Creditors who experience difficulties in collecting payment due from a subsidiary corporation will tend to look at the parent corporation for the satisfaction of their claims. However, since parent and subsidiary are distinct legal entities, the parent is not ordinarily liable for the subsidiary's debts: (1) it is this feature of separate incorporation which makes the use of a subsidiary so attractive. (2) It offers a chance to insulate a particular line of business with its peculiar risks from the rest of a corporate conglomerate's business. The question is in which factual situations and upon which legal principles a disregard of the separate corporateness may be justified: when - by "piercing the veil" (3) - the parent corporation's assets may be made available for the satisfaction of the subsidiary's creditors.

A related issue arises when, in the bankruptcy of the subsidiary, both outside creditors and the parent assert claims against the estate and thus compete for the distribution of assets. The legal distinction between parent and subsidiary implies the possibility of mutual claims and obligations. However, the outside creditors will try to gain priority over the parent pursuant to the principle of equitable subordination, (4) arguing that the special nature of the relationship between parent and subsidiary precludes the recognition of their separate existence.

The intention of this paper is to perform a functional analysis of the factual situations which may lead to the parent's liability or the subordination of its claims. It emphasizes that under the term "disregard of the corporate entity" no independent corporate law principles are at work but principles generally applicable under common law. By explaining the conceptual background of the parent's liability or subordination it tries to render disregard standards easier to apply.

I. The Parent's Liability and Subordination: Basic Features

Statutory provisions imposing personal liability on stockholders, and thus also on corporate stockholders (5) are found in the New York and Wisconsin business corporation laws where stockholders are made liable for unpaid wages under certain circumstances. (6) The Bankruptcy Code in sec. 510 (c) expressly recognizes the doctrine of equitable subordination but does not provide any guidelines for its application. (7) Beyond these sparse statutory provisions, the real discussion of disregard-based liability, as well as of equitable subordination, has been reserved to case law and its reflection in the legal literature. Numerous cases, (8) as well as scholarly writings, (9) have dealt with questions of piercing the veil. Perhaps the most cited general rule is that "a corporation will be looked upon as a legal entity ... until sufficient reason to the contrary appears: but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." (10) Obviously, such a "rule" does not render the determination of the parent's liability or subordination an objective process with a predictable outcome upon given facts.

In order to achieve more precise standard a number of guidelines have been suggested, partly cast in colorful terms. (11) Best known are the "alter ego" and "instrumentality" approaches. (12) Both center on the question when a subsidiary is organized and operated in such a way that it no longer has a sufficient existence of its own to justify its recognition as an independent entity. A subsidiary is deemed to be the parent's alter ego when there is such unity of interest and ownership that the corporations have lost their individuality. (13) Other cases (14) have called the subsidiary an instrumentality of the parent and have disregarded its formal separateness when they perceived such a complete domination that the subsidiary had no separate mind, will or existence of its own. (15) The difference between the alter ego and the instrumentality rule is primarily one of language and perspective rather than of substance. (16) Under both of them, the courts look at the same factual circumstances to find out whether the requirements for disregard are met: stockownership, identity of directors and officers in the affiliates, non-observation of corporate formalities, lack of proper corporate records, mingling of assets and syphoning of funds, parental financing and inadequate capitalization of the subsidiary. (17). And often courts blur elements of the alter ego and instrumentality rules or even do not distinguish them at all. A recent example is <u>Cruttenden v. Mantura</u> where the court stated: "To find that a subsidiary is the alter ego of the parent corporation, it must be established that the parent control is so complete as to render the subsidiary an instrumentality of the parent." (18)

The weakness of the alter ego and instrumentality rules is that their standards continue to be shifting and leave a broad scope of discretion to the court, reducing predictability. The rules do not provide a comprehensive conceptual approach to the problem; (19) a generally accepted legal theory underlying disregard is missing. The "mists of metaphor" that Judge Cardozo observed sixty years ago (20) have not yet cleared. (21)

With respect to the parent corporation's direct liability to the subsidiary's creditors the confusion is still increased by the fact that this liability does not necessarily result from disregard of the corporate entity, but may also follow from the application of common law principles: usually it is suggested that the parent's liability may have a corporate or a non-corporate basis (22) Cases are classified under the non-corporate category when the fact that the parent holds stock in the subsidiary, i.e. the very existence of the parent - subsidiary relationship, is no prerequisite for the parental liability. Here, ceteribus paribus, an individual or corporation not affiliated with the subsidiary would be liable as well.

Under the non-corporate category, creditors may have a claim against the parent upon a guarantee the parent gave, under the principle of respondeat superior where an agency relationship exists, (23) because of misrepresentation or estoppel, (24) or upon a tort theory where the parent violated duties it itself owed to the subsidiary's creditors. (25) The law of fraudulent conveyances may apply when prohibited transfers between the affiliated companies impair the creditor's position. (26) Finally, federal securities laws contain a rebuttable presumption that a controlling person is liable for certain securities law violations of the controlled: the control may, but need not, result from stockownership. (27)

However, the distinction between corporate and non-corporate bases of liability is not always easy to handle. In practice, the borderline is sometimes blurred, and the courts often do not distinguish clearly between the different concepts. (28) A good example is the <u>respondeat superior</u> concept. Agency is normally understood as a consensual relationship in which the agent acts on behalf, for the benefit and under the control of the principal. (29) Such a relationship does not require an express agreement but may be implied from the factual circumstances of a situation. An unrestricted application of agency principles would deprive the parent corporation (or any stockholder, in this case) of the protection from personal liability that incorporation was intended to provide it with: a corporation is usually supposed to work for the benefit of the stockholders and under their ultimate control. (30) Therefore, the principle of <u>respondeat superior</u> must be rendered at least partly inapplicable to parent-subsidiary relationships. What is more, the term agency is unfortunately not used in an uniform way. While the existence of independent entities is crucial for the assumption of an agency relationship some courts, however, call the subsidiary the "mere agent" of the parent to establish that the special character of their relationship precludes their treatment as separate entities. (31)

More important, the distinction between corporate and non-corporate based liability is also not as conceptually clear as it may seem at first sight. True, to contrast liability which can be imposed only upon a parent corporation with liability which can, ceteribus paribus, be imposed upon everyone else as well, seems systematically attractive. One might even speak of the parent's derivative and original liability since in the one case it answers for an obligation which in the first place binds the subsidiary while in the other case the obligation originates in the parent itself without that the subsidiary has necessarily to be liable at all. However, one should neither overestimate the descriptive value of such a model of parent liability nor the legal insight provided by it. When the parent is held liable it is always, also in the cases commonly summarized unter the dubbing "disregard", because it has violated a duty which is designed to protect the subsidiary's creditors. And, as will be shown, the duties the violation of which may cause disregard are related to the duties every debtor has under common law, if they are not only special adaptions of these duties aiming at creditor protection in the special setting of the corporate conglomerate. In fact, a recent article (32) has suggested that underlying the law of fraudulent conveyances and the doctrines of equitable subordination and piercing the veil, that is, what is commonly distinguished as non-corporate and corporate based liability concepts, are the same moral principles governing the conduct of debtors to their creditors. One of the intentions of this paper is to show that in the alternatives of the disregard doctrine we indeed can recognize applications of quite familiar common law principles -- which confirms Latty's early statement that disregard is no solvent for parent-subsidiary problems. (33)

II. Determinative Factors for Disregard

A look at the case law shows that there are certain fact patterns which make disregard actions likely to succeed. In fact, the courts have found several factors determinative for imposing liability on a parent or subordinating its claims in the subsidiary's insolvency. In part, these factors merely refer to factual circumstances of the intercompany relationships, in part, they already require or imply an evaluation of such circumstances. The importance of any single factor varies depending upon whether the setting is one of direct liability or equitable subordination. The different approaches to the disregard issue which result I would describe as

the domination approach,

the commingling approach,

the formalities approach and

the inadequate capitalization approach.

1. The Domination Approach

A finding that a subsidiary is dominated by the parent has been traditionally understood as one of the strongest arguments for piercing the veil. (34) That is not surprising: if one phrases the issue of disregard of the corporate entity in terms of its separateness and independent existence, the language suggests that such qualities cannot be found in an entity which is dominated by another.

As early a case as <u>Lowendahl v. Baltimore & O.R. Co.,</u> (35) the first case to set forth an elaborated statement of the instrumentality rule, required a showing of complete domination that left the subsidiary without a separate mind, will or existence of its own, as the main prerequisite for imposing liability on the parent. (36) In one of the more recent references to the domination factor it was said that liability results where control amounts to total domination of the subservient corporation, to the extent that the latter manifests no corporate interest of its own and functions solely to achieve the purposes of the dominant corporation. (37)

Domination is generally understood as a certain degree of control exercised by the parent (38) In the statutory model of the corporation, control resides in the management, i.e., directors and officers, and with regard to fundamental questions, in the stockholders. Domination hence appears to have something to do with the parent's holding stock in the subsidiary or with parental representatives holding positions in the subsidiary's management. In fact, courts tend to begin their analysis in disregard cases by looking at these circumstances. (39) On the other hand, it is almost common-place in parental liability cases to state that the parent will not be held liable merely because of stock-ownership, a duplication of some or all directors and officers, or an exercise of control that stock-ownership gives to stockholders. (40)

If one, as it is commonly done, accepts that corporations are allowed to hold stock in other corporations, (41) it follows that parental liability cannot be imposed upon them for the mere fact of that stockownership. In fact, it is the general view that the principle of limited liability also applies to corporate stockholders. (42) And if corporations are allowed to hold stock in other corporations, interlocking directors and officers are again only a natural result. Shareholders exercise their power in a corporation by placing people whom they regard as able and trustworthy in managment positions. Very often, especially in closely held corporations, individual shareholders will assume positions in the corporate management themselves. A corporate stockholder, being a legal entity as opposed to a natural person, cannot do that. However, legal entities form their will and act through individuals, their directors and officers. It is logical that these people take similar positions on behalf of the corporate stockholder in the subsidiary.

If the mere facts of stock-ownership and duplicity of directors and officers and the exercise of the control which comes along cannot trigger the parent's unlimited liability, but the degree of control which amounts to domination can, we face the difficulty of finding the borderline. What is allowed as "good" parental control and what is prohibited as "bad" control leading to the loss of the limitation of liability? Is there a limit on the amount of control stockholders can legally exercise on the ground of their stock-ownership? In the statutory model of the corporation the stockholders elect the directors and decide fundamental questions like amendments of the charter, mergers or dissolution while management of the business is left to the directors. (43) But the real influence stockholders may have on policy and business of their corporation is barely described by that. For instance, in a close corporation, that is, where the number of shareholders is limited, the shareholders may have potential influence on all important business decisions, even if they do not hold offices in the company. (44) Communication and information is easy, and everybody knows that the stockholders indirectly have the last say, through the selection of managment. The interest and will of the stockholders are known and determine those of the corporation. It is important to realize that none of this deviates from the path of corporate virtue but is only one possible modelling of a corporation, and in fact a possibility which was potentially anticipated in the corporate form from its inception. As we know, even one-man corporations are recognized by the law, even expressly by some state statutes, (45) and there is no doubt that there the owner's control is total and dominating. The idea that a certain degree of control or influence on the direction of the business leads to the stockholders' personal and unlimited liability is therefore conceptually doubtful.

Instead of inquiring into the degree of control exercised by the parent, one could think of emphasizing the form in which the control is exercised. Apparently that was what Judge Learned Hand meant when he said that the test would be in the form rather than in the substance of control. (46) Then the question would be whether the controlling shareholder, here the parent, used the statutorily provided structures and mechanisms of corporate decisionmaking, or intruded upon the managment without paying them any attention. (47) The provided decisional structure would be that, as long as no fundamental changes are concerned, a shareholder can exercise his power only by electing the directors and, if he does not like their way of running the business, by replacing them. However, such a test ignores the realities of corporate governance: even if the shareholder does not directly contact the managment, the latter will mostly know quite precisely what the majority shareholder expects it to do. What is more, with regard to parent-subsidiary relationships this test is rendered useless by a special factor.

Corporations form and exercise their will through directors and officers: parent corporations exercise their control over the subsidiary through them. Since we accept interlocking directors and officers, the people who control here are the same who are controlled: the potential intruders upon the the subsidiary's management are, themselves, the management. Since the exercise of control normally means issuing orders to people who must obey them, communication is necessary. It can be ascertained whether the normal structures and lines of corporate decision-making are observed by looking at the communication. Where duplication of directors and officers exists, communication of the usual kind becomes dispensable: people who do not suffer from a split personality do not give orders to themselves. Without communication, our means of checking the regular channels of control has been lost. In the end, the attempts to distinguish allowed from prohibited exercise of control by its form seems equally unpromising.

If neither the degree nor the form of control exercised turns out to be a way to determine improper parental conduct leading to unlimited liability, the whole domination approach becomes highly questionable. Indeed, the notion of domination has its origin in the law of agency and its application should be confined to that area. The differences between agency and parent-subsidiary relationships have sometimes been blurred (cf. supra p. 5): that might explain the frequent use of domination terminology in disregard cases. However, Judge Cardozo noted clearly already in Berkey v. Third Avenue Ry. that the use of a domination concept should be reserved to agency cases while the analysis of disregard cases had to do without it. (48)

More important than the mere fact of parental control itself is the purpose for which it is used. That is what I would call the substance of control. What matters is not whether the parent dominates the subsidiary, but whether the parent drains or milks it. And not mere parental domination, but the latter events are a potential threat to the subsidiary and its creditors. In fact, more recent cases seem to choose a low key approach to the domination factor. Even if the language they use does not make that clear at first sight, the factors they look at are not primarily concerned with control issues. (49)

2. The Commingling Approach

Another group of factual circumstances which the courts regularly regard as endangering a subsidary's separateness concerns the commingling of assets. Commingling occurs where parent and subsidiary no longer operate at arm's length where finances are concerned. Rather, their funds and assets have become indistinguishable. (50)

What might happen in commingling cases is that invoices are not paid by the owing corporation but by its affiliate, property is used by the affiliate rather than the legal owner, employees of the subsidiary are paid by the parent, monies received are not put in the bank account of the entity which has been the creditor for the amount but into the other's, or perhaps separate bank accounts do not even exist. (51) Thus, at first glance, commingling means merely a high number of intercompany transfers. Does this alone cause the affiliates to lose their distinctness? And can commingling be more dangerous for the subsidiary's creditors than the parental domination discussed earlier?

The commingling of assets and funds has two sides: downstream transfers from parent to subsidiary (example: parent pays subsidiary's employees or leaves property for its use) and upstream transfers from subsidiary to parent (example: subsidiary's accounts receivable collected by the parent or subsidiary pays parental debt). The latter transactions are a potential threat to the subsidiary's creditors because they divest the subsidiary of funds which might have secured the creditors' satisfaction. Theoretically, if such a transfer from the subsidiary to the parent happens, the first will have a reimbursement claim against the latter, at least for unjust enrichment: in business, nothing is free. Thus, as long as we assume that no transactions are taking place expressly made without any consideration (potentially giving rise to a creditors claim for fraudulent conveyance, see infra p. xx), the amount of assets owned by either affiliated corporation will not change because of the transaction. The assets will only be differently structured. For instance, what has been given away in property or by paying the other corporation's debt, will be made good by a reimbursement claim. The sum of assets in the balance sheet is unimpaired. If the subsidiary goes bankrupt, the trustee of its estate can assert and enforce the reimbursement claim, thereby enlarging the estate which serves the creditors' satisfaction.

However, the point of the whole story is that this all works only as long as proper accounting and bookkeeping exist. But that is what is typically missing in a mingling case. The subsidiary's loss of standing as a distinct financial unit is essentially not caused by transfers to the parent but rather by the lack of appropriate accounting and bookkeeping. If there are no proper records and books kept, it becomes impossible, especially in the subsidiary's bankruptcy, to trace back all the intercompany transfers. It may even becomes impossible to determine with which affiliate the title to a certain asset lies. Potential reimbursement claims cannot be asserted anymore. The assertion of these claims on behalf of the estate and for the benefit of the creditors is seriously impaired. At this point it also becomes clear why commingling is typically found in direct liability cases rather than in equitable subordination cases: in the latter cases the parent asserts a claim against the subsidiary's estate which is only possible if proper accounting, i.e. just that is missing in commingling cases, exists.

In a piercing case the subsidiary is as a rule left without assets. If it turns out that there has been a commingling of assets and funds with the parent and no proper records exist, the facts give rise to a presumption that the subsidiary has been divested of its funds by the parent and that it has reimbursement claims against it. Experience has shown this presumption so strong, that it seems fair and reasonable to locate the burden of proof that no such transfer of assets to the parent occurred and no reimbursement claims exist with the defendant parent. In a commingling case we should assume prima facie that the subsidiary has such claims against the parent. The parent is the party in the best position to provide the information about what really happened: it took part in the concerned transactions and benefited from them. It should have kept its own books and records about all transactions with the subsidiary. If it actually has not, that is its own fault.

Thus, in commingling cases the parent should bear the burden of rebutting the presumption of its liability. In fact, that is precisely what is practised by the courts, even if they do not cast it in terms of burden of proof or rules of evidence. The parent is always allowed to escape the negative implications of a finding of commingling if it provides proper accounting and shows that it has met all its obligations to the subsidiary. (52) However, the parent as a rule cannot do that, and hence is held liable by the court. That means nothing other than that the courts locate the burden to invalidate the presumption of parental liability because of intercompany transfers with the parent.

One question remains: Reimbursement for presumed upstream transfers could only be demanded by the subsidiary and in bankruptcy by its estate, respectively. The parental liability we have found therefore would extend to the subsidiary itself and not directly to the creditors. In order to justify that in this situation the subsidiary's creditor can nevertheless directly sue the parent, we have to realize that to deny this possibility would leave the creditor without any relief and prospect of recovery. He would be forced to seek his satisfaction against the illiquid subsidiary or its estate. The subsidiary or its estate, however, cannot collect the amounts owed them by the parent since, due to the commingling and the absence of accounting, these amounts are not known. In this situation where the creditor finally suffers from this inability to collect the funds belonging to the subsidiary or its estate, it seems only fair to allow him to sue the parent. The possibility that the creditor's claim exceeds the debt owed by the parent to the subsidiary, or what he would be entitled to receive from the distribution of the subsidiary's assets in bankruptcy, does not matter since the parent could have easily escaped its liability if only it had provided proper accounting.

Although commingling has been traditionally introduced to disprove separate existence, the commingling concept, as understood here, does not center so very much on that separateness. Rather, it focuses on compliance with proper accounting standards. If so desired, one can phrase the issue as the subsidiary's independent existence or separateness as an accounting unit -- but that is more a semantic than a legal exercise. More important is that the courts' actual application of the concept makes it clear that the outcome depends on the state of accounting in the corporate conglomerate.

A fine example, which is also instructive with regard to the declining importance of the domination factor, is Edwards Co., Inc. v. Monogram Industries, Inc. (53). The plaintiff sued the parent corporation for unpaid supplies furnished to a general partnership of which the defendant's wholly owned subsidiary was the general partner. After the decline of the partnership's business and substancial losses the subsidiary was financially exhausted. The business was operated out of the parent's offices; neither separate payroll nor a separate telephone existed. All bookkeeping was handled by the parent. The partnership's financing was accomplished through unsecured loans by or guaranteed by the parent. On the other hand the subsidiary's financial records were kept separated from those of the parent; intercompany loans were carefully recorded on the books of each. Minutes of the directors' meetings were kept and resolutions of the sole shareholder, the parent corporation, were recorded.

The court acknowledged that the subsidiary was, like any subsidiary, ultimately controlled by the parent. Yet, sharing the view prevailing today, (54) the court rejected the idea that stock control or the existing duplication of directors and officers could on their own defeat the subsidiary's separate existence. It did not find the other described features of the parent-subsidiary relationship to endanger this separatness. In reaching this conclusion the court relied upon the fact that all intercompany transfers had been properly accounted for and all decision-making had been recorded: all corporate formalities had been observed. The court's position means basically that so long as the subsidiary's separateness as an accounting unit is preserved, the fact that it is run by the same management as the parent, and that it is in financial and organizational regard totally dependent on it, does not matter. The bottom line for recognition as a separate corporate entity then is that intercompany transactions can be traced, that it can be determined where certain assets legally belong to and that the underlying managment decisions are documented. (55)

The understanding of the commingling approach suggested here, makes it clear that liability for commingling and liability under the law of fraudulent conveyances are related concepts. (57) It may even be argued that all the transactions which give rise to parental liability under the commingling approach suggested here are also fraudulent conveyances because the assumed reimbursemnt claims are a mere theoretical construction and do not constitute any real consideration. In cases of transfers from subsidiary to parent with an express agreement of no consideration (free or "gift" transfers), the law of fraudulent conveyances is applicable in any case. The remaining difference between fraudulent conveyance liability and liability due to commingling is that the latter dispenses with the identification of individual transfers.

If one is prepared to follow a commingling concept as suggested here, it should become evident again how questionable the whole traditional distinction between corporate and non-corporate bases of liability in fact is. Commingling of assets has been usually regarded as a factor potentially leading to the disregard of the corporate entity and, therefore, as a corporate basis of liability. The commingling concept as suggested here, however, is primarily a matter of locating the burden of proof and is derived from claims which the subsidiary or its estate originally have against the parent. As parental liability under the law of fraudulent conveyances, to which it is similar, it does not require a disregard but also works under recognition of the existence of separate entities.

3. Observance of Corporate Formalities

Another factor frequently regarded as important for the determination of a subsidiary's separateness is the observance of corporate formalities. (58) The meaning of that phrase differs. It may refer to regular corporate meetings, that is, meetings of the stockholders and the board of directors. It may mean the appropriate recording of the decisions made there. It may concern the way control is exercised. Finally, it may concern the formalities of incorporation.

The purpose of corporate meetings is information spreading and decision-making. As a matter of fact, in parent-subsidiary relationships and especially in the case of interlocking directors and officers, these objectives can often be achieved without formal separate meetings of the subsidiary's organ, for instance, during corporate meetings of the parent. Thus, the formality of regular meetings seems dispensable. Obviously, this is valid only as long as there are no minority shareholders who would be deprived of their rights if no meetings are held.

A different view however applies to the formal recording of decisions once they have been made, whether in a formal meeting or not. Documentation of control or managment decisions makes sense even in a corporate conglomerate. Such a documentation may help to explain in whose capacity a certain action was taken: in the parent's or in the subsidiary's. Those records serve a similar function to that of proper accounting and bookkeeping and are hence especially important if they concern the distribution of assets between the affiliates. If appropriate documentation in that sense is lacking, and if in a creditor's action for recovery it remains unclear which entity is responsible or where certain assets belong, the liability may lie with the parent for the same reason as in the commingling cases: the parent is in the best position to give the required information. Thus, even if formal meetings may be dispensable, it seems advisable for subsidiaries to record carefully the decisions which fall into the shareholders' or the board's responsibilities: as "resolutions". So it was, for instance, done and approved by the court in the Edwards. (59)

With respect to the incorporation of a business, certain requirements must be met before the law recognizes a corporation as a distinct legal entity. Which requirements these are, is determined by state law and may depend on the type of the challenge to the validity of incorporation is. (60) One might call them "formalities of incorporation", but this is only a matter of semantics. The real issue is whether a certain act or event is necessary before the incorporation takes effect. For example, a necessary prerequisite of incorporation may be the filing of Articles of Incorporation with the appropriate state agency.

The question has been discussed -- and actually been answered in different ways -- whether the issuance of stock is such an indispensable requirement for a successful incorporation. (61) Without someone holding stock nobody seems ultimately to own or control a corporation and nobody seems to be entitled to its profits. No system for the distribution of influence or sharing in the benefits of the business is provided. That may speak in favor of denying the existence of a corporation if no stock has been issued. In any case, it is important to note that if we do not recognize a distinct legal entity where no stock has been issued, this is no disregard or piercing case: no corporate entity capable of being disregarded has yet come into existence, and no veil capable of being pierced has yet been woven. The incorporators are liable for the business debts because in the absence of a distinct legal entity, there is no possibility that they could have caused the business operations other than in their personal capacity. However, if we do not regard the non-issuance of stock as hindering valid incorporation, it would be inconsistent to use the same circumstance for supporting the disregard of corporate entity: the finding of valid incorporation means the recognition of a legally distinct entity.

4. Inadequate Capitalization

Perhaps the single most important factor considered by the courts in disregard cases is whether the subsidiary's business was operated with adequate capitalization. (62) This approach examines the parental funding of the subsidiary and centers on the amount invested as equity capital. The equity/parental loan ratio becomes a matter of interest where the parent did not only make an equity investment, but also provided loan financing.

a) The Meaning of Adequate Capitalization: Price for the Corporate Privilege versus Efficient Allocation of Corporate Losses

It is a traditionally held belief that incorporation and the resultant limited liability are a privilege and that the price for that privilege is the provision of sufficient equity capital. (63) Since corporate creditors can look only to the corporate assets for the satisfaction of their claims, incorporators and/or stockholders are supposed to have a duty towards creditors with regard to the adequacy of capital. (64) The amount of capitalization which is deemed to be adequate depends on which equity endowment would provide the corporation with a financial standing enabling it to meet the normal and foreseeable expenses of a business of the kind and size involved and to bear predictable losses. (65) Failure to comply with the requirement of adequate capitalization shall lead to loss of the limited liability privilege and impose upon the parent (as any stockholder, in that case) direct liability for the subsidiary's obligations and shall preclude it from sharing as a creditor for amounts advanced in the distribution of the subsidiary's assets in bankruptcy.

The application of this capitalization approach encounters the difficulty that the standard of adequate capital is insufficiently defined by "the normal and expectable expenses of the business." At the time of a piercing action, that is as a rule when the subsidiary is unable to meet its obligations, it is a matter of fact that its financial standing was insufficient to meet the strains of its business and to bear the present risks. But that is so in every insolvency case. (66) To blame the incorporators for setting up a flimsy corporation, an assessment of the subsidiary's financial needs ex ante, i.e. from before the beginning of the business, would be necessary. If the subsidiary is rendered insolvent only after it has for a time successfully operated, an ex ante-assessment would be necessary whether additional advances of equity should have been made. The task is not one for the courts but for expert witnesses like accountants and bankers; the outcome will necessarily vary with the individual doing the job. Estimates of the general economic prospects of the special line of business may differ as well as of the feasibility of certain undertakings. Risk preferences are not the same. Even if we refer to the average capital endowment of a business comparable in size and kind we would have to allow deviations in order to leave scope for the development of new ways of financing. (67) After all, to ascertain the amount of equity required for the operation of a certain business is a troublesome job. That seems to be one of the reasons why so far apparently no court has based its decision to disregard the corporate entity exclusively on inadequate capitalization. (68)

Adequate capitalization cannot mean that the corporation must be in a position to bear any conceivable loss resulting from its business operations. It is the consequence of the shareholder's limited liability as well as the essential feature of the creditor's restriction to the corporate assets that certain losses may occur which will eventually lie with the creditors. The principles of limited liability in fact externalizes certain losses of the corporation, that is, costs of its doing business. (69) This shifting of losses from someone who causes them to someone not responsible for their origin and in a worse situation to prevent them, is well perceived as one of the characteristics of incorporation. The justification normally given is that the possibility of doing business under limited liability creates new incentives to engage in business ("encouraging investment"), thereby enhancing public welfare and utility. (70) The idea is that the social benefit from limited liability outweighs its social cost.

If one wants to part with the understanding of incorporation as a privilege and adequate capitalization as its price, one can easily put the issue as determining the amount of equity capital which guarantees the most efficient allocation of corporate losses between the corporation and its owners on the one hand and the corporate creditors and the general public on the other hand: the allocation which provides optimum overall utility is sought, that is, the highest excess margin of social benefits over social costs. Needless to say that this different view of the meaning of adequate capitalization does not render the determination whether a given capital endowment is adequate an easier job.

b) Parental Loan Financing: The Subordination Issue

It is generally assumed that a violation of the duty to provide adequate capitalization can occur in two different forms. First the parent may provide an amount of funds sufficient to enable the subsidiary to operate on a solid basis, but only a part of this amount is given as equity and the rest as a parental loan. Here, the inquiry is centered on the structure of the parent's investment, asking when the parent loan has to be treated as disguised equity. Second, the parent's total investment, even after treating eventual loans as equity capital, may be deemed insufficient. Here, the inquiry focuses on the total value of assets provided by the parent rather than on their structure.

With regard to parental lending the issue is one of equitable subordination of the parent's claim in the subsidiary's bankruptcy. In <u>Pepper v. Litton</u> (71) where the accumulated salary claims of a controlling stockholder were subordinated, it was held that "so called loans or advances by the dominant or controlling stockholders will be subordinated to claims of other creditors and thus treated in effect as capital contributions ... where the paid in capital is purely nominal, the capital necessary for the scope and magnitude of the company furnished as a loan." In Arnold v. Phillips (72) a brewery had been incorporated with an initial capital of $50,000 and, in order to finance the construction of a plant, the dominant shareholder had advanced an additional $75,000 as a loan. After the business had operated for some time at a profit, the dominant shareholder advanced additional loans. The court regarded the first loan as capital by its nature since it was a permanent investment being used to build and equip the plant while the further loans could also have been made by outside creditors. Similarly, the parent's claim was subordinated in ITT v. Holton (73) where the subsidiary was provided only with a nominal capital of $1,500. Stock worth $565,000 was financed by parental loans so that the subsidiary started "with an indebtness which rendered it insolvent, in the bankruptcy sense, from the very beginning, and incapable of operation except with the assistance of the parent." In Costello v. Fazio (74) upon incorporation of a partnership the former partners converted the bulk of their capital contributions into loans, leaving the corporation with only a nominal capital while the subsidiary's liabilities exceeded its assets. The court subordinated the stockholders' claims, pointing out that they had stripped the business of eighty-eight per cent of its stated capital at a time when it had a minus working capital and had suffered substantial business losses. Other courts have tried to distinguish capital contributions from true loans by the expectation of repayment. Only if such expectation was reasonable and justified, were the advances treated as loans. (75) Eventually, some recent cases focused on the question of whether an outside lender would have given the funds to the corporation at the time the alleged loans were made. (76)

Summarizing these examples, the courts' approach has typically been that the stockholders should not be able to avoid risk by substituting loans for equity where they should be at risk -- which is no answer but only a different casting of the question. The court decisions lack a comprehensive underlying theory upon which principles and in which situations a parent's claim is to be subordinated. The announced standards appear to be impractical or arbitrarily chosen. Neither has a conceptual theory been provided by the Bankruptcy Code of 1979 which in sec. 510 (c) merely acknowledges the availability of equitable subordination.

It does not seem advisable to make the distinction between permitted parental lending (77) and mere disguised equity financing based on the use of the funds in the subsidiary's operations, viz. for long-term or short-term investments. (78) True, it is good business sense to finance long-term investments only by long-term available funds. However, loan financing can meet that requirement. We should understand that it is not the legal form in which funds are provided, that, alone, renders a business more viable or solid. As long as funds are available and their respective costs do not differ, it does not matter to the business whether it is operated with equity capital or loans. And it is not the formal qualification of funds, i.e. the equity/loan ratio, that determines how resistant the corporation is in periods of bad business, but whether the funds provided as loans remain available or are withdrawn.

The final topic in the discussion of equitable subordination of certain parental claims is the protection of outside creditors. With regard to business entities with limited liability they seem best protected when they are put in a position where they can estimate the risk they run, and when they are assured that facts they reasonably rely upon are not subject to unpredictable changes, and that no attempt to deceive them is sanctioned. We should turn our attention to the circumstances under which parental loans can endanger this position of outside creditors.

Let us assume a subsidiary is rendered insolvent, meaning that it either cannot pay its debts when they become due in the ordinary course of business (equity insolvency) (79) or that its liabilities exceed its assets (bankruptcy or balance sheet insolvency). (80) The usual consequence of insolvency is that the concerned entity will cease doing business. Insolvency is, under most state codes a cause for termination of the corporation (81) and equity insolvency or illiquidity is a cause for an involuntary petition for bankruptcy. (82) Moreover, the termination of business is the normal factual consequence of insolvency since the corporation has usually lost its credit. It is the very meaning of equity insolvency that the potential creditors of the insolvent no longer want to run the risk of dealing with it. And it is also not very likely that creditors are willing to give new credit to a corporation of which the assets do not match liabilities, even if, at the time being, it still can pay its due debts.

Bankruptcy or balance sheet insolvency cannot be overcome by a parental loan because what it adds to the subsidiary's assets (in money) it also adds to the liabilities in the form of a parental claim. However, practically, the loan can solve all the problems which accompany the insolvency. For day-to-day business operations it does not matter in what legal, technical form funds are provided, as long as they are provided. A parental loan can especially provide the working capital so badly needed in most cases and therby secure the subsidiary's liquidity. Since the corporation can now meet its due obligations it can stay in business. Although technically insolvent, as long as nobody looks at the balance sheet -- and most do not -- the firm creates an impression of soundness. That was, e.g., the case in ITT v. Holton. The problem is that when other business entities extend new credit to the subsidiary they will not get what they expect. Since the corporation's liabilities exceed its assets, the newly created liability will not be matched by an equivalent share of assets. If we were to accept the parent's advance as a loan, the new creditor's satisfaction prospects, i.e. the liquidation rate upon bankruptcy, would be less than 100%. A risk has be shifted to them that they did not want to bear. (83) Since the parent is responsible for creating the appearance of a sound business which the creditors relied upon, it may justifiably be estopped from asserting the quality of its advance as a loan. The parent wanted the subsidiary to stay in business and that could be achieved legally only by a supply of fresh equity; thus, its advance should be treated as such although it was given in the guise of a loan.

Equity insolvency (84) means that the debtor cannot liquidate its assets on time to pay the debts. The due dates of assets and liabilities do not correspond. At the same time, the debtor is not able to obtain external credit to overcome this deadlock. The problem can be overcome by an advance of fresh cash through a parental loan. Potential new creditors are now being deceived about the subsidiary's liquidity and they may extend credit when with complete and correct information about the parent's financing they would not have done so. A new creditor's satisfaction prospects will be impaired when the loan is withdrawn: even if there are sufficient assets to satisfy all obligations upon liquidation, the corporation lacks the liquidity to pay him in the ordinary course of business -- and satisfaction in bankruptcy (liquidation values!) is doubtful. The creditor bargained for the prospect of payment when his claim comes due, instead of being put off. In order not to disappoint him, we should first preclude the parent from withdrawing the loan as long as the withdrawal would render the subsidiary illiquid again. Next, when the initial equity insolvency leads eventually to bankruptcy and the liquidation does not yield enough money to fully satisfy all creditors, we should not allow the parent to share as a creditor: again, its loan should be subordinated.

Thus, the summary of the suggestion made here is that whenever the subsidiary lacks the ability to pay all its obligations, parental loans which served to overcome insolvency should be treated as equity and subordinated to the claims of other outside creditors. Not only new creditors (those that become creditors after advance of the parental loan), but also old creditors (those that become creditors before advance of the loan) should be protected because their satisfaction prospects may have been further impaired by the addition of new creditors. The approach suggested here can cope with cases of subsequent as well as of initial insolvency, i.e. when operation of the business was secured only by parental loans from the beginning. (85) One should note that in the liability model suggested here it is ultimately the outside creditors themselves, that is, the group in whose interest and to whose protection an adequate capital is required, who decide when such adequacy exists. The subsidiary's insolvency is proof for the loss of credit, that is, the creditors' unwillingness to extend anymore new loans to it. However, this unwillingness can as a rule be overcome by an advance of fresh equity through the shareholders which is synonymous with a better capitalization. The loss of credit, showing that the outside creditors do not any longer want to assume the risk of doing business with the subsidiary, can therefore be interpreted as their estimation that the subsidiary is without advance of fresh equity undercapitalized. The approach suggested here is again based on common law principles, namely of estoppel and the protection of reliance. The parent is not allowed to shift a risk to outside creditors which those do not want to bear. Again, the assumption that disregard is something basically different from principles applicable under common law turns out to be fragile. A look back at the cases shows that our concept can cope with the problems presented there. That goes without saying for the ITT and the Costello cases. In a factual situation as presented by Arnold v. Phillips we should ask whether the long-term investment of all equity has left the corporation illiquid.

c) Parental Loan Financing and Direct Liability

The question remains whether the advancement of loans can also affect the parent's direct liability to the subsidiary's creditors outside bankruptcy. In fact, some court opinions could be read that way. (86)

When loans are given to overcome insolvency, we have suggested prohibiting the withdrawal of such loans before that aim was reached. As long as the subsidiary's problems have not been resolved these funds should be left with the subsidiary in order not to disappoint the reliance of creditors. If in such a situation a loan has actually been paid back, the claim to its return belongs primarily to the subsidiary and its estate, respectively. This form of parental liability hence bears resemblance to the insider liability for received preferences under sec. 547 (b) of the Bankruptcy Code. In fact, it seems applicable in just the same situations.

With that exception, however, it is not justifiable to base direct parental liability upon the extension of loans. If parental loans are disguised equity, they can be subordinated to the claims of the outside creditors. If they are actually subordinated, their value is lost for the parent. There is a corresponding benefit for the other creditors since their satisfaction prospects (their distributional share) against the subsidiary or the estate increase accordingly. It would not be justified to let parental lending further lead to the parent's direct liability while the money advanced as loan has already been lost. Therefore, parental loans which have not been withdrawn should not serve as a basis for direct liability.

To be sure, some courts have mentioned parental loan financing as a factor to be taken into account when deciding direct liability cases. (87) However, their reason does not seem to be judicial concern that equitable subordination alone does not sufficiently protect outside creditors against the potential dangers of loan financing. Rather, the courts appear to regard parental loans as evidence that the subsidiary is not sufficiently independent from the parent and/or that there is a high number of intercompany transfers, potentially indicating commingling.

For the first point, our suggestion has been that domination as such is hardly a suitable basis for parental liability. With regard to intercompany transfers, one should realize that it is upstream transfers from subsidiary to parent which are potentially dangerous. Parental loans, however, are downstream transfers which provide funds for the subsidiary. The problem here is not to protect outside creditors against potential dangers resulting from the giving of those funds, but making sure that they cannot be arbitrarily withdrawn after the creditors have relied upon them. That latter task, however, is already fulfilled by equitable subordination of the parent's repayment claim in bankruptcy. Consequently, there is no need for direct parental liability here.

The same considerations apply to what I would call hidden parental loans. By this I mean cases where the parent corporation does not directly advance funds to the subsidiary, but otherwise bears its business expenses. The parent may pay the subsidiary's employees, pay its invoices, or allow it to use property free of charge: these too are all downstream transfers from parent to subsidiary. Proper accounting would identify such transfers as disguised loans. If an insolvency is veiled by the use of such means, the same consequences should apply as for parental loans. Then, they are substituting equity and therefore the parent should not be allowed to assert compensation claims in bankruptcy. Again, direct parental liability, i.e. a duty to provide additional funds after the subsidiary has been found unable to meet its obligations, cannot be based upon such methods of financing: the parent has already lost the financial equivalent of these advances when it was precluded from asserting compensation claims. (88)

d) Direct Liability

The remaining cases where the inadequate capitalization concept is potentially applicable, are those where the subsidiary's total assets are not sufficient to satisfy a creditor, no matter how structured. Relief for the outside creditors can be achieved here only by holding the parent directly liable for the subsidiary's debts. If we assume that the parent's only fault in incorporating and financing the subsidiary is that it endowed the business with insufficient capital, that is, that all necessary formalities have been observed, that no commingling occurred and the parent is also not liable for misrepresentation, fraudulent conveyance, tort or upon agency, these cases seem to arise in practice as tort rather than contract cases.

Possibly, the ability of a contract creditor to estimate the prospects of a business he starts dealing with is not bad as long as he is not deceived by mingling of assets, misrepresentation or by substituting loans for required equity. Maybe we can assume that an incorporator whose only fault is that he endows his business with insufficient capital, will not get if off the ground - and if it really flies for some time, this may be proof that the business actually had sufficient funds available, even if provided as disguised equity or other veiled parental support. Furthermore, in a contract action based solely upon inadequate capitalization, it seems justified to leave the loss with the creditor. He was free to enter into the deal or to leave it; he got what he had bargained for. He had to watch out for himself and his ability to do so was impaired by no deceptive means, neither the parent's nor the subsidiary's. (89)

The typical tort parental liability/piercing case seems arises when the subsidiary's business includes activities which are inherently dangerous. (90) Two differently decided cases still center the discussion and, even though they do not concern the liability of parent corporations but individual shareholders, they are instructive enough to be briefly mentioned.

Minton v. Cavaney (91) has been regarded the case most expressly in favor of piercing the veil for mere inadequate capitalization. (91) The plaintiff's daughter drowned in a swimming pool operated by a corporation which had never issued stock. The only corporate asset was the lease to the pool. The court held one of the directors and assigned shareholders liable for a $10,000 judgement against the corporation. It reasoned that the equitable owners of a corporation are personally liable "when they treat the assets of the corporation as their own and add or withdraw capital form the corporation at will..., when they hold themselves out as being personally liable for the debts of the corporation..., or when they provide inadequate capitalization and actively participate in the conduct of corporate affairs."

The first two elements of this three-pronged liability standard reflect the commingling approach and liability because of misrepresentation respectively. The third element does not base liability solely on undercapitalization, but also requires active shareholder participation in the corporate managment. This resembles the domination concept the inconsistencies of which we discussed earlier. The court regrettably did not comment on the failure to issue stock and especially did not discuss whether, because of that failure, a corporation never came into existence in the first place. (93)

In Walkovsky v. Carlton (94) the plaintiff had been injured by a cab of a taxi corporation. The corporation operated two cabs both carrying only the minimum insurance of $10,000. The shareholder of the corporation also held the stock in nine other corporations, all organized in the same pattern. The court dismissed the complaint, reasoning that shareholders may be held liable when they conduct business in their individual capacity and not merely when the assets of the corporation are insufficient to assure a creditor's recovery. It ruled that taking only the minimum insurance even where inadequate is not fraudulent so long as allowed by legislative statute. Under the Walkovsky-holding, to pierce the veil is hence crucial whether the business was conducted in the shareholders' rather than in the corporations capacity. The meaning of that standard is not clear. It can embrace domination, commingling and formalities concepts as well as other bases of liability. In any case, however, Walkovsky appears to be a square rejection of the adequate capitalization approach. (95)

The quite representative Minton and Walkovsky cases show not only that the case law is not uniform on the issue of the importance of the capitalization factor. What is more, while expressing opposing views the cases again do not clearly announce the reasons for their respective holdings or the applied standards. We should start our own analysis of the interaction between tort liability and capitalization by recalling the distinctions between tort and contract cases. The situation where a tort creditor wants to hold the parent liable is characterized by the fact that no previous connection existed between the creditor and the debtor. The tort victim became a creditor involuntarily. There is no reliance which must be protected and on which liability could be based. (96)

Both in contract and tort cases, the creditor's loss results from the business activities of the corporation: a part of the corporation's risk of doing business is shifted to the creditors. In a tort case, this is done not only against the victim's will but also without that he could have anticipated it or taken precautions. The tort victim has, as a rule, no chance to avoid the shifting of the loss. It is apparently this peculiarity of tort cases which has led to the suggestion that the principle of limited liability should be abandoned at large with regard to torts. (97) In view of the background of spectacular cases where a serious loss to the victim, especially in personal injury cases, obviously contrasted with the wealth of the stockholders or parent of the corporate tort feasor who/which benefited from the corporation this may initially sound reasonable.

However, the demand to abandon the principle of limited liability with regard to torts thoroughly mistakes that very principle. It is for the sake of certain social advantages, among them the encouragment of investment, that limited liability insulates investors from uncalculable risks. One of those risks against which protection is needed is indeed tort liability. We should assume that behind the general acceptance of this idea is a policy judgment that applies with regard to torts as well the social benefits of incorporation and limited liability outweigh the social cost or the harm to individuals. Rather than abandoning limited liability at large, we should inquire whether we can determine a level of capitalization which serves both the need of adequate protection of tort creditors and the efficient allocation of resources.

(a) Adequate Capitalization: Ability to Meet Expected Costs

It seems useful to determine the meaning of a certain capitalization level and what the effects of a more substantial capitalization could be at best. Imagine (98) a cab company which operates two cabs, each of a book value of $5,000 and carrying only the statutory minimum liability insurance of $10,000. All of the cab corporation's stock shall be held by a holding corporation which has nine more subsidiaries of that kind.

In our model world, just like in the real one, various kinds of accidents occur: small, medium, serious ones. Each accident is characterized by the damage it causes and the frequency, that is, likelihood it will occur. We may assume that small accidents occur more often than serious ones. If we multiply for each conceivable accident the probability of its occurrence and the magnitude of the harm caused, and then add the results, we can calculate the expected accident costs of the corporation for one year: we so estimate a certain cost of the corporation's doing business. In our example the expected accident cost for each cab shall be $1,000 a year. In contrast we may assume that a serious accident will cause $100,000 worth of damage and occur at a probability of 0.1%, its expected accident costs are $100 (which amount hence contributes a tenth to our total expected costs of $1,000 in a given year).

What would be an adequate capitalization for our hypothetical corporation? Obviously it seems not feasible to require the corporation's financial endowment to be sufficient to pay the damages of the conceivable serious accident. It then would have to own free assets of $100,000 -- just to operate two cabs. That would be a waste of resources and bar an enormous number of possible competitors from entry into the market. As a consequence, the price of the commodity to the public would increase. If we, alternatively, demanded that the corporation must be sufficiently capitalized to meet the cost of an accident that will occur with a certain degree of likelihood, we would have to draw an arbitrary borderline between accidents the corporation must be able to pay for and those for which it is not responsible. To develop a generally accepted reasonable standard would be extremely difficult if not impossible since the low probability that a certain accident will occur (speaking in favor of excluding it from the range of accidents for which the corporation must be able to pay) would be contrasted by the greater damage it causes to the victim (speaking in favor of including it). A third possibility would be to hold the corporation sufficiently capitalized if it can bear the expected accident costs in a given year. The expected accident costs in our example were $1,000 per cab per year. Our corporation disposes of sufficient equity to cover that amount. However, the $1,000 figure represents only an average expectation. When the $100,000 accident, which is not frequent but possible, actually realizes, the corporation could not pay the damage, even upon liquidation. Nevertheless the expected accident cost standard appears not only the most easily applicable, but also the most efficient. That becomes clear if we recall the traditional capitalization standard mentioned earlier that the corporate capital must be sufficient to meet the reasonably predictable cost of the business involved.

Ability to meet reasonably predictable costs and ability to meet the expected accident costs as calculated supra mean basically the same thing: the figure of the expected accident costs is estimated upon a prediction of which and how many accidents will occur in a given time period. What is more, if we look at a long enough time period, the expected and actual accident costs are also likely to match. For an infinite time period, it is true to say that a corporation which can provide an amount equal to the expected accident costs figure can bear all actual accident costs of its doing business.

The problem, however, is that the accuracy of our estimation of accidents lessens the shorter the time period is we examine. In the short run, e.g. if we look at a given year, substantial differences between actual and expected costs will not be unusual.

Consequently, a corporation which may be sufficiently capitalized to put up an amount equal to the expected costs, may not be able to bear the cost of an actual accident if one of the greater risks has realized. And that may be true even for the corporation which is able to put up such amount in any given year and thus provides in the long run an amount sufficient to bear the costs of any conceivable accident.

However, the fact that the corporation can in any given year provide an amount sufficient to meet the expected costs of that year, indicates its general ability to meet the reasonably predictable costs of the business, even if the realization of a great risk in a given year may exceed its funds. I would therefore call such corporation adequately capitalized. A higher capitalization would be a waste of resources -- especially if one takes into account that in many tort cases also a capitalization substantially better than the actual would not have been strong enough to help the victim. Under such standard many famous tort liability cases do not present capitalization issues any more: the corporations seemed still viable enough to put up the expected accident costs.

(b) An Alternative: Liability Insurance

By now, it should not be difficult to realize that there is a more efficient solution to our problem, guaranteeing tort victims full compensation at no increased costs for the corporation: this solution is not a certain capitalization level, but liability insurance. (99) It would pay even the highest accident cost for an amount which would exceed the expected accident cost only by a slight charge for administrative costs including a fair profit for the insurance company. Under such liability insurance the amount a corporation is supposed to be able to provide for expected accident costs would be used to pay the insurance premium.

If such an insurance is not made mandatory by statute, the question arises whether the direct personal liability of the stockholders of the parent could serve as a leverage to pressure the corporation to obtain sufficient insurance "voluntarily". it is conceivable that the otherwise imminent personal liability could serve such purpose -- but is it justified?

If we would require a corporation to carry insurance we would do that because some of its business activities are inherently dangerous. However, the inherently dangerous nature of certain activities does not depend on whether a business is operated on a corporate or an individual basis. Participating in automobile traffic is a good example: corporation operated automobiles are not more dangerous than those operated by individual proprietors or partnerships. If we demand liability insurance only for the incorporated business we create a competitive disadvantage. We would discrimate against an organizational form of doing business which we generally welcome since it supposedly encourages investment.

Such discrimination would be nevertheless justified, if the creditor of a sole proprietor or of a partnership needs, on principle, less protection than the creditor of a corporation. At first sight, the unlimited liability of sole proprietors or partnerships seems to speak in favor of such an assumption. However, that unlimited liability does not mean by itself that a tort victim receives a better compensation than he could expect from an incorporated business. The limit up to which the corporation can compensate him is determined by its assets. Just the same is true for an individual: he also can give away only what he has. If his assets are exhausted he is indeed still liable for the rest of the debt not paid. But that does not help the creditor very much. The debtor can even file for bankruptcy and will then as a rule be discharged from further liability. (100) That means especially that his future earnings are protected: the creditor cannot look for them for satisfaction of the outstanding debt. Put figuratively, in a legal system which allows the discharge of debts (the "free start") everybody doing business operates under limited liability, whether acting in personal or corporate capacity. The bankruptcy law does not make an exception from the discharge principle where a sole proprietor engaged in business activities for which he was not sufficiently capitalized.

If the compensation prospects of a corporate creditor are not principally worse than those of a creditor of a business operated in an individual capacity, the idea of using the possibility of piercing the veil as a leverage to press for voluntary insurance or even better capitalization is not justified. We would unfairly discriminate against corporate business and thereby impair its general advantages. (101)

(c) Liability Because of "Misuse" of the Corporate Form?

A final issue, derived from the New York taxi cab fleet cases, remains to be discussed. There, courts have called it an attempt to defraud the public when a parent or sole stockholder operated a business using several corporations/subsidiaries where economically only one was needed. (102) Accordingly, in our hypothetical we could ask whether the parent is to be blamed or establishing ten subsidiaries with two cabs each instead of one subsidiary with twenty cabs. The question is whether incorporators misuse the corporate form by splitting a business in several legally separate units. (103)

Conceivably, a bigger corporation is in a better position to cope with comparatively high tort costs. However, that does not necessarily mean that such corporation is better capitalized, as some courts seem to assume. (104) If we take a closer look, we soon realize that, for instance, a corporation with twenty cabs is not better capitalized than a corporation with only two cabs. True, the former owns ten times more assets than the latter, but on the other hand the risk from its business operations is increased by the same factor. The satisfaction prospects of a tort creditor are in general not better here: what he wins because of the additional assets, he loses because of the competition of more creditors for those assets. Furthermore, none of the ten constituent subsidiaries is a greater danger to a potential tort victim than a two-cab-business operated by a sole proprietor. The insulation of business risks through the use of several subsidiaries should hence not be regarded as a misuse of the corporate form.

D. Summary

The parent corporation's liability to its subsidiary's creditors and the equitable subordination of its claims in bankruptcy is commonly understood as a question of disregard of the corporate entity. This paper has attempted to show that if necessary the parent can be held liable on the subsidiary's obligations and be precluded from sharing as its creditor even under recognition of distinct entities; just by the use of generally applicable common law principles. The difference between corporate and noncorporate based liability has turned out not as essential as it seems at first sight.

The prevailing tendency to approach parent liability issues in terms of the subsidiary's separatness versus its domination by the parent has turned out to be unworkable. The concept developed here parts with the domination idea. It suggests that the subsidiary's creditors are protected best when the parent cannot arbitrarily deprive the subsidiary of the funds which were used for the operation of its business and the availability of which the creditors relied upon.

Thus, if the financial spheres of the affiliates were commingled and if the subsidiary is left judgement-proof at the time of the creditor's action, we should assume prima facie that upstream transfers from subsidiary to parent have occurred for which the subsidiary received no consideration. The parent should be allowed to escape liability only when it proves by providing proper accounting that it does not owe the subsidiary anything. In case of the parent's financing of the subsidiary, that is, in case of downstream transfers, the parent should be estopped from withdrawing funds so provided or asserting compensation claims (equitable subordination), if those funds served to overcome or conceal the subsidiary's insolvency and thus rendered the subsidiary a creditor trap. In both cases, parent liability would not follow from special corporate law principles but from generally applicable common law principles.

If we make sure that those funds which were used to operate the subsidiary's business are available for the creditors' satisfaction, the importance of adequate capitalization concepts becomes rather small and limited to tort cases. The really interesting issue is, as a rule, not one of the proportion of the corporate assets constituting shareholder (parent's) equity, but one of the adequacy of the total assets, that is, the size of the subsidiary's business. The problem that entities with insufficient financial endowment engage in potentially dangerous activities, is not special to corporations. Since the danger is in the first place not created by the corporate form, it is not corporate law from which relief has to come. The appropriate and efficient protection of tort creditors would be sufficient liability insurance, prescribed by statute, applying to any business which pursues such dangerous activity, no matter in which legal form it is operated.

NOTES

(*) Rechtsanwalt (Member of the German Bar); Studies in Law and Economics, Rheinische Friedrich-Wilhelms-Universitaet Bonn (Grad. 1981); LL.M. University of Michigan (1985); 1985-6 Research Scholar at the European University Institute, Florence. The author wishes to acknowledge his gratitude to Alfred F. Conard, Henry M. Butzel-Professor of Law at the University of Michigan Law School, for his comments on an earlier draft of this paper.

(1) Cf. Model Business Corporations Act, sec. 25: "A holder of or a subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the obligation to pay to the corporation the full consideration for which such shares were issued or to be issued..." As to the stockholders' limited liability see generally A. Conard, Corporations in Perspective (1976), sec. 270, p. 424; H. Henn and J. Alexander, Laws of Corporations and Other Business Enterprises (3th ed. 1983), sec. 73, p. 130, and sec. 202, p. 546

(2) A corporation may set up or adopt a subsidiary rather than create or maintain a division of itself for a variety of reasons. Besides the wish for limited liability, it may do so in order to obtain tax advantages, to avoid the necessity of qualifying as a foreign corporation in another state, to ensure administrative ease and an efficient managment structure in a multi-line business, or to take over other companies by an easier means than merging or consolidating, cf. generally J. Bradley, Fundamentals of Corporation Finance 472 subsequ. (1953); A. Dewing, The Financial Policy of Corporations 980-87 (5th ed. 1953); F. Donaldson/K. Pfahl/P. Mullins, Corporate Finance 595 (4th ed. 1975); Cataldo, Limited Liability with One Man Companies and Subsidiary Corporations, 18 Law and Contemp. Probs. 473 (1953); Douglas and Shank; Insulation from Liability through Subsidiary Corporations, 39 Yale L.J. 193 (1929): Landers; A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy, 42 U.Chi.L.Rev. 589 (1975)

(3) For the development of the piercing terminology, see Conard, supra note (1), sec. 271, p. 425

(4) cf. Henn/Alexander, supra note (1), sec. 152, p. 369: Herzog/ Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand.L.Rev. 83 (1961); that piercing the corporate veil and equitable subordination are related concepts has been recently emphasized by Landers, supra note (2), and Clark, The Duties of the Corporate Debtor to its Creditor, 90 Harv.L.Rev. 505 (1977)

(5) Different from other countries, the legal discussion in the U.S. has never distinguished between individual and corporate stockholders and hence not developed a special set of liability

rules for corporate conglomerates. Liability issues concerning a multi-corporate conglomerate being engaged in world-wide business and multi-billion dollar transactions are basically decided upon the same legal principles as those concerning one man-corporations. Something like the German "Konzernrecht" (law of multi-corporate conglomerates), for instance, is unknown in the American legal system, cf. Conard, supra note (1), sec. 48, p. 82.

(6) McKinney's N.Y.Bus.Corp.Law. sec. 630; Wisc.Bus.Corp.Law sec. 180.40(6)

(7) Cf. recently DeNatale/Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagment Creditors, 40 Bus.Ly. 417 (1985)

(8) As classics deserve mentioning: United States v. Milwaukee Refrigerator Transit Co. 142 F.2d 247 (C.C.E.D.Wisc. 1905); Berkey v. Third Avenue Railroad Co., 244 N.Y. 84, 155 N.E. 58, 217 N.Y.S. 156 (1926); Lowendahl v. Baltimore & Ohio R.R., 247 App.Div. 144, 287 N.Y.S. 62, aff'd 272 N.Y. 360, 6 N.E. 56; Taylor v. Standard Gas & Electric Co., 306 U.S. 307, 59 S.Ct.543, 83 L.Ed. 669 (1939) -Deep Rock-case-; Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); Walkovsky v. Carlton 18 N.Y.2d 414, 223 N.E.2d 6; 276 N.Y.S.2d 585 (1966)

9) Well known are the treatises by E. Latty, Subsidiaries and Affiliated Corporations (1936) and by F. Powell, Parent and Subsidiary Corporations (1931), and the articles by Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 Cal.L.Rev.12 (1925); Berle, The Theory of Enterprise Entity, 47 Colum.L.Rev. 342 (1947); Cataldo, supra note 2, Douglas/Shank, supra note 2; Latty, The Corporate Entity as a Solvent of Legal Problems, 34 Mich.L.Rev. 597 (1936); new approaches to the problem have been more recently sought by Landers, supra note 2, 42 U.Chi.L.Rev. 589 (1975); Landers, Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy, 43 U.Chi.L.Rev. 527 (1976); Posner, The Legal Rights of Creditors of Affiliated Corporations: An Economic Approach, 43 U.Chi.L.Rev. 499 (1976); Posner, Economic Analysis of Law 289 (2d ed. 1977); Clark, supra note 4, 90 Harv.L.Rev. 505 (1977); most recently Easterbrook/Fischel, Limited Liability and the Corporation, 52 U.Chi.L.Rev. 89 (1985)

10) United States v. Milwaukee Refrigerator Transit Co., supra note 8; similar International Aircraft Trading Co. v. Manufacturers Rust Co., 297 N.Y. 285, 292, 72 N.E.2d 249, 252

11) Cf. the listings of the used metaphors provided by Henn/Alexander, supra note 1, sec. 146, p. 344 note 2

12) See Fletcher Cyc. Corp. sec. 41.10 and 43.10

13) Cf. Automotriz del Golfo de California v. Resnick, 47 Cal.2d 792, 796; 306 P.2d 1, 3; Minton v. Cavaney, 56 Cal.2d 549, 364

p.2d 473, 15 Cal.Rpt. 641 (1961); Gentry v. Credit Plan Corporation of Houston, 528 S.W.2d 571

14) E.g. In re Wątertown Paper Co. 169 F.2d 252 (2d Cir. 1909); Lowendahl v. Baltimore & Ohio R.R., supra note 8; Berger v. Columbia Broadcasting System, Inc., 453 F.2d 991 (1972)

15) Under both the alter ego and the instrumentality approaches the courts may, before they pierce the veil, additionally require that the recognition of separate corporateness would promote fraud or injustice, e.g. Automotriz del Golfo de California v. Resnick, supra note 13; Minton v. Cavaney, supra note 13. That element may often have the sole purpose of keeping the standard and its formulation open to any case which in the courts opinion belongs under it, cf. Edwards v. Monogram Industries, Inc., 730 F.2d 977 (1984); McKibben v. Mohawk Oil Company, Ltd., 667 P.2d 1223 (Alaska 1983): Vantage View, Inc. v. Bali East Development Corp., Fla.App. 421 So.2d 728; Note, Liability of a Corporation for Acts of a Subsidiary or Affiliate, 71 Harv.L.Rev. 1122, 1125-6 (1958)

16) Cf. Cruttenden v. Mantura, 640 P.2d 932 (N.M. 1982); Vantage View v. Bali East Development, supra note 15; DeWitt Truck Brothers v. W.Ray Flemming Fruit Co., 540 F.2d 681 (1976)

17) see Cruttenden v. Mantura, supra note 16; DeWitt Truck Brothers v. Ray Flemming Fruit Co., supra note 16; Baker v. Raymond International, Inc., 656 F.2d 173 (1981); Nelson v. International Paint Company, Inc., 734 F.2d 1084 (1984); Herman v. Mobile Homes Corp., 26 N.W.2d 757 (Mich.)

18) see supra note 16

19) cf. Baker v. Raymond International, Inc., supra note 17, at 179; Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985) at 109, speak of the arbitrariness of the tests.

20) In Berkey v. Third Avenue Railroad Co., supra note 8 at 61; Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985) have recently counted the area of piercing the veil among the most confusing in corporate law.

21) Cf. Automotriz del Golfo de California v. Resnick, supra note 13, at 3; Herman v. Mobile Homes Corporation, supra note 17 ("...each case is sui generis and must be decided in accordance with its own underlying facts."); Fish v. East, 114 F.2d 177, 191; Brunswick Corp. v. Waxman, 459 F.Supp. 1222; Baker v. Raymond International, Inc., supra note 17, at 179; Krivo Industries Supply Co. v. National Distiller & Chemical Corporation 483 F.2d 1098, 1103

22) See for instance, Latty, supra note 9, 77-109; Note, supra note (15), 71 Harv.L.Rev. 1122 (1958)

23) Purporting to base liability on this ground: Japan Petroleum Co. (Nigeria Ltd.) v. Ashalnd Oil Co., 456 F.Supp.831 (D.C. Del. 1978); Elvasons v. Industrial Covers, Inc. 269 Or. 441, 525 P.2d 105; Hanson Southwest Corp. v. Dal-Mac. Construction Co., 554 S.W.2d 712 (Tex.App. 1977); Soderberg Advertising, Inc. v. Kant-Moore Corp., 11 Wash.App. 721, 524 P.2d 1355

24) Cf. Latty, supra note 9, at 93, 96; Powell, supra note 9, at 63, 66; Hollander v. Henry, 186 F.2d 582 (2d Cir.), cert.den., 341 U.S. 949 (1951); Soderberg Advertising, Inc. v. Kant-Moore Group, supra note 23; Marr v. Postal Union Life Ins. Co., 46 Cal.App.2d 673, 105 P.2d 649; Pagel, Horton & Co. v. Harmon Paper Co., 236 App.Div. 47; 258 N.Y.S. 168; Wagner v. Manufacturers' Trust Co., 237App.Div. 175, 261 N.Y.S. 136, aff'd 261 N.Y. 699, 185 N.E. 799

25) See Fleming v. Philadelphia Co., 234 Pa. 74, 82 Atl. 1095 (1912): Chicago Economic Fuel Gas Co. v. Myers, 168 Ill. 139, 144, 48 N.E. 66, 68 (1897); Rapid Transit Subway Const. Co. v. City of New York, 259 N.Y. 472, 182 N.E.145; cf. generally Latty, supra note xx, at 78

26) See Uniform Fraudulent Conveyance Act; Bankruptcy Code, 11 U.S.C. sec. 548; a description of the relationship between disregard of the corporate entitiy and fraudulent conveyance law is provided by Clark, supra note 4

27) See Securities Act of 1933, sec. 15 (15 U.S.C. sec. 77); Securities Exchange Act of 1934, sec. 20 (15 U.S.C. sec. 78)

28) Cf. Gladhill v. Fisher & Co., 272 Mich. 353, 370-2, 262 N.W. 371, 377 (1935): Rapid Transit Subway Co. v. City of New York, supra note 25; Amfac Foods, Inc. v. International Systems & Control Corporation, 520 Or.App. 907, 630 P.2d 868

29) See Restatement 2d, Agency sec. 1 (1958); H. Reuschlein/W. Gregory, Handbook of the Law of Agency and Partnership, sec. 2, p. 3 (1979)

30) Cf. Kingston Dry Dock Co. v. Lake Champlain Transportation, 31 F.2d 265, 267 (2d Cir. 1929 through Learned hand): Lowendahl v. Baltimore & Ohio Railroad Co., see supra note 8; see generally Powell, supra note 9, at 89

31) E.g. Amfac Foods, Inc. v. International Systems& Control Corporation, supra note 28; Rapid Transit Subway Construction Co. v. City of New York, supra note 25; Herman v. Mobile Homes Corporation, supra note 17

32) See Clark, supra note 4, 90 Harv.L.Rev. 505 (1977)

33) See Latty, supra note 9, 34 Mich.L.Rev. 597 (1936)

34) See e.g. Lowendahl v. Baltimore & Ohio R.R., supra note 8; Tennessee Consolidated Coal Co. v. Home Ice & Coal Co., 25

Tenn.App. 316, 156 S.W.2d 454, 458; Herman v. Mobile Homes Corp., supra note 17, at 762; International Telephone and Telegraph Corporation v. Holton, 247 F.2d 1789, 183

35) see supra note 8, at 76

36) Also, in cases employing an alter ego terminology the assumption of domination has been used to prove the subsidiary's loss of individuality, cf. e.g. Vantage View, Inc. v. Bali East Development Corporation, supra note 15

37) So Krivo Industries Supply Co. v. National Distiller & Chemical Corp., supra note 21, at 1106; accord: Baker v. Raymond International, supra note 17

38) Cf. Lowendahl v. Baltimore & Ohio R.R., supra note 8; Krivo Industries Supply Co. v. National Distoiller & Chemical Corporation, supra note 21

39) The fact of stock-ownership and interlocking directors and officers has always been included as criteria in the checklists for parental liability provided by the courts in Baker v. Raymond International, supra note 17; McKibben v. Mohawk Oil Co., Ltd. supra note 15, at 1230; also cf. the listings given by Powell, supra note 9, at 9; Ballantine, 14 Cal.L.Rev. 12, 18 (1925): Krendl/Krendl, Piercing the Corporate Veil; Focusing the Inquiry, 55 Denv.L.J. 1 (1978)

40) See Berkey v. Third Avenue Railroad, supra note 8, at 58-9; Kingston Dry Dock Co. v. Lake Champlain Transporation Co., supra note 30; Lowendahl v. Baltimore & Ohio R.R., supra note 8; Berger v. Columbia Broadcasting System, Inc., supra note 14; Baker v. Raymond International, supra note 17; Nelson v. International Paint Co., supra note 17

41) Cf. Model Business Corporation Act, sec. 4; " Each corporation shall have the power: ... (9) to purchase, take, receive, subscribe for or otherwise acquire, owe, hold, vote, use, employ, sell, mortgage, lend, pledge or otherwise dispose, and otherwise use and deal in and with shares or other interests in, or obligations of, other domestic or foreign corporations...'; see generally Henn/Alexander, supra note 1, sec. 183, p. 473

42) Only Landers, supra note 2, 42 U.Chi.L.Rev. 589 (1975), has suggested to make an exception for multicorporate conglomerates, cf. the discussion infra note 77.

43) Cf. Conard, supra note 1, sec. 188, p. 319; Henn/Alexander, supra note 1, sec. 188, p. 490

44) Cf. Donahue v. Rodd Electrotype Co., 367 Mass. 578. 586; 328 N.E.2d 505, 511 (1975); see Henn/Alexander, supra note 1, sec. 257, p. 694

45) E.g. Model Business Corporation Act, sec. 53; Del.G.l.l. sec. 101; see also the leading English case to the point, Salomon v. Salomon & Co. (1897) A.C.22; cf. generally Henn/Alexander, supra note 1, sec. 258, p. 697

46) In Kingston v. Dry Dock Co. v. Lake Champlain Transportation Co., supra note 30

47) Cf. Conard, supra note 1, sec. 273, p. 428

48) supra note 8, at 61, citing Ballantine, supra note 39, 14 Cal.L.Rev. 12 (1925)

49) E.g. Edwards v. Monogram Industries, Inc., supra note 15, E.C.A. Environmental Managment Services, Inc. v. Toenyes, 679 P.2d 213 (Mont 1984), Williams Plaza, Inc. v. Sedgefield Sportswear Division of Blue Bell, Inc., Ga.App. 297 S.E.2d 342

50) For examples for the handling of the commingling factor in the case law see: Ampex Corporation v. Office Electronics, Inc., 21 Ill.App.3d 21, 32o N.E.2d 486 (1974); Zaist v. Olson, 154 Conn. 563, 227 A.2d 552 (1967): Minton v. Cavaney, supra note 13; Baker v. Raymond International, supra note 17; McKibben v. Mohawk Oil Co., Ltd., supra note 15; E.C.A. Environmental Managment Services, Inc. v. Toenyes, supra note 49; Nelson v. International Paint Co., Inc. supra note 17

51) Cf. Automotriz del Golfo de California v. Restrick, supra note 13; Giuffra v. Red River Barge Lines, Inc., 452 So.2d 793 (La.App. 4. Cir. 1984), Edwards Co. v. Monogram Industries, Inc. supra note 15; E.C.A. Environmental Managment Services, Inc. v. Toenyes, supra note 49

52) Cf. the different outcome of Edwards Co. v. Monogram Industries, Inc., supra note 15, and E.C.A. Environmental Managment Services, Inc. v. Toenyes, supra note 49

53) Supra note 15

54) Cf. supra p. 13

55) Similar factual circumstances as in Edwards were presented in Williams Plaza, Inc. v. Sedgefield Sportswear Division of Blue Bell, Inc., supra note 49. Again, a supplier sued the parent on an outstanding debt of the subsidiary. The court entered judgment in favor of the defendant since the companies had maintained different books, no funds had been commingled and there was no evidence that the parent had "milked" the subsidiary. Cf. also E.C.A. Environmental Managment Services, Inc. v. Toenyes, supra note 49

57) See Uniform Fraudulent Conveyance Act; Bankruptcy Code, 11 U.S.C. sec. 548; as for the underlying principles of the fraudulent conveyance law and its relationship to the disregard

concept cf. Clark, supra note 4, 90 Harv.L.Rev. 505 (1977), at 507-17

58) See DeWitt Truck Brothers v. W. Ray Flemming Fruit Co., supra note 16, at 686, 688; Baker v. Raymond International, Inc., supra note 17; Edwards Co., Inc. v. Monogram Industries, Inc., supra note 15, at 986; E.C.A. Environmental Managment Services, Inc. v. Toenyes, supra note 49, at 218; Giuffra v. Red River Barge Lines, Inc., supra note 51, at 795

59) Supra note 15

60) Cf. generally Henn/Alexander, supra note 1, sec. 139, 140, p. 327

61) Cf. Automotriz del Golfo de California v. Restrick, supra note 13, at 4; Minton v. Cavaney, supra note 13, at 475; Geisenhoff v. Mabrey (1943), 58 Cal.App.2d 481, 137 P.2d 36 and Auer v. Frank (1964), 227 Cal.App.2d 396, 38 Cal.Rptr. 684; G.M. Leasing Corp. v. United States, 514 F.2d 935

62) Garden City Co. v. Burden (1951), 186 F.2d 651; Wallace v. Tulsa Yellow Cab Taxi & Baggage Co. (1936), 178 Okla. 15, 61 P.2d 645; Automotriz del Golfo de California v. Restrick, supra note 13; Walkovsky v. Carlton, supra note 8; Herman v. Mobile Homes Corporation, supra note 17; Bartte v. Home Owners Cooperative, 309 N.Y. 103, 127 N.E.2d 832 (1955); Arnold v. Phillips, 117 F.2d 497 (1941); see also Note, Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation, 45 S.Cal.L.Rev. 823 (1972); Note, Inadequately Capitalized Subsidiaries, 19 U.Chi.L.Rev. 872 (1952); Gelb, Piercing the Corporate Veil - The Untercapitalization Factor, 59 Chi.Kent L.Rev. 1 (1982)

63) See e.g. Salomon v. Salomon & Co., supra note 45; Automotriz del Golfo de California v. Restrick, supra note 13, at 4, citing Ballantine on Corporations (rev. ed. 1946); Cf. Cataldo, supra note 2, 18 Law and Contemp. Probs. 473 (1953), at 484; Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985), at 93

64) So e.g. Pepper v. Litton, supra note 8; cf. Note, supra note 15, 71 Harv.L.Rev. 122, 1126 (1958)

65) Cf. Cataldo, supra note 2, 18 Law and Contemp. Probs. 473 (1953), at 484; Note, supra note 62, 45 S.Cal.L.Rev. 823, 840 subsequ. (1972)

66) Cf. Automotriz del Golfo de California v. Restrick, supra note 13, dissenting opinion, at 6

67) Id.

68) Cf. Note, supra note 62, 45 S.Cal.L.Rev. 823 (1972), Note, supra note 62, 19 U.Chi.L.Rev. 872 (1952)

69) Cf. Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985) at 91, 112. Posner has argued that although incorporation shifts a part of the risk of the business to the creditors there is no externalization of costs because they are already compensated for, cf. Posner, 43 U.Chi.L.Rev. 499 (1976); id., supra note 9; cf. also Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985), at 105. Posner suggests that creditors, when they deal with a corporation rather than an unlimited liable individual could charge higher interest rates and prices, respectively. Under this proposition, corporation law would not alter the balance of advantages between debtor and creditor nor affect the allocation of resources. In the world of economic analysis this suggestion sounds good but there are deficiencies, which are admitted by Posner, ibid. First, there is the group of involuntary extenders of credit, that is, people who have become creditors to the corporation without wanting it. They can therefore not adjust their charges. In the lawyer's language these are the tort cases. Second, there are contractual creditors who do not or even cannot adjust the interest rates or prices they charge according to the risk they incur. To begin with, these are the cases where the information costs are to high to allow such adjustment: a trade creditor may not even know that he is dealing with a corporation and not an individual or a partnership. Next, there are cases where the creditor does not have the bargaining power to assert higher charges or to demand a personal guarantee of the performance by the stockholders or the parent corporation. To be sure, the difference from the tort cases is that here the creditor can always refuse to deal.

The assumption that incorporation does not lead to any externalities has hence to be confined to a (very) limited scope: where the creditors actually look at their debtors before dealing and enforce additional charges for increased risk. And in this form the economic analysis' finding does not contribute anything new to the piercing discussion. Courts already have a long perceived tendency to be more willing to pierce the veil in tort rather than contract cases. In the latter cases, so the argument normally runs, the plaintiff voluntarily entered into the deal and received the promise he bargained for; he is expected to watchout for himself, cf. Hanson Southwest Corp. v. Dali Mac Construction Co., (Tex.Civ.App.), 554 S.W.2d 712; see also Douglas/Shank, supra note 2. The courts' hesitation to pierce in contract cases is often illustrated by the requirement of additional factors in their liability standards. For instance, courts may find a showing of the subsidiary's existence as an instrumentality sufficient in tort cases yet requiring an additional showing of fraud or injustice in contract cases, e.g. in Edwards, supra note 15; rather clear also Gentry v. Credit Plan Corporation of Houston, 528 S.W.2d 571, 573 (1975)

70) Cf. Note, supra note 62, 45 S.Cal.L.Rev. 823, 833 subsequ. (1972); Landers, supra note 2, at 617/8; Dodd, The Evolution of Limited Liability in American Industry, 61 Harv.L.Rev. 1351 (1948); Easterbrook/Fischel, supra note 9, 52 U.Chi.L.Rev. 89 (1985), at 97

71) supra note 8

72) 117 F.2d 497

73) 247 F.2d 178

74) 256 F.2d 903

75) E.g. L & M Realty Corp. v. Leo, 249 F.2d 668 (4th Cir. 1957)

76) E.g. In Re Trimble Company, 479 F.2d 103, 116 (3rd Cir. 1973)

77) The so far generally accepted position that stockowners can in principle give loans to their corporations as any other creditors can, and that they are then entitled to the normal rights and remedies of such creditors, cf. e.g. Hill v. Dearmin, 44 Colo.App. 123, 609 P.2d 127; Williams Plaza, Inc. v. Sedgefield Sportswear Division of Blue Bell, Inc. supra note 49; Edwards Co. v. Monogram Industries, Inc., supra note 15, has been recently attacked with regard to parental lending. It has been suggested that a parent's claim against an affiliate should always be subordinated because the investment behavior of a corporate stockholder would differ from that of an individual and would expose the affiliate's creditor to greater risks than creditors of an independent corporation. This theory starts from the assumption that a corporation which is part of a multi-corporation conglomerate is run differently from an independent firm because the investors are interested in the maximmization of their overall return from the whole entity rather than in the profitability or even viability of a single constituent corporation. The danger of inadequate capitalization (as well as of commingling and of intruding in managment) of such a constituent corporation would be increased, cf. Landers, supra note 2, 42 U.Chi.L.Rev. 589 (1975); id., supra note 9, 43 U.Chi.L.Rev. 527 (1976).

The creditors' interests may indeed be especially endangered when the debtor is only a part of a larger corporate conglomerate. However, it is not only investors in such entities who are interested in the overall return of their investment but any rational investor. Any such investor is, in the first place, interested that the sum of the profits from all his investments, which may include corporate stock as well as other ventures, is maximized. And as long as this sum is actually maximized he is less concerned where the profits arise, whether in the corporation or in his other undertakings. The dangers which may result from such investment behavior are not confined to corporate conglomerates but are present wherever the investor may still have some influence on the direction of the corporate business, that is, potentially in any close corporation. As we have seen, however, the peculiarities of close corporations are inherent in the system of corporation and cannot serve to abandon the very same system of incorporation completely with regard to subsidiaries.

78) even though done in Arnold v. Phillips, supra note 72

79) See Bankruptcy Code, 11 U.S.C. sec. 101 (29); Uniform Commercial Code, sec. 1 - 201 (23); cf. generally Henn/Alexander, supra note 1, sec. 319, p. 878

80) See Uniform Commercial Code, sec. 1 - 201 (29); cf. generally Henn/Alexander, supra note 1, sec. 319, p. 878

81) see Model Business Corporation Act, sec. 97b, 102; cf. Conard, supra note 1, sec. 131, p. 236

82) see Bankruptcy Code, 11 U.S.C. sec. 303 (h) (1)

83) Cf. Judge Learned Hand's analysis in his concurring opinion, In Re V. Loewer's Gambrinus Brewery Co., (2d Cir.) 167 F.2d 318 (320)

84) At first sight, one might think that the case of mere equity insolvency is of rather theoretical interest in the context of our discussion. Where the subsidiary's assets still exceed its liabilities, there would be sufficient funds to satisfy all creditors. However, it seems unlikely, that in an eventual liquidation the real or only the book value of the assets can be realized; rather, as a matter of experience their liquidation value will not suffice to pay all creditors. Therefore, the outside creditors' interests are also endangered by a mere equity insolvency.

85) For that, International Telephone and Telegraph Corporation v. Holton, supra note 73, and Costello v. Fazio, supra note 74, are very illustrative.

One factual setting remains to be discussed. What applies when a parental loan was given to a sound subsidiary of which the financial situation changed thereafter, so that without the loan it now would be insolvent? If the business is terminated, there is no basis for liability: the loan financing was permissible when provided and the subsequent failure of the business does not change that, cf. Herzog/Zweibel, supra note 4, 15 Vand.L.Rev. 83, 95 (1961). However, when the business operations are continued and no equity capital capital is advanced, the situation is not less deceptive for outside creditors than the extension of loans after the onset of liability. Because they do not know about the situation, the outside creditors will not take appropriate measures, e.g. compel the termination of the business or the advance of new equity by the parent. The parent, on the other hand is in a much bettter position to watch out and knows about all that. If it nevertheless agrees to the continuance of the subsidiary's business operations, it is again responsible for shifting risk to the outside creditors that they do not want to bear. Again, we should therefore subordinate the parent's claim.

86) see Nelson v. International Paint Co., Inc., supra note 17; Raymond v. Baker International, Inc., supra note 17; Giuffra v. Red River Barge Lines, Inc., supra note 51; E.C.A. Environmental managment Services v. Toenyes, supra note 49

87) Id.

88) For the contribution of property cf. Luckenbach S.S.Co., Inc. v. W.R. Grace & Co., Inc., 267 F. 676 (1920); cf. Herzog/Zweibel, supra note 4, at 96. The contribution of property differs from the provision of loans in the respect that the parent remains the legal owner of the property leased to the subsidiary. The parent may have a claim for rent due, but does not have a money claim which would correspond to the whole value of the property and which could be subordinated. Since nevertheless the leased property can substitute equity, one might in such situations contemplate precluding the parent from demanding return of the property.

89) Cf. Hanson Southwest Corp. v. Dali Mac Construction Co., 554 S.W.2d 712 (Tex.Civ.App.); see Douglas/Shank, supra note 2, 39 Yale L.J. 193 (1929)

90) Cf. Minton v. Cavaney, supra note 13; Walkovsky v. Carlton, supra note 8; Wallace v. Yellow Cab Taxi & Baggage Coo., supra note 62; Mull v. Colt, 31 F.R.D. 154; Giuffra v. Red River Barge Lines, Inc., supra note 51

91) Cf. supra note 13

92) Cf. Note, supra note 62, 45 S.Cal.L.Rev. 823 (1972); Gelb, supra note 62, 59 Chi.Kent L.Rev. 1 (1982)

93) Cf. supra p. 22 subsequ.

94) Cf. supra note 8

95) A view opposite to the Walkovsky holding was taken by the court in Mull v. Colt, supra note 90. The court there called the divison of a taxi cab fleet into several corporations an attempt to defraud the public. Since the court, in addition, regarded the taxi cab corporations' capitalization as inadequate, it found sufficient cause of action to pierce the corporate veil.

96) Cf. supra p. 32 subsequ.

97) See Note, Should Shareholders Be Personally Liable for the Torts of their Corporations?, 76 Yale L.J. 1190 (1067)

98) id.

99) Cf. Bankruptcy Code, 11 U.S.C. sec. 523, 524

100) It seems also to be an incorrect assumption that a business conducted in an individual capacity causes less accidents because the owner knows and cares about his personal liability. Many accidents are caused by employees whose negligence level is not determined by their employer's legal form.

101) See Mull v. Colt, supra note 90; Teller v. Clear Service Co., 9 Misc.2d 495, 173 N.Y.S.2d 183 (1952)

102) Cf. Note, supra note 97, 76 Yale L.J. 1190 (1967)

103) Cf. Mull v. Colt, supra note 90; Teller v. Clear Service, supra note 101

EUI WORKING PAPERS

EUI Working Papers are published and distributed by the European University Institute, Florence.

Copies can be obtained free of charge -- depending on the availability of stocks -- from:

The Publications Officer
European University Institute
Badia Fiesolana
I-50016 San Domenico di Fiesole(FI)
Italy

Please use order form overleaf.

PUBLICATIONS OF THE EUROPEAN UNIVERSITY INSTITUTE

To The Publications Officer
European University Institute
Badia Fiesolana
I-50016 San Domenico di Fiesole (FI)
Italy

From Name....................................
Address....................................
....
....
....

Please send me: ☐ a complete list of EUI Working Papers
☐ the following EUI Working Paper(s):

No.:......................
Author, title:.................................
....
....
....
....

Date:...............

Signature: ....

PUBLICATIONS OF THE EUROPEAN UNIVERSITY INSTITUTE June 1986

85/191: Patrick KENIS	Industrial Restructuring The Case of the Chemical Fibre Industry in Europe *
85/192: Lucia FERRANTE	La Sessualita come Ricorsa. Donne Davanti al Foro Arcivescovile di Bologna (sec. XVII) *
85/193: Federico ROMERO	Postwar Reconversion Strategies of American and Western European Labor *
85/194: Domenico Mario NUTI	The Share Economy: Plausibility and Viability of Weitzman's Model *
85/195: Pierre DEHEZ and Jean-Paul FITOUSSI	Wage Indexation and Macroeconomic Fluctuations
85/196: Werner HILDENBRAND	A Problem in Demand Aggregation: Per Capita Demand as a Function of Per Capita expenditure
85/197: Thomas RAISER	The Theory of Enterprise Law and the Harmonization of the Rules on the Annual Accounts and on Consolidated Accounts in the European Communities*
85/198: Will BARTLETT/ Milica UVALIC	Bibliography on Labour-Managed Firms and Employee participation *
85/199: Richard T. GRIFFITHS Alan S. MILWARD	The Beyen Plan and the European Political Community
85/200: Domenico Mario NUTI	Hidden and Repressed Inflation in Soviet-type Economies: Definitions, Measurements and Stabilisation
85/201: Ernesto SCREPANTI	A model of the political-economic cycle in centrally planned economies *
85/202: Joseph H.H. WEILER	The Evolution of Mechanisms and Institutions for a European Foreign Policy: Reflections on the Interaction of Law and Politics *
85/203: Joseph H.H. WEILER	The European Court, National Courts and References for Preliminary Rulings - The Paradox of Success: A Revisionist View of Article 177 EEC. *
86/204: Bruno P. F. WANROOIJ	Progress without Change

* : Working Paper out of print

	The Ambiguities of Modernization in Fascist Italy *
86/205: Antonio MUTTI, Nicolò ADDARIO, Paolo SEGATTI	THE ORGANISATION OF BUSINESS INTERESTS The Case of the Italian Textile and Clothing Industry *
86/206: Volker DEVILLE	Bibliography on The European Monetary System and the European Currency Unit
86/207: Gunther TEUBNER	Gesellschaftsordnung durch Gesetzgebungslärm? Autopoietische Geschlossenheit als Problem fur die Rechtssetzung *
86/208: P. Nikiforos DIAMANDOUROS/ Pilar RIVILLA/ Joaquìn LOPEZ NOVO/ Huri TURSAN/ Philippe C. SCHMITTER	A Bibliographical Essay on Southern Europe and its recent Transition to Political Democracy
86/209: Renaud DEHOUSSE	E Pluribus Unum? Eléments de confédéralisme dans les relations extérieures des Etats fédéraux *
86/210: Pauline JACKSON	Industrialisation and Reproductive Rights *
86/211: Gunther TEUBNER	Hyperzyklus in Recht und Organisation: zum Verhältnis von Selbstbeobachtung, Selbstkonstitution und Autopoiese
86/212: Emil CLAASSEN and Melvyn KRAUSS	Budget Deficits and the Exchange Rate
86/213: Gunther TEUBNER	Autopoiese im Recht: Zum Verhaltnis von Evolution und Steuerung im Rechtssystem *
86/214: Albert CHILOSI	The Right to Employment Principle and Self-Market Socialism: A Historical Account and an Analytical Appraisal of some Old Ideas by Alberto Chilosi
86/215: Ruggero RANIERI	Italy and the Schuman Plan Negotiations
86/216: Diana PINTO	The Presence of an Absence:

* :Working Paper out of print

	The Ambiguity of the American Reference in the French and Italian Intellectual Renewal of the Late 1950's
86/217: Michela NACCI	Un'Immagine della modernità: L'America in Francia negli Anni Trenta
86/218: Emil-Maria CLAASSEN	The Optimum Monetary Constitution: Monetary Integration and Monetary Stability
86/219:Stuart WOOLF	The Domestic Economy of the Poor of Florence in the Early Nineteenth Century
86/220:Raul MERZARIO	Il Capitalismo nelle Montagne L'evoluzione delle strutture famigliari nel comasco durante la prima fase di industrializzazione (1746-1811)
86/221:Alain DROUARD	Relations et Reactions des Sciences Sociales "Françaises" Face Aux Sciences Sociales "Americaines"
86/222:Edmund PHELPS	Economic Equilibrium and Other Economic Concepts: A "New Palgrave" Quartet
86/223:Giuliano FERRARI BRAVO	Economic Diplomacy: The Keynes-Cuno Affair
86/224:Jean-Michel GRANDMONT	Stabilising Competitive Business Cycles
86/225:Donald GEORGE	Wage-Earners' Investment Funds: Theory, Simulation and Policy
86/226:Jean-Pierre Cavaillè	Le Politique Rèvoquè Notes sur le statut du politique dans la philosophie de Descartes
86/227:Domenico Mario NUTI	Michal Kalecki's Contributions to the Theory and Practice of Socialist Planning
86/228:Domenico Mario NUTI	Codetermination, Profit-Sharing and Full Employment

* :Working Paper out of print

PUBLICATIONS OF THE EUROPEAN UNIVERSITY INSTITUTE June 1986

86/229:Marcello DE CECCO	Currency, Coinage and the Gold Standard
86/230:Rosemarie FLEITHEN	Determinants of Labour Migration in an Enlarged European Community
86/231:Gisela BOCK	Scholars'Wives, Textile Workers and Female Scholars' Work: Historical Perspectives on Working Women's Lives
86/232:Saul ESTRIN and Derek C. Jones	Are there life cycles in labor-managed firms? Evidence for France
86/233:Andreas FABRITIUS	Parent and Subsidiary Corporations under U.S. Law - A Functional Analysis of Disregard Criteria
86/234:Niklas LUHMANN	Closure and Openness: On Reality in the World of Law
86/235: Alain SUPIOT	Delegalisation and Normalisation

* :Working Paper out of print