and is generally held to be insufficient to establish alter ego liability alone:

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45. *In re Silicone Gel Breast Implants*, 837 F. Supp. at 1134.

46. *Joiner v. Ryder Sys. Inc.*, 966 F. Supp. 1478, 1486 (C.D. Ill. 1996) (emphasis added); *see also In re Silicone Gel Breast Implants*, 837 F. Supp. at 1135 (“[A]rrangements— involving the payment of consideration for services rendered—during the formative years of a subsidiary’s existence do not suggest a degree of involvement by the parent that supports a claim for piercing the corporate veil many years later.”); *Connors v. Peles*, 724 F. Supp. 1538, 1568 (W.D. Pa. 1989) (no alter ego liability where “management fees were paid by [subsidiaries] for services rendered”).

47. FLETCHER, *supra* note 5, § 41.50, at 246–47 (“Evidence that shareholders used corporate funds for personal purposes, mixed corporate and personal accounts, or commingled assets so that the ownership interests were indistinguishable will be weighed, along with other factors, when a disregard of corporate separateness is urged.”).

48. *Id.* at 249 (“In the parent/subsidiary context, a court will not pierce the corporate veil merely because the parent and subsidiary issued consolidated financial statements, or because the parent provided financing to the subsidiary.”).

[I]t is entirely appropriate for directors of a parent corporation to serve as directors of its subsidiary, and that fact alone may not serve to expose the parent corporation to liability for its subsidiary's acts . . . . This recognition that the corporate personalities remain distinct has its corollary in the "well established principle [of corporate law] that directors and officers holding positions with a parent and its subsidiary can and do 'change hats' to represent the two corporations separately, despite their common ownership."<sup>49</sup>

Thus, "[w]hile stock control and common directors and officers are generally prerequisites" for imposing alter ego liability, "they are not sufficient by themselves to bring the rule into operation."<sup>50</sup> Indeed, "[p]arents and subsidiaries frequently have overlapping boards of directors while maintaining separate business operations."<sup>51</sup> In practice, therefore, this factor is not particularly useful, and certainly not dispositive, in determining whether the corporate veil should be pierced or alter ego liability imposed.

##### 5. *Miscellaneous factors*

Finally, there are a number of miscellaneous factors that courts sometimes consider in assessing veil piercing claims, most of which are generally deemed to be of limited relevance. One such factor is the filing of consolidated financial statements or tax returns. However, courts have held that a parent corporation's "decision to include [its subsidiary] in its consolidated tax return hardly demonstrates domination" and is insufficient to establish even a "prima facie" case to pierce the corporate veil.<sup>52</sup> Similarly, courts "do not consider the fact of consolidated financial reports to be a sufficient basis to impose liability under the alter ego doctrine."<sup>53</sup> As

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49. *United States v. Bestfoods*, 524 U.S. 51, 69 (1998) (quoting *Lusk v. Foxmeyer Health Corp.*, 129 F.3d 773, 779 (5th Cir. 1997) and *Am. Protein Corp. v. AB Volvo*, 844 F.2d 56, 57 (2d Cir. 1988)).

50. *Steven v. Roscoe Turner Aeronautical*, 324 F.2d 157, 161 (7th Cir. 1963); *see also Akzona, Inc. v. E.I. Du Pont de Nemours & Co.*, 607 F. Supp. 227, 237 (D. Del. 1984) (holding that overlapping directors was insufficient to pierce veil); *Scott-Douglas Corp. v. Greyhound Corp.*, 304 A.2d 309, 314 (Del. Super. Ct. 1973) (same).

51. *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1460 (2d Cir. 1995); *see also Calvert v. Huckins*, 875 F. Supp. 674, 678 (E.D. Cal. 1995) ("Courts have repeatedly held that [factors such as some interlocking directors and officers] do not justify piercing the corporate veil.").

52. *AT&T Co. v. Compagnie Bruxelles Lambert*, 94 F.3d 586, 591 (9th Cir. 1996).

53. *Lowell Staats Min. Co. v. Pioneer Uravan, Inc.*, 878 F.2d 1259, 1264 (10th Cir. 1989).

with overlapping directors and corporate officers, “consolidating the activities of a subsidiary into the parent’s annual reports is a common business practice. It is allowed by both the Internal Revenue Service and the Securities and Exchange Commission, and it is recommended by generally accepted accounting principles.”<sup>54</sup>

Another factor that courts sometimes consider is the operation of multiple corporate entities from a centralized location. While plaintiffs sometimes point to the fact that affiliated companies have the same corporate headquarters as evidence of “domination and control,” a number of courts have likewise noted that “[t]he separate corporate entities of two corporations may not be disregarded merely because one owns the stock of another or because the two share common directors or occupy the same office space.”<sup>55</sup> The physical location of the two entities is simply not particularly dispositive of whether they are alter egos. Moreover, there are many perfectly legitimate reasons two corporate entities may share a single physical location.

#### *B. Fraud and Misuse of the Corporate Form*

Not only must plaintiffs demonstrate “domination and control” in order to pierce the corporate veil or establish alter ego liability, but typically they also bear the burden of demonstrating that there was “misuse of the corporate form constituting fraud or promoting injustice.”<sup>56</sup> Domination or control of a subsidiary by a corporate

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54. *Calvert*, 875 F. Supp. at 678–79; *see also* *Dalton v. R & W Marine, Inc.*, 897 F.2d 1359, 1363 (5th Cir. 1990) (holding no alter ego liability even though parent remained responsible for general policy, received money from subsidiaries that was funneled into centralized bank accounts, filed a consolidated tax return, and offered benefit plans to its subsidiaries’ employees); *O’Berry v. McDermott, Inc.*, 712 S.W.2d 206, 207 (Tex. App. 1986) (holding that overlapping directors and officers, filing consolidated tax returns, maintaining employee benefits for subsidiary, capitalizing and financing the subsidiary, making decisions for subsidiary, and being regarded by the public as one business unit was insufficient to establish alter ego relationship).

55. *Hornsby v. Hornsby’s Stores, Inc.*, 734 F. Supp. 302, 308 (N.D. Ill. 1990) (quoting *Sumner Realty Co. v. Willcott*, 499 N.E.2d 554, 557 (Ill. App. Ct. 1986)); *see also* *13-D Elec. Co., Inc. v. Barnett Constr. Co.*, 706 S.W.2d 135, 140 (Tex. App. 1986) (“Evidence that [two corporations] officed in the same building does not invoke the ‘alter ego’ theory.”).

56. *Aronson v. Price*, 644 N.E.2d 864, 867 (Ind. 1995); *see also* *FLETCHER*, *supra* note 5, § 43, at 296 (“[A]lthough corporations are related, there can be no piercing of the veil without a showing of improper conduct.”); *id.* § 41.32 (“Some courts have required intentional misconduct, while others reiterate the more general requirement that there must be

parent is not sufficient. In order to pierce the corporate veil there must be “evidence of fraud or misrepresentation.”<sup>57</sup>

The test in this regard is also particularly stringent. Only a specific kind of fraud or misrepresentation is sufficient to establish liability.

[T]he act of one corporation is not regarded as the act of another merely because the first corporation is a subsidiary of the other, or because the two may be treated as part of a single economic enterprise for some other purpose. Rather, to pierce the corporate veil based on an agency or “alter ego” theory, “the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.”<sup>58</sup>

A corporation is not a “sham” or “vehicle for fraud” if it “engaged in substantial business operations.”<sup>59</sup> In all but the most egregious cases this requirement will not be met.

In particular, it is well established that “[t]he underlying cause of action does not supply the necessary fraud or injustice. To hold otherwise would render the fraud or injustice element meaningless, and would sanction bootstrapping.”<sup>60</sup> Quite simply, “[t]he ‘injustice’ must be more than the breach of contract alleged in the complaint.”<sup>61</sup> Likewise, “[m]ere use of the corporate form to avoid liability is insufficient to warrant piercing the veil.”<sup>62</sup> There must be

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some form of deception, injustice, defeat of public policy, or fraudulent, improper or criminal purpose.”).

57. *Extra Energy Coal Co. v. Diamond Energy and Res., Inc.*, 467 N.E.2d 439, 442 (Ind. Ct. App. 1984); *see also* *Resolution Trust Corp. v. Latham & Watkins*, 909 F. Supp. 923, 927, 930–31 (S.D.N.Y. 1995) (“Absent proof of intentionally fraudulent conduct, courts simply do not pierce the corporate veil . . . .”); *Mobil Oil Corp. v. Linear Films*, 718 F. Supp. 260, 268 (D. Del. 1989).

58. *In re Sunstates Corp. S’holder Litig.*, 788 A.2d 530, 534 (Del. Ch. 2001) (quoting *Wallace v. Wood*, 752 A.2d 1175, 1184 (Del. Ch. 1999)); *see also* *Kaplin v. First Options of Chicago, Inc.*, 19 F.3d 1503 (3d Cir. 1994) (same).

59. *Sunstates Corp.*, 788 A.2d at 534.

60. *See, e.g., Mobil Oil Corp.*, 718 F. Supp. at 268; *see also* FLETCHER, *supra* note 5, § 41.32, at 200–02 (“A fraud or injustice which relates to ancillary activity is generally not a sufficient basis for piercing the corporate veil.”).

61. *Outokumpu Eng’g Enters. v. Kvaerner EnviroPower*, 685 A.2d 724, 729 (Del. Super. Ct. 1996).

62. *Itel Containers Intern. Corp. v. Atlanttrafik Exp. Serv. Ltd.*, 909 F.2d 698, 704 (2d Cir. 1990), *rev’d on other grounds*, 982 F.2d 765 (2d Cir. 1992); *see also* *Radeszewski v. Telecom Corp.*, 981 F.2d 305, 311 (8th Cir. 1992) (“The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke.”); *Zubik v. Zubik*, 384 F.2d 267, 273 (3d Cir. 1967) (“Limiting one’s personal liability is a traditional

evidence that the *misuse of the corporate form* perpetrated a fraud on the plaintiffs.<sup>63</sup>

The requirement that the alleged misuse of the corporate form constitute a fraud or misrepresentation is particularly difficult to meet in contract cases. As the Seventh Circuit observed in *Secon Service Systems*, courts generally require “more than control to pierce the corporate veil for the benefit of contract creditors.”<sup>64</sup> The reason for this is simple: “[U]nless the corporation engaged in some practice that might have misled its contract creditors into thinking they were dealing with another entity, there simply is no need to ‘protect’ them.”<sup>65</sup> This is because, “[u]nlike tort claimants, they chose to deal with the corporation; to allow them access to shareholders or parent corporations when the deal goes sour is to give them more than the benefit of their bargain.”<sup>66</sup>

Even in cases that do not involve contract claims, plaintiffs seeking to pierce the corporate veil face a high burden. At a minimum, they must establish that the defendant’s conduct was somehow intentionally “wrongful”—i.e., that defendants committed some act “akin to fraud or deception.”<sup>67</sup> Thus, parties seeking to establish liability must show that the “parent is employing the subsidiary to perpetrate a fraud or commit wrongdoing”; “[m]erely showing control” is “insufficient to overcome th[e] presumption” that corporate entities are separate.<sup>68</sup>

These requirements are imposed for good reason. They ensure that the economic and legal benefits of limited liability will be preserved and will only be breached where there has been some abuse of the corporate form in a way that is not economically

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reason for a corporation.”); *Oriental Commercial and Shipping Co. v. Rosseel, N.V.*, 702 F. Supp. 1005, 1020 (S.D.N.Y. 1988) (“[T]he mere fact that an entity may or may not have the capital to respond to a potential large award against it does not justify piercing the corporate veil.”).

63. *See, e.g., Mobil Oil Corp.*, 718 F. Supp. at 269 (“The law requires that fraud or injustice be found in the defendants’ use of the corporate form.”); *Resolution Trust Corp. v. Latham & Watkins*, 909 F. Supp. 923, 927, 930–31 (S.D.N.Y. 1995) (noting that courts generally “pierce the corporate veil only upon ‘proof of deliberate misuse of the corporate form—tantamount to fraud’”).

64. *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 415 (7th Cir. 1988).

65. *Id.* at 415–16.

66. *Id.* at 416.

67. *Hystro Prods., Inc. v. MNP Corp.*, 18 F.3d 1384, 1390 (7th Cir. 1994).

68. FLETCHER, *supra* note 5, § 43, at 289–92.

beneficial. In sum, the corporate veil may not be pierced based on “the mere prospect of an unsatisfied judgment.”<sup>69</sup> If it could, the limited liability of the corporate form would be rendered meaningless.

### *C. Causation*

Finally, in addition to complete domination and control and the use of the corporate form to commit fraud or some similar wrong, courts generally require that the fraud or wrong result in an actual injury to the plaintiff.<sup>70</sup> For example, when misuse of the corporate form leads to undercapitalization and leaves plaintiffs without an adequate monetary remedy, there may be grounds for piercing the corporate veil.<sup>71</sup> It is not enough that there was fraud or misuse of the corporate form; fraud or misuse must lead to a tangible injury to the plaintiffs.<sup>72</sup> Thus, as in other areas of the law, there is a strong causation requirement. The law will not provide a remedy where there has been no injury.

## II. CRITICISMS OF THE VEIL PIERCING DOCTRINES

These requirements for piercing the corporate veil have been criticized on all sides. Some commentators have argued that the requirements for veil piercing are too stringent and that it is unjust

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69. *Hystro Prods.*, 18 F.3d at 1390.

70. *See, e.g.*, *W. Passalacqua Builders v. Resnick Developers South, Inc.*, 933 F.2d 131, 138 (2d Cir. 1991); *Morris v. Dep't of Taxation & Fin.*, 623 N.E.2d 1157, 1160–61 (N.Y. App. 1993) (holding that plaintiffs must show that “(1) the owner[] exercised complete domination of the corporation in respect to the transaction attacked[] and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury”); *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983, 987 (Del. Ch. 1987).

71. *See, e.g.*, *Zubik v. Zubik*, 384 F.2d 267, 273 (3d Cir. 1967) (citing L.S. Tellier, Annotation, *Inadequate Capitalization as Factor in Disregard of Corporate Entity*, 63 A.L.R. 2d 1051 (1959)).

72. *See, e.g.*, *Radaszewski v. Telecom Corp.*, 981 F.2d 305, 306 (8th Cir. 1992) (noting that there is no liability without harm); *Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1985) (“If the corporation responsible for the plaintiffs’ injury is capable of paying a judgment upon proof of liability, then no reason would exist to attempt to pierce the corporate veil and have shareholders pay for the injury.”); *see also Arch v. American Tobacco Co.*, 984 F. Supp. 830, 840 (E.D. Pa. 1997) (“Courts do not pierce the corporate veil unless the ‘corporation is so undercapitalized that it is unable to meet debts that may reasonably be expected to arise in the normal course of business.’” (quoting *Laborers Clean-Up Contract Admin. Trust Fund v. Uriarte Clean-Up Serv., Inc.*, 736 F.2d 516, 525 (9th Cir. 1984))).

to shield assets from potential claimants where a related enterprise may have received the benefits of the activity conducted by another enterprise.<sup>73</sup> Others have argued that the veil piercing doctrines are harmful to economic progress and should be abandoned altogether.<sup>74</sup>

*A. Enterprise Liability and Other Doctrines Seeking to Erode the Requirements for Piercing the Corporate Veil*

The detractors of limited liability often argue that it allows corporations to externalize the costs of their risky activities to innocent third parties.<sup>75</sup> A variety of academic commentators have advocated revising or even entirely abandoning the doctrine of limited liability. Proponents of such views often espouse some version of “enterprise liability” to replace the traditional requirements for piercing the corporate veil. Enterprise liability focuses upon the control element that is traditionally part of the veil piercing analysis.<sup>76</sup> However, it eliminates or severely weakens the other requirements—i.e., that there be some fraud or misuse of the corporate form that actually causes an injury to the plaintiffs. Moreover, it seeks to erode the traditional “control” requirement itself. In the place of the “extraordinary” level of control that is required under traditional veil piercing analysis, some commentators hope to substitute the ordinary control that a parent corporation typically exercises over its subsidiary.<sup>77</sup> In the place of limited

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73. See, e.g., PHILIP I. BLUMBERG ET AL., *BLUMBERG ON CORPORATE GROUPS* (2005) [hereinafter *BLUMBERG ON CORPORATE GROUPS*]; Hansmann & Kraakman, *supra* note 3.

74. See, e.g., Bainbridge, *supra* note 2, at 534–35.

75. *Id.* at 494 (“A number of commentators have complained that limited liability permits investors to externalize the risks of modern industrial enterprise.”). The proponents of limited liability recognize this phenomenon, but have argued that “[t]he implications of this point . . . are unclear, both because modifying limited liability has its costs and because moral hazard would exist without limited liability.”); Easterbrook & Fischel, *supra* note 2, at 104. Moreover, they note that “there is no externality with respect to voluntary creditors.” *Id.* (citing Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 503 (1976)).

76. See 1 *BLUMBERG ON CORPORATE GROUPS*, *supra* note 73, § 10.03[E], at 10–11 (stating that these doctrines “focus[] . . . on the common business, control, and extensive integration of operations and management of the enterprise”); Phillip I. Blumberg, *Control and the Partly Owned Corporation: A Preliminary Inquiry Into Shared Control*, 10 FLA. J. INT’L L. 419, 424 (1996) (“Control plays a crucial role in the application of enterprise principles wherever they have been adopted in U.S. law.”).

77. See Blumberg, *supra* note 76, at 426, 460.

liability, some advocate enterprise liability as a form of strict liability that may be asserted against parent corporations for the actions of their subsidiaries.

Other commentators have gone even further, openly advocating for the complete elimination of limited liability or at least the elimination of limited liability with respect to tort creditors.<sup>78</sup> The rationale for such reforms is that limited liability allows shareholders to externalize the risks of their activities and shoulders innocent creditors with the burden. They contend, for example, that “[p]ermitting an enterprise to avoid the full costs of its activities creates incentives for excessive risk-taking.”<sup>79</sup> They further argue that “limited liability in tort permits the firm’s owners to determine unilaterally how much of their property will be exposed to potential tort claims, thereby inviting opportunism and inefficiency.”<sup>80</sup> In addition, some argue that shareholders may be superior risk-bearers given that they are able to diversify against firm-specific risks.<sup>81</sup>

### *B. Calls for Abolition of the Veil Piercing Doctrine*

At the same time that many academics have argued for an expansion of corporate liability, other commentators have urged retention of the traditional standards or even abolition of the veil piercing doctrine in its entirety.<sup>82</sup> One of the primary rationales for retention of the traditional stringent standards for piercing the corporate veil is the significant economic benefits associated with limited liability.<sup>83</sup> Commentators have hailed limited liability as a

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78. See, e.g., Hansmann & Kraakman, *supra* note 3, at 1880; see also David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1605 (1991) (observing that “the case for limited liability with respect to tort victims is far more tenuous” than for contract creditors).

79. Thompson, *supra* note 20, at 14.

80. Hansmann & Kraakman, *supra* note 3, at 1880, 1920.

81. Thompson, *supra* note 20, at 17 (“A dominant argument for extending liability to shareholders rests on the superior risk-bearing ability of dispersed shareholders of public corporations.”).

82. See, e.g., Easterbrook & Fischel, *supra* note 2, at 90–98; Presser, *supra* note 1, at 407 (“It is, or at least once was and ought again to be, hornbook law that a shareholder or a parent corporation should not lose the protection of limited liability unless that shareholder or parent has somehow ‘abused’ the corporate form.”).

83. Professor Bainbridge has argued that even with respect to tort creditors who may have a stronger argument in favor of relaxation of the traditional standards, limited liability “can be justified on grounds that it increases the size of the pie out of which the tort creditors’

significant source of economic growth in the United States as well as an important means by which ordinary citizens may have a chance to move up in the social ladder by starting small businesses unhampered by the significant threats and uncertainties associated with unlimited liability.<sup>84</sup> Moreover, these commentators note that limited liability “is not unique to corporations” but is a general principle of law that spans across many different contexts: investors’ risk is typically limited to the amount of their investment, regardless of whether the corporate form is involved.<sup>85</sup> Finally, they cite a number of less obvious economic benefits of limited liability such as encouraging diversification of equity ownership, ensuring that positive net value projects will not be rejected as “too risky,” and reducing monitoring costs.<sup>86</sup>

In response to the critics of limited liability, these commentators argue that the long-recognized benefits of limited liability exceed any alleged costs. In particular, they observe that there is no externality with respect to contract creditors who voluntarily contract with the corporation. They also note that “[f]or all the academic controversy, the evidence is hardly overwhelming that limited liability causes a significant increase in a corporation’s willingness to engage in risky behavior.”<sup>87</sup> The judiciary seems to share their view, as academic attacks on limited liability have gained little traction in the courts.<sup>88</sup>

Most of these commentators, however, do not favor abandoning the traditional exceptions to limited liability under the veil piercing doctrines. They recognize that “the exceptions serve valuable

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claims may be satisfied by encouraging equity investment in corporations.” Bainbridge, *supra* note 2, at 497.

84. See *supra* note 2.

85. Easterbrook & Fischel, *supra* note 2, at 90.

86. See generally *id.* at 93–98.

87. Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 421 (1992); see also Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77, 96 (arguing that “there is no reason to believe that veil piercing causes equity claimants to internalize the risks associated with their business’ operations” and that because of its vagueness, “[i]t seems unlikely that veil piercing even inadvertently addresses concerns over negative externalities”); Presser, *supra* note 1, at 410 (arguing that it is “far from clear” that “by externalizing the costs of tortious behavior through limited liability, we will encourage corporations to engage in more hazardous behavior”); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 439 (1992) (arguing that “the potential for externalities may be less than has been supposed”).

88. See Bainbridge, *supra* note 87, at 95.

functions” as well.<sup>89</sup> However, they argue that the traditionally stringent requirements for piercing the corporate veil are necessary to ensure the preservation of limited liability as the general rule and shareholder liability as the exception. Courts have tailored traditional standards to hold shareholders liable only where they are directly responsible for some wrongdoing or the corporate form is used as a sham to perpetrate a fraud.

Nonetheless, other commentators go even further, arguing that limited liability should be strengthened by abolishing the veil piercing doctrines. They reason that “[t]he standards by which veil piercing is effected are vague, leaving judges great discretion.”<sup>90</sup> As a result, they argue that there is “uncertainty and lack of predictability, increasing transaction costs for small businesses,” and that there is “no evidence that veil piercing has been rigorously applied to effect socially beneficial policy outcomes.”<sup>91</sup> As these commentators observe, this vagueness and uncertainty “imposes substantial costs” because “litigation risks cannot be confidently predicted.”<sup>92</sup> As a result, “parties can be deterred from engaging in socially desirable activities or, at the least, will take excessive [and costly] precautions.”<sup>93</sup>

In place of the veil piercing theories, critics would substitute direct liability for shareholders who actively engage in wrongdoing.<sup>94</sup> Thus, shareholders would be ensured that they will not be subjected to liability unless they personally engage in some form of unlawful conduct. This approach dispenses entirely with the laundry list of factors typically employed in determining whether the corporate veil should be pierced and substitutes a form of direct liability for the indirect liability that occurs where the corporate veil has been pierced.

While the veil piercing doctrines may not be the model of clarity and are often based on haphazard lists of factors that courts must

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89. Easterbrook & Fischel, *supra* note 2, at 89.

90. Bainbridge, *supra* note 2, at 481.

91. *Id.*; *cf.* Easterbrook & Fischel, *supra* note 2, at 109 (“The arbitrariness of the[] nominal tests [for piercing the corporate veil] casts further doubt on the utility of the doctrine.”).

92. Bainbridge, *supra* note 2, at 514.

93. *Id.*

94. *See id.* at 481–82.

consider in determining whether to breach the corporate form,<sup>95</sup> there are some standards that emerge from the cases that may be used to enable more principled decision making. For example, as noted above, the factors that courts enumerate may in reality form categories of evidence demonstrating a handful of more fundamental elements. The courts generally require a high level of control by shareholders over the corporation whose veil is to be pierced as well as an element of fraud in the misuse of the corporate form that causes plaintiffs some tangible injury. While these more fundamental elements are not always applied in a principled manner, courts may rigorously apply the veil piercing doctrines if they adhere to these categories and requirements.

Likewise, there are certain instances in which the veil piercing doctrines are more commonly utilized. Many commentators have noted that courts pierce the corporate veil more frequently in cases involving closely held corporations as opposed to large, publicly owned corporate entities.<sup>96</sup> In such situations, the degree of direct shareholder control is likely to be greater and the potential for utilizing the corporate entity as a “sham” is increased.

Similarly, commentators have theorized that veil piercing may be more common in the context of tort creditors, compared with contract creditors. Unlike contract creditors, tort creditors do not make a conscious decision to enter into a relationship with the subject corporation.<sup>97</sup> While commentators have raised questions

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95. See Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140, 162 (1994) (“The law has never been very clear about what is the standard for piercing the corporate veil.”).

96. Easterbrook & Fischel, *supra* note 2, at 109 (“Almost every case in which a court has allowed creditors to reach the assets of shareholders has involved a close corporation.”); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1047 (1991); Thompson, *supra* note 20, at 9 (empirical study of 1600 veil piercing cases “found no case in which shareholders in a public corporation were held liable”); *cf.* Bainbridge, *supra* note 2, at 503 (observing that “the tort creditor of the close corporation” is “the hardest case in which to justify limited liability” because “the shareholders of a close corporation frequently are actively engaged in the business on a full-time basis”). *But see* Leebron, *supra* note 78, at 1649 (arguing that “the case for limited liability of closely held corporations has been understated”).

97. See FLETCHER, *supra* note 5, § 41.85 (“[C]ourts are more likely to disregard the corporate entity in tort cases than in cases of contract because the injured party in contract cases had the opportunity to select the entity with whom he or she contracted; in a tort case, no such selection is made by a plaintiff.”); Easterbrook & Fischel, *supra* note 2, at 112 (“Courts are more willing to disregard the corporate veil in tort than in contract cases. The rationale for this distinction follows directly from the economics of moral hazard—where

regarding whether this theory is borne out in practice,<sup>98</sup> it provides another means by which principled line drawing may achieve socially desirable outcomes. Finally, commentators have observed that the veil piercing doctrines are most often applied where the shareholders are active participants in wrongdoing.<sup>99</sup> In such circumstances, the actions of the shareholders contribute to creditors' loss and there is a stronger case for liability. Moreover, the shareholders in closely held corporations are more likely to undertake an active role in the conduct of the corporation, unlike the passive investors typical of most large, publicly held corporations who hold only a small minority interest in the firm and have a smaller stake in its operations.<sup>100</sup>

At bottom, this Article is agnostic with respect to these criticisms. Whether veil piercing has become so haphazard and unprincipled that it serves no useful purpose or whether limited liability inefficiently and improperly shifts costs to unsuspecting creditors, there is one area in which commentators should be able to reach agreement. The benefits of limited liability outweigh any associated risks within certain industries in which the regulatory framework eliminates or mitigates the dangers associated with limited liability. Accordingly, the arguments made by critics of limited liability simply do not apply or are less significant under such circumstances. Similarly, those who wish to eliminate veil piercing doctrines in their entirety will approve this proposal as a welcome first step.

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corporations must pay for the risk faced by creditors as a result of limited liability, they are less likely to engage in activities with social costs that exceed their social benefits.”).

98. Compare Thompson, *supra* note 96, at 1058, 1068 (empirical study finding that the veil was more likely to be pierced in contract cases than in tort cases) with Presser, *supra* note 2, at 167–68 (concluding based on a review of leading cases that “the veil is more likely to be pierced in tort than in contract cases”).

99. See, e.g., Bainbridge, *supra* note 2, at 507 (“Minority shareholders who do not actively participate in the corporation’s business or management are rarely held liable on a veil piercing theory.”); Thompson, *supra* note 1, at 10; Thompson, *supra* note 20, at 9 (observing that empirical study of 1600 veil piercing cases “found . . . no civil case in which individual shareholders identified as passive in corporations of any size were held liable”).

100. In addition to these categories, some commentators have argued for greater veil piercing where the shareholder is a corporation. See Presser, *supra* note 2, at 173 (“There has long been a feeling on the part of some commentators . . . that it ought to be easier to pierce the veil in the context of the parent-subsidary relationship than in that of the individual shareholder and his or her corporation.”).

## III. THE REGULATORY FRAMEWORK

While there has been significant disagreement over the extent to which courts should afford corporations the benefits of limited liability, there may be some areas in which all commentators can agree that it should be preserved. One such area is in the context of regulated industries in which the regulatory framework seeks to prevent the conduct the veil piercing doctrines seek to remedy. While there may be other industries in which such a rule may be appropriate,<sup>101</sup> prime examples may be found in the insurance and banking industries. Insurance regulators in various states have developed a complex regulatory framework aimed at preventing the domination and control and fraudulent use of affiliated corporate entities. This comprehensive framework applies to the same sorts of factors the veil piercing doctrines identify. Likewise, federal regulators seek to ensure that banks are adequately capitalized and that where they function within holding company systems, intercompany transactions do not undermine their financial security. Accordingly, a prohibition on veil piercing where such regulatory frameworks exist may be warranted.

Holding company systems composed of complex interrelationships among affiliated corporate entities are common in the insurance and banking industries and have significant advantages. For example, “[h]olding companies can provide subsidiaries with a level of financial flexibility, including capital infusions, access to capital markets, and in some cases, additional cash flow sources from other operations.”<sup>102</sup> Such systems can also help the company “diversify risks” among different entities engaged in different lines of

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101. Professor Blumberg has observed the following:

Insurance has joined banking, savings and loan, public utilities, and casino gambling as the areas in American federal and state law in which the holding company and the corporate group are major subjects of regulatory concern. These statutes regulate the holding company systems conducting the regulated activities and extend the outer boundaries of statutory obligation to all component companies of the system whether or not the company itself is engaged in the regulated activities. Similarly, the statutes extend the regulatory program to apply statutory provisions regarding disclosure and regulation of transactions with “insiders” to all companies in the system and affiliated companies and interests as well.

Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 311 (1996); see also 3 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, §§ 120.01–120.06, 121.01–121.07, at 120-1 to 120-56 (discussing firewalls between banks and affiliated entities).

102. Preface, 2004 Best’s Insurance Reports—Life/Health, at xiii.

business.<sup>103</sup> In addition, they can allow specialization among different corporate entities within the same system, utilizing subsidiaries dedicated to providing investment management or other corporate services. This division of labor is advantageous for all entities within the holding company system, which benefit from the efficiencies and reduced costs associated with this structure.<sup>104</sup> Finally, holding companies can be advantageous from a tax perspective; by combining losses and gains from different subsidiaries, all companies may benefit through reduction in tax liabilities.<sup>105</sup> Accordingly, there are many advantages associated with holding company systems that make them an ideal structure within the insurance, banking, and other industries.

#### *A. The Insurance Industry*

Regulators in the insurance industry have sought to preserve the significant benefits of holding company systems while regulating the potential hazards associated with intercompany relationships. In the process, they have developed regulatory frameworks on a state-by-state basis founded on model laws that closely track the potential hazards that veil piercing doctrines are designed to remedy. Accordingly, each state has developed detailed regulations for monitoring the interactions among insurance companies that operate within their jurisdiction.

##### *1. Insurance holding company acts*

Within this regulatory framework, each state has a Holding Company Act that imposes certain requirements on the parent of an insurance subsidiary. The National Association of Insurance Commissioners (“NAIC”), an organization comprised of insurance regulators in all fifty states and the District of Columbia that was established to ensure cooperation and coordination among the state regulators,<sup>106</sup> has promulgated a Model Insurance Company System

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103. Robert C. Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 823 (1979).

104. *See id.* at 819.

105. *See id.* at 818.

106. *See generally* 4 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 128.01, at 128-5 (observing that the NAIC “plays a significant role in the coordination of state regulation”); Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 635

Regulatory Act that has been substantially enacted in nearly all states.<sup>107</sup>

Among other things, the statutes require disclosure and approval of changes in control of an insurer as well as material transactions and relationships between the insurer and the insurer's affiliates.<sup>108</sup> They also provide standards governing material transactions between the insurer and the insurer's affiliates.<sup>109</sup> As a result, "[r]egulators have access to the most direct and detailed information on individual insurers through the filings made with the states. These include annual and quarterly statements, MD&A, audited financial statements, and filings made pursuant to the state's Holding Company Act and other regulatory filings."<sup>110</sup> Using these submissions, regulators can easily monitor companies' conduct and police the interactions among corporate entities within a holding company system.

The various state departments of insurance scrutinize insurance subsidiaries' conduct to prevent them from, among other things, entering into transactions or relationships with affiliated companies on terms that are not fair and reasonable or paying dividends to shareholders that jeopardize the financial condition of the insurer. Hence, insurers must file an Insurance Holding Company System Registration Statement with their domestic regulators containing current information regarding their various corporate structures, financial conditions, and relationships among related companies. Such relationships include, among other things, investments, management and service contracts, cost-sharing arrangements,

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(1999) (discussing role of the NAIC in insurance regulation and observing that it "has increasingly assumed a national role, centralizing many basic regulatory functions and operating as a quasi-federal agency by attempting to enforce national standards").

107. See Insurance Holding Company System Regulatory Act, in 3 NAIC, MODEL LAWS REGULATIONS AND GUIDELINES 440-1 to 440-58 (Oct. 2005) [hereinafter MODEL ACT]. For examples of the Model Act as enacted in various states, see CAL. INS. CODE §§ 1215-1215.16 (West 2008); CONN. GEN. STAT. §§ 38a-129 to -140 (2005); DEL. CODE ANN. tit. 18, §§ 5001-15 (1999); 215 ILL. COMP. STAT. ANN. 5/131.1 to .28 (2000); IND. CODE ANN. § 27-1-23-1 to -13 (1999); MASS. GEN. LAWS ch. 175, § 206-206(D) (1998); and TEX. INS. CODE ANN. § 823.001-.503 (Vernon 2007).

108. See MODEL ACT §§ 3, 5, at 440-4 to -9, 440-16 to -20.

109. See *id.* § 5, at 440-16 to -20; see also 4 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 128.09, at 128-28 ("IHCSRA § 5(A)(1) and virtually all the state statutes establish far-reaching standards for transactions within the holding company system.").

110. NAIC, FRAMEWORK FOR INSURANCE HOLDING COMPANY ANALYSIS 24 (March 2002).

reinsurance agreements, and tax allocation agreements.<sup>111</sup> The insurer must amend its registration statement whenever a new affiliated transaction is executed.<sup>112</sup>

In addition, insurance holding company statutes require a domestic insurer that is a member of an insurance holding company system to provide regulators with notice of its intent to complete a “material” transaction with an affiliated entity. Insurers may only complete such transactions if the state department of insurance has not disapproved the transactions within thirty days of receiving notice.<sup>113</sup> “Material” transactions include reinsurance agreements, management agreements, service contracts, cost-sharing agreements, certain kinds of loans, or any other transaction that the regulators determine could impact the insurer’s policyholders.<sup>114</sup> Likewise, an insurer must provide notice to regulators of all dividends paid to another corporate entity within the holding company system and must gain approval for dividends of “extraordinary” magnitude.<sup>115</sup>

States will not approve material transactions with an affiliate and will not allow shareholder dividends unless the transactions or dividends leave the insurer with surplus that is reasonable in relation to its outstanding liabilities. Regulators follow a set of statutorily prescribed factors to determine whether an insurer’s surplus is adequate and reasonable, which include:

The size of the insurer as measured by its assets, capital and surplus, reserves, premium writings, insurance in force and other appropriate criteria . . . . The quality, diversification, and liquidity

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111. MODEL ACT § 4(B), at 440-14 to -15.

112. *Id.* § 4(A)(3), at 440-14.

113. *Id.* § 5(A)(2), at 440-17; *see also* 4 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 128.09, at 128-29 (discussing requirements).

114. MODEL ACT § 5(A), at 440-17 to -18.

115. *Id.* §§ 4(E), 5(B), at 440-15, 440-18 to -19. The Model Act provides in relevant part:

[A]n extraordinary dividend or distribution includes any dividend or distribution of cash or other property, whose fair market value together with that of other dividends or distributions made within the preceding twelve (12) months exceeds the lesser of: (1) Ten percent (10%) of the insurer’s surplus as regards policyholders as of the 31st day of December next preceding; or (2) The net gain from operations of the insurer, if the insurer is a life insurer, or the net income, if the insurer is not a life insurer, not including realized capital gains, for the twelve-month period ending the 31st day of December next preceding, but shall not include pro rata distributions of any class of the insurer’s own securities.

*Id.* § 5(B), at 440-19.

of the insurer's investment portfolio . . . . The recent past and projected future trend in the size of the insurer's investment portfolio . . . . The surplus as regards policyholders maintained by other comparable insurers . . . . The adequacy of the insurer's reserves . . . . [And] [t]he quality and liquidity of investments in affiliates.<sup>116</sup>

Moreover, states specifically scrutinize transactions to ensure that the terms are "fair and reasonable"—i.e., that excessive fees are not charged, and that the transactions are properly accounted for.<sup>117</sup>

Because the states, and not the federal government, have traditionally regulated insurance companies, an insurer engaging in a material transaction with an affiliate must not only satisfy its domestic regulator, but must also meet the approval of the affiliate's domestic regulator. Similarly, different regulatory entities must give their approval before a company's funds may be paid as dividends up through the corporate chain. Accordingly, each transaction may be subject to multiple layers of review, thereby ensuring that corporations within the holding company system are not subject to undue domination or control and that they are not employed as mere "sham" corporate entities. The Holding Company Act authorizes insurance commissioners to conduct periodic examinations to ensure that companies are complying with the regulatory requirements.<sup>118</sup>

The NAIC publishes guidelines to coordinate efforts among authorities responsible for regulating holding company systems that aid regulators in obtaining "a general understanding of the consolidated holding company structure and assess[] current and/or

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116. *Id.* § 5(D), at 440-20.

117. *Id.* § 5, at 440-16. The Model Act contains other optional provisions designed to lessen the dangers of excessive domination and control. For example, the Act provides that:

[n]ot less than one-third of the directors of a domestic insurer, and not less than one-third of the members of each committee of the board of directors of any domestic insurer shall be persons who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with the insurer and who are not beneficial owners of a controlling interest in the voting stock of the insurer or entity.

*Id.* § 5(C)(3), at 440-19; *see also id.* § 5(C)(4) (requiring the establishment of a committee of independent directors that shall be responsible for recommending the selection of independent certified public accountants and reviewing the insurer's financial condition and the results of any independent or internal audits).

118. *Id.* § 6, at 440-21; *see also* 4 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 128.15, at 128-48 to -51 (2005) (discussing examination procedures).

potential risks to the insurance affiliates.”<sup>119</sup> This multi-layer regulatory framework that monitors the relationship between companies functioning within insurance holding company systems “focuse[s] on ‘walling off’ the insurance company from the holding company” through “examinations of insurance companies on a state by state basis.”<sup>120</sup>

## 2. *Regulation of insurance subsidiaries*

Insurance subsidiaries are also subject to direct regulation and supervision by the insurance regulatory agencies of the states in which they transact business. Each state has an insurance company act that imposes certain regulatory requirements on the insurance subsidiary wholly apart from their transactions within a holding company system. State laws establish supervisory agencies with broad regulatory authority, including the power to: (1) grant and revoke business licenses; (2) regulate and supervise trade practices and market conduct; (3) establish guaranty associations; (4) license agents; (5) approve policy forms; (6) approve premium rates for some lines of business; (7) establish reserve requirements; (8) prescribe the form and content of required financial statements and reports; (9) determine the reasonableness and adequacy of statutory capital and surplus; (10) perform financial, market conduct, and other examinations; (11) define acceptable accounting principles; (12) regulate the type and amount of permitted investments; and (13) limit the amount of dividends and surplus debenture payments that can be paid without obtaining regulatory approval. Insurance subsidiaries are subject to periodic examinations by state regulatory authorities pursuant to such provisions.

In particular, the regulators closely monitor the insurance subsidiary’s capitalization. Companies are required to file annual statutory financial statements in the departments of insurance for the states in which they engage in the business of selling and servicing insurance policies. Regulators in each of these jurisdictions use such financial statements along with other information in scrutinizing the financial condition of the insurance subsidiary to ensure that it meets capital, surplus, and reserve requirements on an ongoing basis.

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119. NAIC, *supra* note 110, at 28.

120. *Id.* at 26.

State statutes require companies to file annual financial statements with their domestic regulators.<sup>121</sup> Such financial statements must be independently audited and must include, among other things, the following information: “(1) [t]he report of the insurer’s independent auditor[;] (2) [a] balance sheet reporting admitted assets, liabilities, capital, and surplus[;] (3) [a] statement of operations[;] (4) [a] statement of cash flow[; and] (5) [a] statement of changes in capital and surplus.”<sup>122</sup>

State insurance regulations also require each insurer to prepare and file an actuarial memorandum opining on the adequacy of the company’s reserves.<sup>123</sup> Each memorandum presents a detailed analysis of the assumptions used to project future liabilities, the assumptions used to project future earnings, and whether expected future earnings plus reserves exceed expected liabilities. State regulators scrutinize the actuarial memorandum’s conclusions carefully and sometimes hire outside experts to determine the reasonableness of a memorandum. As an added layer of oversight, state departments of insurance perform periodic market conduct examinations of insurers doing business in their state. As part of these examinations, the regulators often examine, among other things, the propriety of an insurer’s transactions within its holding company system.

On the basis of statutory statements filed with state regulators annually, the NAIC calculates certain financial ratios to assist state regulators in monitoring the financial condition of insurance companies. The NAIC’s risk-based capital (“RBC”) standards establish capital requirements for insurance companies based on the ratio of the company’s total adjusted capital (defined as the total of its statutory capital, surplus, asset valuation reserve and certain other adjustments) to its RBC. The standards are designed to help identify companies that are undercapitalized and require specific regulatory actions in the event an insurer’s RBC ratio falls below specified levels.

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121. *See, e.g.*, 215 ILL. COMP. STAT. ANN. 5/136 (2000); IND. CODE ANN. § 27-1-3.5-1 (1999); TEX. INS. CODE ANN. § 802.001 (Vernon 2007).

122. IND. CODE ANN. § 27-1-3.5-7 (1999).

123. *See* 50 ILL. ADMIN. CODE tit. 50, § 1408.10 (2008); 760 IND. ADMIN. CODE § 1-57-1 to -10 (2008); 28 TEX. ADMIN. CODE § 3.1601 (2008).

### *B. The Banking Industry*

The banking industry has a similar regulatory framework that protects against the potential hazards associated with intercompany relationships. While regulation of banks is done primarily on the federal rather than the state level,<sup>124</sup> regulators closely monitor the same risks posed by intercompany transactions to ensure the financial stability of banks and other entities operating within holding company systems.<sup>125</sup>

#### *1. The Bank Holding Company Act*

The Bank Holding Company Act governs holding company systems in the banking industry and imposes certain requirements for entities seeking to operate as bank holding companies. Among the factors considered by the Federal Reserve in determining whether an entity qualifies to function as a bank holding company are the financial strength of the entity and whether it is adequately capitalized.<sup>126</sup> By regulating entry into the industry, the Act provides regulators with powerful tools to ensure that holding company systems are financially sound and to protect against corporate entities that are designed to function as mere sham corporations or to function in a fraudulent manner.

Federal law also imposes regulatory requirements that apply to the operations of the holding company and its subsidiaries. Among other things, the Act imposes restrictions regarding intercompany transactions that are similar to those found in the insurance industry. Within a holding company structure, transactions among corporate entities are subject to significant regulation to ensure that these entities conduct transactions on an arms-length basis.

The Federal Reserve Act likewise provides several safeguards to ensure the financial stability of regulated banking entities. Section 23A of the Act places restrictions on a variety of transactions, including loans, purchases of securities and other assets, and

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124. There are also state regulations that mirror the provisions of the Bank Holding Company Act. *See generally* 3 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, §§ 121.03[C], 123.04[B], 123.05, 123.06-.10, at 123-13 to -42.

125. *See id.* § 121.05, at 121-36 (“The general thrust of bank holding company regulation is to bolster the safety and soundness regulation of the banks they own.”).

126. *See* 12 C.F.R. § 225.14(c) (2007).

accommodations between banks and their affiliates.<sup>127</sup> There is a quantitative restriction on the total amount of transactions among affiliates: they may not exceed twenty percent of bank capital and surplus. Moreover, § 23A prohibits transactions amounting to more than ten percent of capital and surplus with any affiliate.<sup>128</sup> There are also qualitative restrictions to ensure that banks comply with safe and sound banking practices.<sup>129</sup> Likewise, § 23B of the Act requires that bank holding companies complete other transactions on an arm's length basis.<sup>130</sup> These requirements are designed to prevent self-dealing among affiliated entities and to ensure the continued financial stability of regulated entities.

The regulations also impose capital restrictions that are designed to ensure that banks are adequately capitalized.<sup>131</sup> Thus, much like the regulations governing the insurance industry, a key function of the regulations is to ensure that none of the corporate entities in a holding company system are undermined through intercompany transactions. In addition, the regulations specifically provide that holding companies must refrain from any actions that “constitute[] a serious risk to the financial safety, soundness, or stability of a subsidiary bank.”<sup>132</sup> Indeed, the regulations go so far as to suggest that a bank holding company must maintain financial resources to assist its subsidiaries if necessary and “serve as a source of financial and managerial strength to its subsidiary banks.”<sup>133</sup>

As in the insurance industry, regulators have significant powers to undertake reviews to ensure banks meet these regulatory requirements. The Bank Holding Company Act, for example, provides for inspection of records in order to ensure that the regulatory requirements are met.<sup>134</sup>

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127. 12 U.S.C. § 371c (2000).

128. *Id.* § 371c(a)(1)(A)–(B), (b)(8).

129. *See id.* § 371c(a)(4), (b)(10), (c)(1)–(2).

130. *See id.* § 371c-1(a)(1)(A)–(B).

131. 12 C.F.R. § 225 App. A (2007); *see generally* 3 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 121.01, at 121-4 (“[T]he bank holding company regulatory scheme seems to take an entity approach when it requires individual banks to be capitalized in accordance with regulatory guidelines or when it requires banks to be formed and maintained in accordance with special rules designed to respect the integrity of the bank as a separate entity within the holding company structure.”).

132. 12 C.F.R. § 225.4(a)(2) (2007).

133. *Id.* § 225.4(a)(1).

134. 12 U.S.C. § 1844(c) (2000); *see also* 3 BLUMBERG ON CORPORATE GROUPS, *supra* note 73, § 123.13[A], at 123-49 (“The federal statutes . . . provide the federal regulatory

*2. Regulation of banking and other subsidiaries*

Likewise, as in the insurance industry, there are regulations governing the financial subsidiaries of national banks. Under the National Bank Act, the Comptroller of the Currency may regulate the charters for national commercial banks.<sup>135</sup> Among the factors regulators consider in determining whether to grant a charter are the adequacy of the bank's capital structure and its financial history and condition.<sup>136</sup> In determining whether a bank may become a member of the Federal Reserve System, regulators look at similar factors, including the financial history of the bank and the adequacy of its capital structure.<sup>137</sup>

The Gramm-Leach-Bliley Act loosened the restrictions on the activities in which banks or their affiliates may engage, but at the same time provided that a national bank must have reasonable procedures and policies designed to preserve the bank's limited liability by separating the bank from its financial subsidiaries.<sup>138</sup> In addition, the Act requires financial subsidiaries of banks to comply with the restrictions on transactions among corporate entities found in §§ 23A and 23B of the Federal Reserve Act.<sup>139</sup> Finally, the Gramm-Leach-Bliley Act further provides that the Comptroller of the Currency, the Federal Reserve, and the FDIC shall issue "prudential safeguards" to ensure that transactions within the holding company structure are appropriate.<sup>140</sup>

Thus, as in the insurance industry, there are multiple layers of regulation seeking to ensure the independence of corporate entities functioning within a holding company system. While the regulation in the banking industry occurs primarily at the federal level, many of the goals and effects of the regulatory system are the same. As a result, the regulatory framework in the banking industry, as in the

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authorities with broad powers of supervision, and they do so on a pervasive enterprise basis. Under the Bank Holding Company Act, the Fed has the power to require reports and examine bank holding companies and their subsidiaries, bank and nonbank, federally chartered or state chartered.").

135. 12 U.S.C. § 21 (2000).

136. 12 C.F.R. § 5.20(f)(i)(A)–(E) (2007).

137. *See* 12 U.S.C. § 1815 (2000); 12 C.F.R. § 208.5(a)(1) (2007).

138. 12 U.S.C. § 24a (2000).

139. *See* 12 U.S.C. § 371c (2000).

140. 12 U.S.C. § 1828a (2000).

insurance industry, ensures that many of the potential dangers that veil piercing is designed to remedy do not occur.

#### IV. A PROPOSAL FOR SOME MODEST LIMITATIONS ON VEIL PIERCING CLAIMS

Compliance with such regulations, in essence, demonstrates that the requirements that are typically cited in veil piercing cases cannot be met. Accordingly, there is a strong argument that applying the veil piercing doctrines in such regulated industries is simply inappropriate. At a minimum, the regulators' judgment that an entity has complied with these requirements should be entitled to significant judicial deference.<sup>141</sup> "Where an agency is charged with responsibility for regulating a complex industry, it is much better equipped than the courts, 'by specialization, by insight gained through experience, and by more flexible procedure,' to gather the relevant facts that underlie a particular claim involving that industry."<sup>142</sup> Indeed, courts have long recognized that, in general, deference is warranted given such agencies' "expertise in ascertaining, interpreting and distilling the facts and circumstances underlying the legal issues."<sup>143</sup> Moreover, "[w]here . . . a regulatory agency possesses such extensive authority and control over a particular subject matter, and where consideration of the same subject matter is sought before that agency and the courts, the possibility of a judicial-administrative conflict should be avoided."<sup>144</sup>

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141. Courts generally give such regulatory determinations significant deference. *See, e.g.*, *Indus. Commc'ns Sys., Inc. v. Pac. Tel. & Tel. Co.*, 505 F.2d 152, 157-58 (9th Cir. 1974); *Simi Corp. v. Garamendi*, 1 Cal. Rptr. 3d 207, 214 (Cal. Ct. App. 2003) (quoting *Yamaha Corp. of Am. v. State Bd. of Equalization*, 78 Cal. Rptr. 2d 1, 4 (Cal. 1998)) (noting that courts "giv[e] deference to the determination of the agency appropriate to the circumstances of the agency action"); *In re Comm'r's Failure to Adopt 861 CPT Codes*, 817 A.2d 355, 363 (N.J. Super. Ct. App. Div. 2003) ("This court allows substantial deference to the interpretation of the agency charged with enforcing an act. Particularly in the insurance field, the expertise and judgment of the Commissioner may be allowed great weight.") (citations omitted); *Foster v. Mutual Fire, Marine and Inland Ins. Co.*, 614 A.2d 1086, 1093 (Pa. 1992) ("[G]reat deference in favor of the Insurance Commissioner and the resulting narrow scope of review for the courts are in recognition of the expertise of the administrative agency or individual officer assigned the task of regulating a given industry.").

142. *Indus. Commc'ns Sys., Inc.*, 505 F.2d at 157 (citing *Far E. Conference v. United States*, 342 U.S. 570, 575 (1952)).

143. *Id.*

144. *Id.* (citing *Carter v. AT&T Co.*, 365 F.2d 486, 495 (5th Cir. 1966)).

Federalism concerns may also counsel in favor of strong deference where a suit is brought in the federal courts seeking to pierce the veil of a state-regulated entity. The deference accorded state insurance regulators by the federal courts is particularly strong given that “[i]nsurance regulation has long been recognized as an area of traditional state concern.”<sup>145</sup> Thus, federal courts in a variety of contexts have recognized “a strong federal policy of deferring to state regulation of the insurance industry.”<sup>146</sup>

Economic theory suggests that the veil piercing theories are counterproductive in regulated industries such as insurance and banking. In such industries, all of the benefits of limited liability may be realized while at the same time largely dispensing with the associated costs. Because the regulatory framework seeks to prevent the same conduct that veil piercing doctrines were designed to remedy, it provides a ready substitute for mitigating the potential costs of limited liability. Moreover, entities operating in such industries already incur the costs associated with reducing the hazards of intercompany interactions; it makes no sense to incur both the costs of veil piercing and those of the regulatory structure. Because the costs of regulation are already being incurred, it makes sense to eliminate the duplicative set of costs attributable to veil piercing.

The strong arguments in favor of abandoning veil piercing in such regulated industries appear to be borne out in practice where there seems to be a *de facto*, albeit largely unrecognized, prohibition on such claims. Given the heavily regulated nature of the industry and rigid separation imposed upon regulated entities, for example, it is not surprising that courts routinely reject attempts to pierce the corporate veil of entities operating in the insurance industry.<sup>147</sup>

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145. *Gross v. Weingarten*, 217 F.3d 208, 223 (4th Cir. 2000).

146. *Murff v. Prof'l Med. Ins. Co.*, 97 F.3d 289, 293 (8th Cir. 1996) (quoting *Wolfson v. Mutual Benenfit Life Ins. Co.*, 51 F.3d 141, 147 (8th Cir. 1995) (internal quotation marks omitted)).

147. *See, e.g.*, *Nobles v. Rural Cmty. Ins. Servs.*, 303 F. Supp. 2d 1279, 1288 (M.D. Ala. 2004) (holding that there was “no evidence” that parent controlled operations of insurance subsidiary); *Wady v. Provident Life & Accident Ins. Co. of Am.*, 216 F. Supp. 2d 1060 (C.D. Cal. 2002); *Forest v. Equitable Life Assurance Soc’y of the U.S.*, 2001 WL 1338809, at \*9 (N.D. Cal. June 12, 2001) (“The Court concludes that no genuine issues of material fact exist to support the alter ego argument and [the insurance company’s parent] is entitled to judgment as a matter of law.”); *Bejcek v. Allied Life Fin. Corp.*, 131 F. Supp. 2d 1109, 1112 (S.D. Iowa 2001) (rejecting argument that parent was alter ego of insurance company on ground that “[d]efendants’ alter-ego argument is without merit”); *Smith v. S&S Dundalk*

Likewise, veil piercing seems to be exceedingly rare in the banking industry.<sup>148</sup> However, these decisions are utterly devoid of any theoretical analysis regarding the inappropriateness of applying alter ego principles in such regulated industries. Rather, courts typically apply the standard multifactor analysis used in other veil piercing cases. Nonetheless, a more general analysis of these factors dictates that alter ego liability is, at a more fundamental level, inappropriate in such regulated industries. The regulatory environment in which such companies operate undercuts any theory of alter ego liability in several ways.

*A. The Relationship Between Traditional Requirements for Piercing the Corporate Veil and the Regulatory Framework*

The traditional standards for piercing the corporate veil have little application in the heavily regulated insurance and banking industries. Indeed, the regulatory framework of these industries act to assuage traditional veil piercing concerns such as domination and control, capitalization, questionable inter-corporate transactions, and commingling of assets.

*1. Domination and control*

As noted above, veil piercing typically requires “complete domination ‘in respect to the transaction attacked’ so that the [other defendants] had ‘at the time’ no separate will of [their] own.”<sup>149</sup> However, the series of “legal firewalls” between the holding company and its affiliated entities found in the insurance and banking industries, for example, effectively prohibits any improper

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Eng’g Works, Ltd., 139 F. Supp. 2d 610 (D.N.J. 2001) (granting motion to dismiss in favor of insurance company parent); Jemez Agency, Inc. v. CIGNA Corp., 866 F. Supp. 1340 (D.N.M. 1994); Am. Home Ins. Co. v. Travelers Indem. Co., 122 Cal. App. 3d 951 (Cal. Ct. App. 1981).

148. See, e.g., Bentler v. Bank of Am. Nat’l Trust & Savings Ass’n, No. 88-6271, 1989 WL 150139, at \*3 (9th Cir. Dec. 6, 1989); Marshall & Ilsley Corp. v. Heimann, 652 F.2d 685 (7th Cir. 1981); Reinke v. Bank of Am., N.A., No. 4:04-CV-1758, 2005 WL 3454428 (E.D. Mo. Dec. 16, 2005); Guining Li v. Citigroup, Inc., No. 99-C-635-C, 2000 WL 34237511, at \*3 (W.D. Wis. July 26, 2000); Leuthold v. Camp, 273 F. Supp. 695, 702 (D. Mont. 1967); Main Bank of Chi. v. Baker, 427 N.E.2d 94, 101-02 (Ill. 1981); Richardson v. Bank of Am., N.A., 643 S.E.2d 410, 421-22 (N.C. App. Ct. 2007). *But cf. In re Jarax Int’l, Inc.*, 122 B.R. 793 (Bankr. S.D. Fla. 1990) (piercing veil to reach subsidiary of parent bank).

149. Am. Protein Corp. v. AB Volvo, 844 F.2d 56, 60 (2d Cir. 1988) (quoting Lowendahl v. Baltimore & Ohio RR, 287 N.Y.S. 62, 76 (App. Div. 1936)).

domination or control. Because regulators closely monitor transactions among corporations on an ongoing basis, the dangers of inappropriate intercompany interactions are significantly mitigated.

Likewise, an important aspect of this regulatory scheme is a comprehensive system of financial reporting and accounting that is dictated by statute and regulation. The reporting requirements in the insurance industry, for example, include extensive annual statements that disclose all of the company's revenues, expenses, obligations, and assets. These disclosures include a listing of each investment and its risk rating as determined by the NAIC.<sup>150</sup> The regulations ensure that an insurance company is not a mere "shell," as alter ego liability requires, but a distinct corporate entity whose obligations are backed by substantial assets.

Moreover, the regulators in such industries monitor companies to ensure that they observe corporate formalities and that any overlap in corporate board or officers does not lead to any undue influence or control. Thus, the regulatory regime at the same time acknowledges the utility of the holding company structure and puts in place checks and balances to ensure that it is not abused. While the regulators' primary purpose in monitoring such entities may be to protect the interests of policyholders or deposit holders, this regulatory structure has more wide-ranging benefits in preventing fraud or abuse of the corporate form.

## *2. Adequate capitalization*

The regulatory framework likewise seeks to ensure that corporate entities are adequately capitalized. Insurance regulators, for example, using their own conservative benchmarks, set capitalization requirements for insurance companies and then monitor the finances of these companies to assess the adequacy of their capital. Regulators are charged with the responsibility of ensuring the solvency of the subsidiary corporate entities. When there are concerns about a company's finances, regulators may intervene to ensure that the company retains sufficient funds to meet its obligations to policyholders. As a result, the regulatory framework ensures that companies are adequately capitalized, thereby undermining a key component of alter ego liability.

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150. See 215 ILL. COMP. ANN. 5/136 (2000); IND. CODE ANN. § 27-1-3.5-1 (1999); TEX. INS. CODE ANN. § 802.052-.056 (Vernon 2007).

In particular, the regulators monitor transactions that may impact a company's working capital. For example, a company may be required to give notice of ordinary dividends and to receive approval for extraordinary dividends. The regulators may also require dividends to be drawn from surplus capital.<sup>151</sup> And the regulators may not allow a company to "make any payments in the form of dividends or otherwise" unless it "possess[ed] assets in the amount of such payment, in excess of its liabilities, including its capital stock."<sup>152</sup> In approving corporate dividends, regulators specifically consider "whether an insurer's surplus is reasonable in relation to the insurer's outstanding liabilities and adequate to its financial needs."<sup>153</sup> In doing so, regulators ensure that corporate entities remain adequately capitalized.

Likewise, the capitalization of banks is closely monitored by regulators.<sup>154</sup> Holding companies are prohibited from taking actions that may undermine a subsidiary's financial resources or "financial safety" and "soundness."<sup>155</sup> Piercing the corporate veil in regulated industries would require courts to second-guess the judgment of these regulators.

### *3. Inter-corporate transactions*

Like the veil piercing doctrines, the regulatory framework in the insurance and banking industries also acts to prevent improper transactions between a parent company and its subsidiaries. Indeed, the extent to which these regulatory frameworks prevent improper domination or control is impressive. Because each material transaction between corporate entities is subject to oversight, these frameworks can be particularly effective in preventing abuse of the corporate form. As noted above, for example, insurance regulations strictly limit the movement of capital from an insurance subsidiary to a holding company or its affiliates. These regulations prohibit insurance companies from paying dividends beyond a specified level without obtaining prior regulatory approval and require regulatory

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151. See MODEL ACT § 4(E), 5(B), at 440-15, 440-18 to -19.

152. *Id.*

153. IND. CODE ANN. § 27-1-23-4(f) (1999).

154. See, e.g., 12 C.F.R. §§ 225.14(b), 225 App. A (2007).

155. 12 C.F.R. § 225.4(a)(2) (2007).

approval of agreements between insurance companies and their affiliates.<sup>156</sup>

Regulators therefore prohibit the sort of “siphoning” of funds from a holding company through dividends or exorbitant administrative or investment advisory fees that plaintiffs may allege in attempting to pierce the corporate veil. The dividends paid upstream through the holding company system are registered and, in some instances, approved by multiple regulatory entities. Moreover, the regulators review and approve each intercompany payment and transfer and each affiliate agreement that plaintiffs might cite in an attempt to establish an alter ego relationship. These regulators review investment advisory agreements, administrative services agreements, and tax sharing agreements to determine whether all of the agreements are “fair and reasonable” and based on arm’s-length transactions.<sup>157</sup>

Likewise, regulators monitor transactions in bank holding company systems to ensure that they are consistent with sound banking policy and are conducted on an arms-length basis.<sup>158</sup> The regulatory framework is specifically designed to ensure that transactions among related entities are not used to undermine banking subsidiaries, and indeed the regulations specifically preclude extensive intercompany transactions by placing quantitative limitations on the amount of such transactions.<sup>159</sup>

#### *4. Commingling of assets*

Finally, regulations may also prevent the “commingling of assets” that is a standard element of veil piercing claims. Affiliated entities in the insurance industry, for example, typically have their own separate bank accounts and accounting records. Premiums received from policyholders are deposited, maintained, and controlled by the entity that holds the policies. Commissions to agents are disbursed from accounts the company owns and controls.

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156. *See, e.g.*, IND. CODE ANN. §§ 27-1-23-1.5, 23-4 (1999).

157. Such intercompany transactions are not uncommon in the insurance industry. “Insurance subsidiaries generally fund debt service and other obligations of their holding company through a combination of dividends, tax sharing payments and other expense allocation agreements with their holding company.” 2004 Best’s Insurance Reports—Life/Health, at xiii.

158. *See, e.g.*, 12 U.S.C. § 371c (2000).

159. *See id.* § 371c(a)(1)(A)–(B), (b)(8).

Regulatory audits ensure that an entity's accounting systems properly support the financial reports that are required by the regulations. These legal firewalls ensure that corporations' finances remain separate and distinct.

Because the regulatory framework in which these companies operate establishes such legal firewalls, imposition of alter ego liability is particularly inappropriate. The regulatory framework fully accounts for the factors courts typically consider in determining whether to impose such liability, thereby ensuring that the conduct necessary to support such claims does not occur.

Moreover, the regulators have developed specialized expertise in applying these standards in a particular industry. That expertise warrants preventing the courts from second guessing regulatory judgments. Indeed, in the insurance context, the regulatory framework imposes much more stringent requirements than would be imposed by the courts. The detailed monitoring of each material corporate transaction—often by multiple regulatory authorities—is far more demanding than the analysis typically employed by courts in ascertaining whether to pierce the corporate veil. Finally, there is inefficiency in having both regulators and the courts resolve the same questions. Judicial resources can be conserved by allowing such issues to remain where they belong—with the regulators.

#### *B. Cost-Benefit Analysis*

Not only does abandonment of the veil piercing doctrines in the context of regulated industries make sense within the framework articulated by the courts, it also makes sense from an economic perspective. A wide range of law and economics scholars have argued that the veil piercing doctrines are best viewed as an attempt to engage in a cost-benefit analysis, which seeks to retain limited liability in circumstances where its benefits outweigh its costs and articulate certain exceptions to this general rule where the costs outweigh the benefits.<sup>160</sup>

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160. See, e.g., Bainbridge, *supra* note 87, at 77 (“A standard academic approach treats veil piercing as a safety valve allowing courts to address cases in which the externalities associated with limited liability seem excessive.”); Easterbrook & Fischel, *supra* note 2, at 109 (“The [veil piercing] cases may be understood, at least roughly, as attempts to balance the benefits of limited liability against its costs. Courts are more likely to allow creditors to reach the assets of shareholders where limited liability provides minimal gains from improved liquidity and

*1. Benefits of limited liability*

The traditional rule of limited liability for corporate shareholders may be justified on several grounds summarized in a classic article by Easterbrook and Fischel, and embellished in subsequent work by other law and economics scholars.<sup>161</sup> First, limited liability reduces the economic costs of equity investment.<sup>162</sup> Aside from the obvious reduction in cost associated with rigid rules prohibiting claims against shareholders, limited liability decreases shareholders' "need to monitor" the corporation, as well as the potential liability they may incur to creditors absent such restrictions.<sup>163</sup> In doing so, it encourages economic investment and the growth of organized markets. Conversely, abandoning limited liability may result in shareholder free riding. If there is no limited liability, "only a fraction of the gains expected from effective monitoring will go to the monitor."<sup>164</sup> The overall result may be a decrease in monitoring of corporate managers.

Second, some commentators argue that limited liability also eliminates the costs of "monitoring other shareholders."<sup>165</sup> Because any judgments must be satisfied by the holdings of the shareholders in the absence of limited liability, shareholders have an incentive to monitor the wealth of all the other shareholders. While this factor may not be the most significant of those identified, to the extent it plays a role at all, it increases the costs associated with abandoning limited liability.

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diversification, while creating a high probability that a firm will engage in a socially excessive level of risk taking.").

161. See, e.g., Easterbrook & Fischel, *supra* note 2; see also *infra* notes 162–82 (discussing scholarly work building on Easterbrook and Fischel's analysis).

162. See Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 390 (1992); Bainbridge, *supra* note 2, at 499; Leebron, *supra* note 78, at 1573; Presser, *supra* note 1, at 408.

163. Easterbrook & Fischel, *supra* note 2, at 94; Thompson, *supra* note 20, at 18 ("Unlimited liability . . . can affect the market indirectly to the extent that it impacts on the amount of monitoring.").

164. Bainbridge, *supra* note 2, at 491–92; see also Ribstein, *supra* note 1, at 103.

165. Easterbrook & Fischel, *supra* note 2, at 95; Thompson, *supra* note 20, at 32–33 ("[L]arge transaction costs are likely to be incurred in a move to extended liability; these costs include excessive monitoring and evasion strategies exceeding what now occurs."). Easterbrook and Fischel also argue that limited liability reduces the cost of monitoring management because creditors may "possess a comparative advantage in monitoring particular managerial actions." Easterbrook & Fischel, *supra* note 2, at 100.

Third, commentators have suggested that limited liability facilitates the “free transfer of shares” and thus “gives managers incentives to act efficiently.”<sup>166</sup> Limited liability facilitates the transfer of shares because all shares are valued equally and are “fungible”; the identity and wealth of other investors is irrelevant to the value of particular shares.<sup>167</sup> If limited liability were abandoned, the value of shares would *not* be determined by the cash flows of the corporation, but rather would be dependent in part on these other factors. For the same reason, limited liability allows the share price to embody information about the actual “value of firms.”<sup>168</sup> As a result, investors need not necessarily do their own research before purchasing but, assuming market efficiency, can have some confidence in the market’s valuation of a particular share.<sup>169</sup> Without limited liability, there would be a significant danger that organized markets could not function efficiently, or at all, given the barriers shareholder liability may impose on the free transfer of shares.

Fourth, limited liability affords shareholders an opportunity to diversify their holdings. Without limited liability, shareholders would be unlikely to hold a wide array of stocks under circumstances in which their personal holdings would be put at risk, and thus would be denied an important mechanism for reducing risk.<sup>170</sup> Rather, they would more likely focus on only a few companies where they could better monitor management. The costs associated with increased monitoring would limit the scope of investment. Limited liability thereby ensures the benefits of diversification. Although critics have argued that a rule of proportional liability would eliminate the need for limited liability to ensure diversification,<sup>171</sup> commentators

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166. Easterbrook & Fischel, *supra* note 2, at 95.

167. *Id.* at 95–96.

168. *Id.* at 96.

169. *Id.*

170. Bainbridge, *supra* note 2, at 491 (“A rule of personal liability . . . would decrease shareholders’ ability to invest in a diverse portfolio of investments. The greater the degree of monitoring of each investment required, the fewer investments that will be made.”); Easterbrook & Fischel, *supra* note 2, at 96 (“limited liability allows more efficient diversification”); Thompson, *supra* note 20, at 32 (“[E]xtended liability will have a significant negative effect on the ability of shareholders to diversify, which in turn removes their risk-bearing advantage and more generally will remove the standardized pricing of shares that has contributed significantly to the growth and development of liquid financial markets for shares.”).

171. *See, e.g.*, Hansmann & Kraakman, *supra* note 3.

continue to argue that this is a powerful reason for continuing with the traditional approach.

Fifth, limited liability prevents managers from becoming overly risk averse and rejecting projects that may have a positive net present value. According to Easterbrook and Fischel, this is “the real benefit of limited liability.”<sup>172</sup> In the absence of limited liability, corporate managers would not undertake projects that may benefit society as a whole but involve inherent risks because they would fear that courts would impose shareholder liability.

Finally, commentators have suggested that the transaction costs of bringing suit against numerous shareholders spread across the country (and in foreign jurisdictions)—which would be required if limited liability were abandoned—would be prohibitive.<sup>173</sup> Given the practical difficulties and costs associated with imposing liability on corporate shareholders, any benefits derived from abolishing limited liability would be fleeting. Likewise, eliminating limited liability may increase the monitoring costs incurred by creditors who may be forced to monitor numerous shareholders in order to ensure that claims could be satisfied.<sup>174</sup>

## 2. *Mitigation of costs*

While some commentators have questioned these benefits of limited liability (albeit, less than completely persuasively), to the extent these benefits exist, they apply with equal weight in the context of regulated industries.<sup>175</sup> Moreover, the regulatory framework eliminates or reduces certain of the potential costs of limited liability asserted by commentators. As one commentator has observed, “[w]ith limited liability, some business people will be tempted to cheat their creditors by obtaining credit when they know

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172. Easterbrook & Fischel, *supra* note 2, at 97.

173. Bainbridge, *supra* note 2, at 492 (arguing that “it would be prohibitively costly for the creditor of a corporation to bring individual suits against thousands of geographically diverse investors”); *see also id.* at 497 (“A related source of administrative costs for both tort creditors and society-at-large arises out of the difficulty of deciding which investors are liable on particular claims.”); Leebron, *supra* note 78, at 1611 (“The transaction costs of collecting the pro rata shares against typical individual shareholders would in almost every case be so high that it would not be worth it. The uncertain application of the rule would create substantial uncertainty.”).

174. Bainbridge, *supra* note 2, at 492–93.

175. *See, e.g.*, Booth, *supra* note 95, at 147 (“None of the arguments in favor of limited liability is ultimately persuasive.”).

they are unlikely to be able to repay or to cheat their customers and innocent third parties by knowingly selling dangerous products and services without adequate capital or insurance.”<sup>176</sup> The regulatory framework mitigates these dangers by reducing the moral hazard problem associated with the externalization of risk where limited liability applies.

First, the regulatory scheme significantly reduces the danger of undercapitalization. Undercapitalization increases the risks associated with limited liability because “the lower the amount of the firm’s capital, the greater the incentive to engage in excessively risky activities.”<sup>177</sup> The constant monitoring of firms’ capitalization in the insurance and banking industries coupled with minimum capital requirements reduces the risk of undercapitalization and the concomitant risk that management may have an incentive to externalize costs for projects that would not have a net positive present value absent such externalization.

Indeed, as Easterbrook and Fischel observed in their seminal article, “[l]egislatively imposed minimum-capitalization requirements are one method of internalizing the cost of risk taking.”<sup>178</sup> It is exactly this sort of legislatively imposed requirement that mitigates the costs of limited liability within regulated industries such as the insurance and banking industries. Moreover, while Easterbrook and Fischel observe that there are obvious costs associated with such requirements, such as administrative costs and the cost of setting capital requirements too high<sup>179</sup>—and thus imposing minimum capitalization requirements may be a less desirable means of controlling moral hazard than the veil piercing doctrines—the fact that these requirements *already exist* in regulated industries means that these costs will be incurred anyway. Having incurred these costs, it is foolish not to reap the associated benefits and instead insist on the continuation of the veil piercing doctrines in such regulated industries. Veil piercing merely imposes additional costs without achieving any greater benefits (or at least benefits that are sufficiently great that they justify the additional costs).

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176. *Id.* at 161.

177. Easterbrook & Fischel, *supra* note 2, at 113.

178. *Id.* at 114.

179. *Id.* (arguing that “the rate of return on equity investments will decrease” if minimum capital requirements are adopted across the board).

Second, direct “regulation of inputs” reduces the likelihood that managers will engage in unduly risky activities.<sup>180</sup> As Easterbrook and Fischel observe, direct regulation of the business activities of corporations can be used to prevent the externalization of risk where inappropriate.<sup>181</sup> This is exactly the situation in the insurance and banking industries, in which regulators directly monitor corporate activities to ensure that corporations do not engage in overly risky activities. Again, Easterbrook and Fischel argue that this means of addressing the moral hazard problem may not be superior to veil piercing because “[r]egulators have no better incentives than market participants to balance the social costs and benefits of engaging in certain activities.”<sup>182</sup> However, like the rules governing capitalization, this is a system that is already in place. It makes no sense to incur the costs of duplicative mechanisms to control the same moral hazard problem when there is no evidence that there will be any incremental benefit, much less an incremental benefit that outweighs the significant additional costs.

In sum, the costs of allowing veil piercing within regulated industries such as the insurance and banking industries significantly outweigh the benefits. Corporations functioning within such regulatory systems are already subject to multiple mechanisms designed to control the moral hazard problem. These mechanisms, like veil piercing, impose costs on society. Allowing veil piercing under such circumstances merely adds additional costs without any demonstrable additional benefits. Thus, from an economic perspective, veil piercing within such regulated industries simply makes no sense.

## V. CONCLUSION

The debate over limited liability and the proper scope of the veil piercing doctrines is likely to continue unabated given its significant practical importance and the lack of concrete empirical data to support the arguments on either side. Nonetheless, within this debate, there may be some common ground upon which scholars

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180. *Id.*

181. *Id.*

182. *Id.* at 116 (“Whether the social costs of regulation exceed the social costs of excessively risky activities is an empirical question.”).

and commentators can reach a consensus. This Article attempts to identify one such area.

Regulated industries such as insurance and banking provide a forum in which all commentators should agree that veil piercing is inappropriate and that the benefits of strict limited liability should be preserved. Regulation is an independent means by which the dangers of interactions among shareholders and corporate entities may be mitigated. Accordingly, it reduces the potential costs associated with limited liability that some commentators have suggested warrant erosion of such guarantees. At the same time, it retains many of the widely-recognized benefits of limited liability, which may be in some part responsible for the significant economic progress of our nation over the last two centuries. Accordingly, where such regulatory frameworks exist, the veil piercing doctrines should be abandoned. Indeed, the courts may already be applying such a de facto rule. Because these regulatory frameworks largely preclude the sort of conduct that courts have traditionally cited as justifying veil piercing, the actual application of such doctrines in these regulated industries appears to be rare.

