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Piercing the Corporate Veil
– a Law and Economics Analysis

Master thesis
30 ECTS Credits

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Commercial Law

Summer 2009
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Summary

Piercing the corporate veil is the practice of disregarding the limited liability characteristic of a corporation in order to make its shareholders, either individuals or parent corporations, answer for the corporation’s liabilities. In determining whether to apply corporate veil piercing, courts in the United States commonly employ the instrumentality theory, as well as the alter ego and identity doctrines. These principles provide courts with methods of establishing whether the corporation can be considered a deception. Metaphors used include “sham”, “shell”, “dummy” or “alias”. Circumstances indicating the validity of such metaphors, and consequently of corporate veil piercing, have evolved in case law and legal theory. Commonly, grossly inadequate capitalization, few shareholders, a disregard of corporate formalities, common directors and the intermingling of corporate assets can be considered telltale indicators of corporate veil piercing. Swedish courts apply the very same criterions, though not under the heading of theories or doctrines.

As the limited liability trait of the corporate form has proven to be a remarkable vehicle for risk taking and entrepreneurialism, and has enabled enormous economic development and provides society with wealth gains beyond compare, there is good reason for caution when disregarding it. It is thus clear that thorough economic consideration should be the foundation of any usage of veil piercing. It must be ascertained that the criterions for its applicability are in line with sound economic rationale, as well as the consequences of its application need to be analyzed from an economic point of view.

This thesis will provide a thorough description and an economic analysis of the characteristics of the corporate form. It will describe the theories surrounding veil piercing in both the United States and in Sweden, as well as it will present a comprehensive account of case law from both countries, both of which will be interpreted from an economic point of view. It will be shown that the criterions employed in the application of veil piercing are economically reasonable, and that courts take the potential economic repercussions into consideration in their lines of reasoning. It will also be shown that piercing the corporate veil can in some situations provide an economic advantage, an efficiency gain. It can in fact counter market imperfections and provide predictability in transactions.
Sammanfattning


Eftersom det begränsade ansvaret har varit framgångsrikt i att uppmuntra risktagande och entreprenörskap, vilket har medfört enorm ekonomisk utveckling samt ökat samhälleligt välstånd, fordras stor försiktighet i dess åsidosättande. Således borde nationalekonomiska resonemang ligga till grund för samtliga tillämpningar av ansvarsgenombrottsinstitutet. Det måste klargöras att kriterierna för ansvarsgenombrottets tillämpning stämmer överens med nationalekonomisk teori. Dessutom måste konsekvenserna av ansvarsgenombrottets tillämpning analyseras från ett nationalekonomiskt perspektiv.

Preface

Ett stort tack till min handledare, David Reidhav, för goda råd, stor entusiasm samt för hans tålamod.

Helsingborg den 18 december 2009

Philip Örn
1 Introduction

The doctrine of corporate veil piercing presents creditors as well as tort victims with a measure of last resort to receive repayment or compensation. When a corporation, which a creditor has lent money to or a tort victim has a claim on, is unable to meet its obligations due to certain improper circumstances, the creditor may claim that the limited liability characteristic of the corporation should no longer separate the corporate entity and its shareholders. This will enable the creditors or the victims to hold the shareholders directly liable for their claims on the corporation, perhaps with a greater chance of being remunerated.

Thus, it is clear that the institution of corporate veil piercing is of great importance for commercial law. Without it, the existence of a corporate entity would present plaintiffs with an insurmountable obstacle to the reinforcement of court rulings in some scenarios. It is also likely that the absence of corporate veil piercing would result in a greater incidence of breached contracts, nonperforming debt and uncompensated victims as the corporate form would be used *turpiter*.\(^1\)

If corporate veil piercing were not option, that is if limited liability would be absolute under all circumstances, uncompensated creditors and tort victims would constitute a vast externality. Corporate veil piercing offers courts a means of internalizing these externalities. As externalities are costs which are born involuntarily by third parties, internalization would result in societal wealth gains.\(^2\)

1.1 Statement of Purpose

This master thesis provides a deep theoretical knowledge of the corporation, its characteristics and their inherent problems. Furthermore it strives to thoroughly explain the concept of corporate veil piercing, and its usage in the United States and in Sweden. These two aims will form the necessary foundation of knowledge for the main purpose of the thesis, which is to conduct a rigorous law and economics analysis of the institution of corporate veil piercing.

I have chosen to incorporate legal perspectives from the United States in my thesis as it would be rather difficult to conduct any meaningful, profounder, discourse on the topic of corporate veil piercing without including relevant legal theory and case law from the United States. Both can be considered the origin of the institution of corporate veil piercing, and have served as worldwide models for the development of legal thought on the subject.

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\(^1\) The term debt includes loans, bonds and mortgages.

Concerning the first aim, I wish to present to the reader the inherent characteristics of the corporate entity. The traits which are intrinsic to the corporate form, the manner by which they function together and necessitate each other, as well as problems associated with or arising from these corporate qualities.

The second aim is to explain the concept of corporate veil piercing, and then in a second phase, profoundly and meticulously describe its criterions and application in the United States and in Sweden with legal theory and an abundance of illustrating case law. Pertaining to the case law, I will also conduct a concise comparative analysis of the application of veil piercing in both countries, in order to see whether US and Swedish case share any similarities.

The principal purpose of the thesis is to carry out a law and economics analysis of corporate veil piercing. I will scrutinize the criterions utilized by courts in deciding whether veil piercing is a suitable measure. I will clarify their economic consequences, as well as I will establish whether they are consistent with economic rationale. Do they make sense from an economic perspective, bearing in mind what courts want to achieve with the application of corporate veil piercing?

This law and economics analysis will be intertwined with references to case law from the United States and Sweden, in an effort to embody the legal reasoning behind the criterions. These cases will also be analyzed and commented on from a law and economics perspective.

Are the courts reasoning in an economically sound manner, considering the function of corporate veil piercing? What are the economic consequences of veil piercing if the corporation is owned by corporate or individual shareholders, if the corporation is close or public, if the law suit is a contract or tort case? Do courts take consideration such altered circumstances when deciding whether to apply veil piercing?

It will be shown that corporate veil piercing can be an economically efficient measure in certain scenarios. It can contribute to greater predictability in transactions, as well as it can lower transaction costs. It may also internalize externalities and achieve a more economically efficient allocation of capital as it brings about a more correct representation of risks.

## 1.2 Limitations

There are a number of legal topics which concern the allocation of liability to a corporation’s shareholders under certain circumstances, which fall outside the spectrum of this thesis. This thesis shall deal solely with the doctrine of corporate veil piercing. That is, the breach of the limited liability of a corporation, and the allocation of liability to its shareholders, due to misuse of the corporate entity.
If one searches exclusively for the process of having shareholder’s shoulder a corporation’s liability, there a number of methods available to courts in the United States to achieve just this. Possible foundations for such court rulings are agency, fraud, estoppel, contract theory, unjust enrichment and breach of fiduciary duties. While these factors can result in the same consequences for shareholders as corporate veil piercing, they are however part of legal topics which are clearly distinguishable from the latter. Therefore, none of these reasons will be dealt with any further in this thesis.

It is stipulated in chapter 25, paragraph 19 of the Swedish Companies Act, that shareholders, as well as board members, are collectively responsible for any liabilities which they let a corporation assume, if they are aware that the corporation is required to enter into liquidation due to a lack of capital. The rule applies to shareholders and board members which decide to continue the operation of a corporation which has a legal obligation to liquidize. This matter does deal with an exception to limited liability, it is however not linked directly to corporate veil piercing per se, it will therefore be excluded from any deliberations in this thesis.

The exclusion of close, yet dissimilar legal areas will aid in focusing the content of this thesis squarely on the practice of piercing the corporate veil.

1.3 Methodology

This thesis has been written using both a legal dogmatic method and a law and economics method. The former implies that the traditional legal sources; laws, legislative materials, case law and legal literature, have been utilized.

Legal literature has been employed to identify the principles and criterions of corporate veil piercing, after which case law was analyzed and interpreted in order to find additional lines of reasoning as well as further requisites applied in practice by courts. As corporate veil piercing is an institution originating in case law, this source is of great importance in attaining an thorough understanding of the veil piercing doctrine. It will thus be interpreted with the intention of identifying reoccurring line of reasoning as well as arguments utilized by courts in their settling of veil piercing suits.

The purpose of this method is to first provide the reader with the theoretical rationale on which veil piercing rests, and then supply a detailed account of case law from both the United States and Sweden, which illuminates the practical application of the doctrine.

Concerning the law and economics method, it must first be mentioned that there are two fields of law and economics, a positive and a normative. The former, sometimes also called the descriptive field, deals with the

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formulation of economically efficient solutions to legal predicaments, as well as it encompasses analyses of the economic consequences of laws and regulations, case law and legal solutions.\textsuperscript{5} Furthermore, laws, regulations and other legal solutions alter the economic conditions in society, and by doing so direct the actions of individuals, as they according to the \textit{Homo Economicus}-theory will act to maximize their own utility.\textsuperscript{6} It is therefore useful to conduct economic analyses of what behavior regulation will give rise to, whether it results in economically desirable conduct. The latter, the normative field, is concerned with providing arguments in favor of constructing economically efficient laws and regulations. That is, normative law and economics argues that economic efficiency is a factor which various legal solutions should take into account.\textsuperscript{7}

In applying the positive aspect of a law and economics method, I have conducted analyses of the economic consequences of the institution of corporate veil piercing. More specifically, I have evaluated the theoretical criterions for veil piercing as well as the practical application by courts from an economic perspective, in order to come to terms with the consequences and the behaviors which are produced. The purpose is to discover whether the general principles of veil piercing and case law in the United States and in Sweden are in line with economic rationale.

Concerning the normative side of the law and economics method applied in this thesis, my analyses are conducted from the perspective that economic efficiency is an essential concept, as it minimizes costs, which maximizes societal wealth, which in turn benefits society as a whole. The analyses found in this thesis are thus cost-evaluating. A legal solution which results in society assuming larger costs than necessary, or which even creates costs for society to bear, is not economically efficient. As society stands to gain from economic efficiency, legal solutions, such as corporate veil piercing, should strive to adhere to economic rationale.

\textbf{1.4 Disposition}

Chapter 2 accounts for the historical and theoretical aspects of the corporation. The section begins by giving a concise relation of the emergence of the corporate form, after which it will deal with the characteristics of the corporate form, more specifically: legal personality, limited liability, transferable shares, separation of ownership and control as well as profit maximization.

Chapter 3 deals with the doctrine of corporate veil piercing. The chapter is divided into two parts, one dealing with the United States and the other with Sweden. Both parts first delve into the approach to veil piercing adopted by the courts, after which descriptive case-law is presented. The chapter is

\textsuperscript{5} Dahlin, Glader and Reidhav, (2004), p. 70.
\textsuperscript{6} Dahlin, Glader and Reidhav, (2004), p. 16.
\textsuperscript{7} Dahlin, Glader and Reidhav, (2004), p. 70.
concluded by a comparative analysis of the application of veil piercing and case-law in the United States and in Sweden. The section aspires to present a comprehensive insight into the methods, including their backdrops, applied by courts in the United States and in Sweden when considering piercing the corporate veil. This insight is illustrated by continuously relating to relevant case law as well as providing the reader with a final, thorough examination of an ample selection of highly pertinent precedents.

In chapter 4 a law and economics analysis is conducted of the doctrine of piercing the corporate veil. First the criteria emphasized by courts in applying veil piercing are scrutinized from a law and economics perspective, in an effort to determine whether their application is economically rational. This is followed by an investigation of the economic rationale of veil piercing in respect to the defendant. The application of veil piercing on close and public corporations, as well as on corporate and individual shareholders, is analyzed in order to resolve which approach would be optimal from a law and economics point of view. The practice of courts is then put in comparison with the economically favorable policy. After this the very same procedure is conducted with the application of corporate veil piercing in contract and in tort cases. First it is determined what the economically optimal course of action is, then select court rulings are analyzed in the light of these results.
2 The Corporation

The firm essentially functions as a collector of inputs from owners of factors of production, with the purpose of directing these to produce an output which is made available to consumers. Since the firm in fact is composed of its input and output relationships, it is vital for it to be able to secure these entering and exiting lines through contracts. Contracts are as Jensen and Meckling conclude, the essence of the firm. The firm can therefore be defined as a nexus of contracts, connecting suppliers of inputs with customers.

This chapter will delve into the historical and theoretical background of the corporation, providing a theoretical foundation for the thesis. First off it will shortly describe how the corporation as an entity evolved, and for what reasons. We will then proceed to the main focus of this section, which is to describe the essential attributes of the corporate form. The economic implications of the corporation’s characteristics will be explained, as well as potential sources for problems and possible solutions to these. The section is concluded by a law and economics analysis of the benefits of the corporation.

2.1 A Historical Viewpoint

Early guilds in England carried some of the traits of the joint stock company. They were for instance governed by boards which were summoned by an alderman who maintained control of the guild. Economic progress soon made it clear that the guild system was not optimal. This gave rise to the regulated company. These still possessed some striking similarities to the guilds as their organization emphasized membership and apprenticeship. Members would be a part of the company, but would do business on their own, though still obeying the company’s rules. Since members of these regulated companies were not allowed to cooperate with non-members, the concept of partnerships began to be utilized for that purpose as they allowed for business to be conducted between anyone. Walker writes that real predecessors to the joint stock company were large such partnerships founded to mine tin in Cornwall.

It was at this time, around the turn of the 16th century, that the joint stock company came into being. The reasons for this are disputed. The traditional view by scholars, including Walker, is that joint stock companies were formed in response to an increased demand in capital. Newly founded trading companies and the development of industries needed amounts of

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capital which partnerships only with difficulty could gather, since they were constructed primarily for smaller undertakings where most partners were involved in the business. As it was generally considered necessary in the middle of the 16th century that invested capital should yield higher returns in order to refill English coffers which had been drained over the past half century, merchants were looking for lucrative business opportunities. Since the closest trading routes already were taken their attention was turned to Russia and Africa. Such ventures needed much more capital than those common at the time and thus arose the need for joint stock companies.13

However, a different perspective on the rise of the joint stock company has been presented by Ekelund and Tollison of The RAND Corporation. They consider the classical demand-side view of the corporation to have its merits. As trading companies needed more capital for excursions and infrastructure such as warehouses, joint stock companies with limited liabilities allowed for a large shareholder base and thus a larger capital inflow. Nevertheless, they claim that this ignores the supply-side perspective.14 They instead advocate a property-rights explanation which emphasizes the need which arose for the transferability of shares in guilds, regulated companies and partnerships. Members and partners of such organizations did not have any possibilities of easily exiting the organizations or sell their rights. Ekelund and Tollison stress the advantages of transferable shares found in the possible wealth gains when a more competent owner can seize a business by buying shares and improve its operations, as well as in the inherent monitoring qualities of capital markets. These beneficial traits of transferable shares would have given owners of such partnerships and regulated companies incentives to try to create an organizational form which allowed for transferability of property rights.15 Since a capital market, which would allow for such transfers to take place, functions awfully in the absence of limited liability, the joint stock company was created.16

### 2.2 Attributes of the Corporation

The corporation possesses a number of distinct traits that together distinguish its anatomy. Most authors in the field of corporate law compile their own usually mutually overlapping list of these attributes. When Jensen defines the corporation as a legal fiction, operating as a nexus of contracted relationships, having divisible residual claims on its assets and cash flows which can be sold generally without consent of other contracted individuals, he identifies three traits of the corporation in a single sentence: legal personality, transferable shares and shared ownership.17 Easterbrook and Fischel mention limited liability, legal identity and perpetual existence as

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distinctive features of the corporation.\textsuperscript{18} In our account of the attributes of the corporation we will make use of Hansmann’s and Kraakman’s five point list of the core structural characteristics of the business corporation consisting of: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital.\textsuperscript{19}

2.2.1 Legal Personality

Viewing the firm from a contractual theoretical perspective, as a nexus of contracts, the need for an ability to conclude such contracts is made obvious. For the firm to be competent to conclude agreements and own assets separate from those of its shareholders, it is necessary for the firm to possess a legal personality of its own.\textsuperscript{20}

According to Hansmann and Kraakman the corporation enjoys a strong form legal personality, meaning that both a priority rule as well as a rule of liquidation protection apply. The former stipulates that a firm’s creditors enjoy a higher priority right to its assets than the personal creditors of the shareholders. The rule makes the firm’s concluding of contracts easier as creditors can rely to a greater extent on the security for credit provided by assets. The latter rule states that shareholders cannot demand to receive their share of a company’s assets at any given time, possibly forcing a liquidation of the firm. This rule shelters the continued functioning of the firm as well as it maintains its value from shareholders or their potential personal creditors.\textsuperscript{21}

2.2.1.1 Implications of the contractual perspective

Focusing on the contractual nature of the corporation makes obsolete any extensive attention paid solely to the legal personality of the corporation, i.e. the legal body created by the process of incorporation. If attention is paid only to this entity which the legal personality represents, sight is lost of its composition, which is a web of contracts.\textsuperscript{22} Instead of viewing the corporation as an assortment of assets separate from those of the shareholders, it can be seen as a constellation of relationships between a fictional entity, the corporation, suppliers of inputs such as labor, material and capital, and the consumers of output.\textsuperscript{23}

Jensen uses this perception of the corporation as a body consisting solely of contracts to ward of any assertions that the corporation has a social responsibility or should act in accordance with certain ideas. Since the corporation is a fictional creature, functioning as a marketplace in its setting

\textsuperscript{18} Easterbrook and Fischel, (1996), p. 11.
\textsuperscript{19} Kraakman et al., (2004), p. 5.
\textsuperscript{22} Easterbrook and Fischel, (1996), p. 12.
\textsuperscript{23} Bergström and Samuelsson, (2001), p. 68.
of an equilibrium between the supply of inputs and the process resulting in an output, the outcome of this equilibrating process is not given by the corporation’s will or intentions, but by the process of cooperation between providers of input and demand. The contractual perspective asserts that corporation is not to be viewed as an entity or a body, it is merely a mechanism, a platform, where buyers and sellers meet and through contracts to buy and supply set an equilibrium. When the corporation is viewed not as a real being, but merely as a construction to simplify a process, effort if you will, of matching various interests with the purpose of attaining a certain output, it makes sense not to ascribe it such human attributes as social responsibility and adherence to ideological ideas.

### 2.2.2 Limited Liability

Limited liability is the restriction of the amount of capital which shareholders stand to lose when they invest in a corporation. No more than the capital put into the business, i.e. the acquisition value of the shares held, can be lost in the case of bankruptcy of the company. The concept of limited liability has a number of positive side-effects for the corporation, the first being a reduction in shareholders’ monitoring costs, both of agents and other shareholders. Putting it simply, shareholders monitor agent relatively to the degree of the risk they experience by investing. Since a diversified shareholder would not risk all of his wealth when investing in a firm, his need to control the actions of agents is less than it would be under unlimited liability.

Under unlimited liability on the other hand, shareholders would do best in watching the actions of the management closely as the amount of risk they face is larger since both invested and personal wealth is at stake. Concerning the reduced monitoring costs of other shareholders, consider a situation of unlimited liability. In the case of bankruptcy creditors would most probably go for the deepest pockets, probably ignoring the shallower pockets. Thus, shareholders would be wise in constantly monitoring the individual wealths of other shareholders since a reduction in those would imply an increased chance of being the target of creditors. Limited liability erases these monitoring costs since the personal wealths of shareholders do not matter.

The concept of limited liability makes a number of other traits of the corporation feasible. For example the transferability of shares, dealt with more extensively below, would be severely hampered in the absence of limited liability. Every potential buyer of shares in a company would have to investigate the wealths of all other shareholders in order to determine the exact risk he faces in becoming a shareholder. Insecurity concerning the risk carried by an investment directly results in complications in the valuation of shares. Limited liability consequently enables the existence of stock markets since a single share price can be listed for investors to observe. Under

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unlimited liability share prices would fluctuate not only due to the operations of the company which affect the present value of future cash flows, but also due to changes in the personal wealths of all shareholders. As will be explained in more detail under section 2.2.3, this simplification of transferability acts as a check and balance against the power of management.

Another field which depends on limited liability is modern portfolio theory. It stipulates that investors can construct an optimal portfolio of assets with a desired risk-reward profile through diversification. In the absence of limited liability it would be impossible to shape the amount of specific risk of a portfolio through diversification since every investment could claim not only invested capital but also personal wealth. In fact, in the case of unlimited liability, diversification would rather increase your risks since every investment could potentially go bankrupt and ruin you. A rational investor would therefore minimize the number of companies he invests in, in order to be able to monitor these businesses closely and reduce his risk that way instead.

In the case of unlimited liability diversification would, as was mentioned above, be impossible, resulting in higher risks for investors. As accepting more risk comes with a price tag, investors will demand higher returns on their investments to offset sleepless nights and the very real possibility of personal ruin. Consequently companies wishing to attract investors face higher costs of capital. Rephrased, limited liability reduces the cost of capital for corporations.

2.2.2.1 Insurance as an Alternative to Limited Liability

Supposing that limited liability no longer was a given characteristic of the corporation, and assuming the existence of free contractibility, one can envision that the concept of limited liability, given its numerous advantages, would be constructed some other way. One way would be by buying failure insurance for shareholders. In such a situation creditors would rest assured knowing that their loans were safe, and shareholders would not risk anything beyond their investment. These insurances would be provided by the party which is the best in assessing risks of failure in firms and having best possibilities of monitoring companies. If this definition sounds familiar it is because it describes creditors as a group. Creditors are usually well informed of the industries in which corporations operate and therefore would have the lowest monitoring costs.

Therefore what insurance as an alternative to limited liability would accomplish, is in fact limited liability. In exchange for a premium, creditors

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would accept the risk of failure of firms, leaving shareholders liable only to the extent of their investments. This illustrates clearly that the institution of limited liability serves a reducer of transaction costs. Since limited liability is already included as an inherent characteristic of the corporation, parties do not have to enter into contracts to attain it. However, it has been put forward that in the long run insurance companies would attain the same level of knowledge of a certain industry as creditors commonly are thought to possess, and therefore face the same costs of monitoring, something which sounds very reasonable.\(^{31}\)

However, insurance does come with an advantage under certain circumstances. As will be entered into in more detailed under section 2.2.4, separation of ownership and control can result in conflicts of interests between shareholder and management. The latter will try to maximize their own utility, sometimes through actions which stand in direct contrast to the interest of the shareholders. A blunt example would be a manager which carries out extremely environment unfriendly disposals of nuclear waste in order to pocket a percentage of the massive profits achieved by cutting corners. If an insurance had been purchased by an insurance company with a comparative advantage in monitoring nuclear waste disposal, the insurance would function as an instrument of management control. Since the insurance company has an interest in minimizing unwarranted risk taking it will monitor the actions of the management closely and make better assessments of these due to their superior knowledge.\(^{32}\) The example depicted can of course be transposed onto companies in all lines of businesses, as long as the insurance is purchased from an insurer with superior knowledge and monitoring skills of the type of operations in question.

### 2.2.2.2 Transfer of Risk to the Creditor

Since limited liability ensures that the investor does not risk anything beyond the amount invested in a company, a moral hazard arises. The company can undertake the riskiest of operations, if they go well the investors stand to gain the profits, and if they turn ugly their losses are cut short and the creditors have to bear the brunt of the losses. Easterbrook and Fischel write that the size of this externality imposed on creditors is grossly overstated.\(^{33}\) They point at the fact that a firm engaged in excessive risk taking must pay accordingly when borrowing money. Firms may also have to agree upon avoiding some too-risky-for-comfort undertakings in order to secure favorable interest rates. Furthermore it is mentioned that when firms return to the credit markets to refinance loans they will incur costs corresponding to their present risk exposure.\(^{34}\) It can be speculated that firms with risky behavior in the past will have to pay for this when refinancing even though the uncertain operations in question might be concluded.


It is sometimes argued that the limit which limited liability imposes on losses by investors is compensated by the augmented potential losses faced by creditors. The reasoning goes as follows: due to their limited liability investors enjoy a safer position, for which they consequently will demand smaller rates of return on their invested capital. Limited liability thus reduces the cost of capital from investors. However, since creditors will be exposed to more risk under limited liability than they would have under unlimited liability, they will demand higher rates of interest for loans forwarded, in order to compensate for the new additional risk they are taking on. Limited liability thus increases the cost of capital from creditors. The argument therefore concludes that while risk is reduced for investors, it is increased for creditors. While the cost of capital from investors decreases, it does the opposite when coming from creditors. Therefore limited liability does nothing to reduce the cost of capital, right?

What the argument fails to acknowledge is that if one of the sources of capital, investors or creditors, would possess a comparative advantage in monitoring the actions of the corporation which are the causes of the risks, shifting the consequences of these risks to the comparatively advantaged party would reduce monitoring costs and consequently the cost of capital. Since creditors commonly will have a thorough understanding of the sector in which a business operates it will be better positioned than investors to control the actions of a firm. Its monitoring costs will thus be lower than those of investors. If the creditor holds secured debt his monitoring needs and costs are reduced even more. Limited liability thus reduces the cost of capital.35

2.2.2.3 Dealing With the Moral Hazards Caused by Limited Liability

2.2.2.3.1 Piercing the Corporate Veil

The incentive for corporations to enter into excessively risky undertakings lies in the constricted responsibility for the full costs of the possible aftermath. An aftermath which very well could greatly exceed the invested capital. One possible countermeasure to such little-to-lose behavior by firms is the concept of piercing the corporate veil. It is the circumvention of the corporation’s characteristic of limited liability. When it is applied, which though not exclusively, can be in cases of tort, fraud, misrepresentation and undercapitalization, creditors are given access to the assets of shareholders.36

The questions of when and why the corporate veil is pierced, and if such a practice is in accordance with law and economics is, as the reader might have noticed, the topic of this thesis and will thus be dealt with in great detail further on.

2.2.2.3.2 Minimum-capital Requirements

Limited liability only hurts creditors if the assets in the corporation are less than what has been lent to it. It speaks for itself that the creditor’s position becomes safer as the capitalization of the corporation increases. It can also be speculated that companies with little capitalization will act as if they have little to lose, a notion brought forward by Easterbrook and Fischel. By such a reasoning companies with a small capitalization would be riskier for creditors than their opposites. 37 Minimum-capital requirements stipulated by legislation would with such a train of thought reduce excessive risk taking. The disadvantages of such a regime are however numerous and daunting.

First of all, how are the capital requirements determined? By what method will it be established what amount of capitalization is just right for a certain firm? Not only is it difficult bordering on impossible, but the administration needed to enforce such a legislation has an eerie resemblance to those found in planned economies. Second, what if they get it wrong? Too high requirements would create barriers to entry and consequently monopolies. Put them too low and there useless. Thirdly, what assets are good enough to count towards the capitalization requirement? Is working capital good enough? Can a machine be posted as security?

Easterbrook and Fischel write that for the rule to be effective, companies would have to post a bond or keep risk-free assets in their treasury to an amount equal to their highest potential liability. This would cause the company to have a lot of latent, unproductive capital laying around just in case, which would affect return on capital negatively. 38 Also, if a vast number of companies began to place large amounts in risk-free assets as security for their operations, demand for risk-free assets such as Treasury Bills and Treasury Notes would surge. This would push down the yields on these instruments, punishing savers and possibly cause a constantly higher level of interest rates, needed to both stave off inflation and attract investors other than companies.

2.2.2.3.3 Mandatory Insurance

Legislation stipulating mandatory insurances would face administrative complications as well as it would create barriers to entry. Easterbrooks and Fischels line of reasoning is that start-ups, not possessing the same kind of knowledge as established companies, would have to pay higher premiums, effectively raising entry costs. Such a regime could however backfire, causing moral hazards and excessive risk taking for the same reasons limited liability could cause it. Of course that would only be the case if insurance companies would have a hard time monitoring companies properly. 39

37 Easterbrook and Fischel, (1996), p. 60
38 Easterbrook and Fischel, (1996), p. 60


2.2.2.3.4 Managerial Liability

Making managers partly liable for losses which a corporation incurs, acts to decrease their propensity to partake in very risky business activities. Managers would then be responsible for a certain fraction of the business’ liabilities, caused for example by tort injuries to third parties. Such a liability for the operations of a firm can obviously be directly translated into a cost. A cost levied on a manager, tied to his job, would equal a pay cut. Naturally companies would have to reimburse managers for such costs in order to bring their salaries up to par again. The result of shifting liability is thus that firms would pay managers to accept liability for the firm’s operations. Managers facing such liability alongside the firm will act to either insure the firm or increase its capitalization, both of which result in increased risk aversion.40

The problem with shifting liabilities onto managers is that the costs that are associated with such a shift might be larger than the benefits of decreasing exposure to risky operations. To be more precise about the costs, managers will have to pay insurance premiums, they will have a decreased propensity to invest in risky operations that nevertheless might be profitable and advantageous from a societal point of view.41

2.2.2.3.5 Regulation of Inputs

The regulation of inputs refers to the limitation of investment possibilities in certain ventures. It would be applied to restrain companies’ possibilities of partaking in certain extremely risky operations. Easterbrook and Fischel mention the regulation of nuclear power plants. However, internalizing the externalities of too risky projects is complicated, determining if the social cost of a project exceeds its benefits is notoriously difficult.42 Furthermore, resorting to labeling some operations as too risky for society’s taste and consequently smothering them with regulations, a realistic threat when taking the nature of politics into account, would not be desirable from an economic point of view.

2.2.3 Transferable Shares

The transferability of shares makes possible the continuation of a corporation’s operations even as the ownership of it alters. The trait is closely intertwined with the notion of limited liability. Without limited liability shares would be very hard to value, since the corporation’s creditworthiness would depend on the wealth’s of the individual shareholders.43 Though not only is the transferability of shares dependent on limited liability, there is a reverse relationship as well. Suppose that under a rule of unlimited liability a company is going bankrupt, wealthy shareholders will hurry up to sell their shares in order to protect their

personal wealths from the company’s creditors. Those who will buy these shares will be individuals with little or no personal wealth to lose. The transferability of shares has consequently resulted in a limited liability for shareholders.44

The transferability of shares does not only create de facto limited liability, in addition it functions as a monitor of management. If management acts in ways detrimental to the firm, affecting the value of shares unfavorably, an outside investor will notice this, identify a potential profit, purchase a controlling bloc of the company from shareholder making use of their option to exit, and oust the unqualified management. Since this threat of an active outside investor on a cleaning spree is very real for management, they will have a powerful incentive, keeping their job, to act in ways that keep with the wishes of shareholders, i.e. maximizing shareholder value.45

2.2.4 Separation of ownership and control

When Hansmann and Kraakman speak of a centralized management under a board structure, they recognize the important role delegated management plays in larger firms having numerous shareholders. The delegation enables the degree of centralization of management needed to efficiently coordinate production and also refer to difficulties concerning the allocation of authority, a problem which gets more complex the bigger the corporation. The ceding of decision-making power to a board of directors is mentioned as a significant mark of the corporation. A number of traits of a board of directors are listed, among them its election by the shareholders. A process ensuring that the corporation is run according to the owners’ wishes.46

2.2.4.1 The Decision System

For the sake of a complete comprehension of the following deliberations, it is important to correctly separate between residual claimants, decision management and decision control. The residual claimants are the shareholders of a corporation. In exchange for the profits of the corporation they contribute capital and by doing so accept the risk of losing this. The second group, the decision management, is the management of the company. In the initiation process they generate options for the corporation which must be decided upon and in the following ratification process they make decisions concerning these options. The decision control group most commonly consists of a board of directors. These execute the decisions made by management and simultaneously control these decisions.47 Taken together the latter two make up the decision system.

2.2.4.2 The Agency Problem

Agency problems, and consequently costs, arise because of the inexistence of the costless conclusion and enforcement of complete contracts.\(^{48}\) Since it is virtually impossible to specify and include every possible eventuality in a contract, as well as perfectly pinpointing the future effort of employees, contracts cannot be complete.\(^{40}\) Agency costs are the greatest when the decision management does not share any of the monetary consequences of their decisions. In the absence of a sufficient control mechanism they will be tempted to act in contrast to the wishes of the residual claimants. For example, instead of maximizing shareholder value they could act to increase their own power, divest resources from the corporation by for example buying expensive company cars, or in the worst case commit outright theft from the company.\(^{50}\)

2.2.4.3 The Benefits of Separation of Ownership and Control

The separation of ownership and control, or rather the separation of residual claimants, the decision management and decision control, carries with it a number of benefits. To know that the type of corporation referred to in the following section is a so called open corporation, with unrestricted common stock residual claims, will also further clarify the subsequent contents. Unrestricted common stock residual claims are defined by three traits: that residual claimants, i.e. stockholders, are not required to participate in any way in the running of the corporation, secondly that rights to residuals are transferable, and thirdly that the rights to residuals are unrestricted in the sense that they are endless.\(^{51}\)

Fama and Jensen argue that organizations with a separation of ownership and control, or of decision management and residual risk as they phrase it, are so called complex organizations. A complex organization is one where special knowledge needed for certain decisions is spread throughout all levels of the organization. They continue by reasoning that if the necessary knowledge is distributed all through the corporation, costs would be reduced by delegating decision management powers to parts of the organization with specific knowledge.\(^{52}\) The notion they put forward is that the corporation as a whole is benefited if decision making capabilities are brought closer to the expertise needed to comprehensively assess the decisions at hand.

Just as Hansmann and Kraakman did, Fama and Jensen discuss the benefits of delegation considering the vast numbers of shareholders which modern corporations commonly have. All shareholders cannot be involved in the control and ratification of decisions, either because of a lack of qualifications, lack of want or the sheer inefficiency of such an arrangement.

\(^{50}\) Dahlman, Glader and Reidhav, (2004), p. 191, 197.
\(^{52}\) Fama and Jensen, (1983a), p. 308.
Therefore corporations having so called *diffuse residual claims*, meaning numerous shareholders, will commonly have a complete separation and specialization of decision control and ownership. They continue by stating that in such a scenario decision management and control will probably be separated dealing with the agency problems. Their conclusion is that the benefits of delegation of control from residual claimants exceed the agency costs which the arrangement gives rise to.\(^{53}\)

### 2.2.4.4 Separation of Ownership and Control in Noncomplex Organizations

Fama and Jensen define noncomplex organizations as those, usually small, companies where the decision-relevant information lies with a small number of agents. Since only a few possess the knowledge necessary to make informed decisions it is optimal that decision management and control are assigned to the same individuals. Such a combination of the management and control of decisions would give rise to serious agency problems. However, these can be dealt with by making sure that residual claims are restricted to agents holding important posts in decision management and control.\(^{54}\) The agency problem is thus solved, though the method implies that decision agents must be fit into a narrow criteria. In addition to having the relevant knowledge and decision skills they must be willing to risk capital in order to be a residual claimant.\(^{55}\) This therefore illustrates a situation where separation of ownership and control would not be optimal: in smaller corporations with restricted residual claims, called close corporations.

### 2.2.5 Shared Ownership by Contributors of Capital

Another point on Hansmann’s and Kraakman’s list is shared ownership by contributors of capital, also phrased simply as *investor ownership*.\(^{56}\) Ownership of a corporation comes with two rights: to control the operation, usually through voting, and to receive its residuals. Both these rights are generally given to investors in quantities proportional to their share in the corporation, that is to their share of the total capital put into the company. It should be noted that there exist some variations to the one share one vote rule, for example in the state of Delaware where shares can be given any number of votes.\(^{57}\)

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2.2.6 The Corporation – Profit Maximizing by Default?

An issue which is not included in Hansmann and Kraakman’s list which nevertheless is quite debated in corporate legal theory is whether profit maximizing is an essential trait of the corporation. The topic has however made it onto Bergström and Samuelsson’s six-point list of the corporation’s characteristics. The list’s fourth entry states that the purpose of the corporation’s operations is to generate a profit for its shareholders. This is a direct reference to chapter 3, paragraph 3 of the Swedish Companies Act of 2005 (Aktiebolagslagen), stipulating that if the purpose of the company is not to generate profits, this should be specified in the company’s articles of association. This is a principle of profit maximization for the company, which according to Bergström and Samuelsson is necessary in order to be able to separate ownership from control. They argue that if a company was operated according to a different principle than that of maximizing financial gain, it would entail a shift of power away from the shareholders into the arms of the managers. This is the case since any number of actions can be justified when the main criterion consists not of maximum profit but of softer substitutes.58

Easterbrook’s and Fischel’s approach to the quandary whether the firm’s goal is to generate profits is to simply dismiss it. The argue that since the corporation is composed of contracts, defining the purpose of a corporation is just a term in yet another contract.59 The only aspect of the question they find truly important is the enforcement of such contracts. If a corporation is founded with the purpose of profit maximizing, it cannot after a while favor charitable contributions to its community and let profit generation come in second. However they note that it is essential for a corporation to make up its mind. Giving management two objectives to fulfill, for example profit maximizing as well as granting loans to certain income groups, will empower it and cause agency costs to rise dramatically.60

2.3 The Importance of the Corporation

As has been detailed in the sections above, the individual characteristics of the corporation carry a number of advantages. In this section we will venture into the benefits of these traits when they are merged with each other, creating a corporation.

It would be proper to begin such an account by discussing Ronald H Coase’s deliberations of the benefits of using a firm to conduct transactions. As the reader is aware of by now, the corporation can be likened to a nexus of contracts. The firm acts as a abridger of relationships between owners of factors of production and buyers. In the absence of the firm these suppliers

58 Bergström, Clas and Samuelsson, Per, (2001) p. 72-76.
would have to deal directly with all the complementary suppliers as well as the buyers. All these contracts would carry a price tag, they would not be costless to conclude. Coase phrased it as that there was a cost of using the price mechanism. He saw this cost as the foremost reason for the organization of firms. He identified the firm as greatly reducing these costs, since owners of factors of production would not have to conclude contracts with a vast number of counterparts, but instead only with the firm. Many contracts are replaced by one. \(^\text{61}\) This line of reasoning make its abundantly clear what wealth gains stand to be acquired by operating corporations. As the costs of concluding transactions diminishes through the formation of firms, a number of agreements with gains that otherwise would have been shadowed by the price of the contract itself can now be carried out.

The concept of limited liability, inherent in the corporation, enables diversification by investors. Since they need not monitor every action of management in order to minimize the risk of personal ruin, it is rational to spread investments over a number of investments so as to attain a desired risk-return level. The fact that investors will provide capital for numerous projects instead of just for a few fail proof ventures, creates societal benefits as it provides greater opportunity for technological and economic progress. The fact that investors do not risk all of their wealth by investing in one single business makes them less risk averse when considering potential investments. The fact that the investor has the freedom to transfer shares in such operations to others when his appetite for it has subsided, brings even more undertakings in from the cold of too risky to invest in. As projects do not have to reach up to the same level of security as they most certainly would have to under unlimited liability, investors will consider a greater span of projects, both risky and safe. There is a substantial societal gain to be had from such willingness to provide uncertain ventures with capital. The more ideas that are sponsored to be develop, the better the chance that one of these will award society with a technological or scientific advance. Thus, the possibility to organize ventures in corporate form advances general entrepreneurship and consequently provides societal benefits.

3 Piercing the Corporate Veil

The piercing of the corporate veil is the practice by courts to allow creditors of a corporation to reach the assets of its shareholders. It circumvents the limited liability trait of the corporation in order to satisfy the creditor’s claims. Piercing the corporate veil falls into somewhat of a legal gray area. US state laws do not mention any exceptions to the absoluteness of the corporation’s limited liability. Neither can any trace of an expressed support for veil piercing be found anywhere in Swedish law. Quite to the contrary, chapter 1, paragraph 3 of the Swedish Companies Act of 2005 stipulates that shareholders are not personally responsible for the liabilities of the corporation. The concept of piercing the corporate veil has instead, in legislation’s place, been shaped by precedents. Having in certain situations found that limited liability would be an unreasonable model to uphold, courts have broken through it in order to avoid loading the full weight of liability onto creditors.

3.1 In the United States

Judge Cardozo famously described the relationship between parent corporations and their subsidiaries as enveloped in mists of metaphor. He encouraged caution, since even though metaphors might make chains of thought more straightforward, they may come to dominate the very reasoning they were intended to simplify. He continued by stating that labeling a subsidiary corporation as an “alias” or “dummy” should not cloud that what in fact is attempted to be defined is the actual operation of the subsidiary.

Courts in the United States have developed numerous theories, methods if you will, to determine whether a corporate veil should be pierced or not. These theories function as something resembling a template for courts in their pursuit of a decision.

3.1.1 The Instrumentality Theory

When the corporate veil is pierced by courts in the United States this is done by applying the instrumentality, sometimes also called the instrumentality rule. Commonly courts consider a number of established aspects in order to determine whether this principle should be applied. The importance which is assigned to the various points is uncertain, consequently, so are the outcomes of different combinations of factors, presenting the courts with sizeable discretionary powers. When courts apply the instrumentality theory they are not concerned with the fictional façade which the

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corporation creates. Instead they are concerned with reality, how the corporation actually was directed, and what the shareholder’s role in the operation consisted of.  

These factors and the process through which they are applied by courts in order to evaluate whether it is appropriate to employ the doctrine of instrumentality owe much of their composition to Fredrick J. Powell’s instrumentality test of 1931, also known as the Powell Rule. Even though the rule was initially created with corporate parent-subsidiary relationships in mind, it is applied to private shareholders as well. It consists of three parts: instrumentality, improper purpose and proximate causation.

### 3.1.1.1 Powell’s First Prong - Instrumentality

Concerning the first part, it must be shown that the corporation is operated not to advance the goals of the corporation itself, but rather to further the objectives of a dominant faction. Powell compiled a list of eleven circumstances which in various combinations might point towards subsidiary instrumentality.

1. The parent corporation owns all or most of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation.
5. The subsidiary has grossly inadequate capital.
6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation, or no assets except the ones conveyed to it by the parent corporation.
8. In the papers of the parent corporation or in the statements of the officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation’s own.

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9. The parent corporation uses the property of the subsidiary as its own.

10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the latter’s interest.

11. The formal legal requirements of the subsidiary are not observed.

These eleven points outline an analysis of a corporation’s instrumentality. It should be noted that it is not a “tick the boxes and count them test”, as various combinations can yield differing results. Having said that, it is a comprehensive list of factors, circumstances if you will, which courts consider when determining whether instrumentality exists.

In DeWitt, Circuit Judge Russell stated that merely the fact that all stock is owned by one or a few shareholders is not enough to justify disregarding the corporate entity. He continued by stating that courts will readily pierce the veil if such ownership structure is combined with other factors which obviously, on grounds of fairness, support disregarding the corporate form. The existence of a large, or a small number of large shareholders does thus not provide sufficient grounds for veil piercing. A multitude of circumstances must therefore be present in the case. Russell expresses it as that a decision to disregard the corporate entity may not rest solely on a single factor, but must include a number of such, as well as it has contain an injustice or unfairness.

In Laya v. Erin Homes, Inc. Judge McHugh, referring to a list of the same factors as are mentioned above, though worded differently, stated that examining factors indicating instrumentality in a “totality of the circumstances” test yields a more informed balancing of the motives behind limited liability against reasons justifying a piercing of the corporate veil. Judge McHugh went on to state that grossly inadequate capital together with disregard of corporate formalities, if unfairness is caused, are sufficient grounds for a court to pierce the corporate veil in favor of a party who has entered into contract with the corporation. This statement was adhered to in Kinney Shoe Corporation v. Polan, where Judge Chapman mentioned it in his deliberation of Polan’s undercapitalization.

70 DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Company, 540 F.2d 681, 687.
3.1.1.2 Powell’s Second Prong – Improper Purposes

The next question of the Powell Rule, to be asked if the first question is answered in the affirmative, is whether the dominating party has utilized its influence for fraud or improper purposes. The rationale behind the second query is that the corporate veil should not be pierced unless some kind of injury or fraud has been perpetrated.\(^{74}\) Powell gave a number of examples of such improper purposes:

1. Actual fraud.
2. Violation of a statute.
3. Stripping the subsidiary of its assets.
5. Estoppel.\(^{75}\)
6. Torts.
7. Other cases of wrong or injustice.

Krendl and Krendl have drawn the conclusion from case law that a plaintiff seeking to pierce the corporate veil need not provide evidence sufficient to establish ordinary fraud, but merely needs to present proof of some sort of equitable wrong. Showing the inadequate capitalization of a subsidiary is mentioned as a potentially sufficient improper purpose which could satisfy the second question of the Powell Rule.\(^{76}\)

3.1.1.3 Powell’s Third Prong - Proximate Causation

The third part of the Powell Rule concerns proximate causation. The question stipulates that the plaintiff seeking to pierce the corporate veil has to show that the dominating control of the corporation in combination with its improper action has caused him injury.\(^{77}\) The last leg of the Powell Rule makes sure that the corporate veil is pierced only in cases where some sort of damage actually has occurred, and that due to the instrumentality of the corporation as well as the inappropriate behavior on the corporation’s part.

3.1.1.4 Applying the Instrumentality Rule in Tort Cases

In tort cases, instead of being based on a voluntary agreement, the plaintiff most likely has been unwillingly involved. In such cases, whether to pierce the corporate veil or not is determined by applying the instrumentality rule. As the reader will know by now, the third part of this rule is concerned with injuries imposed on the plaintiff. More precisely there must exist a causal link between an injury suffered by the plaintiff, and any inappropriate use of the corporation by a dominating party.

Typically, injuries giving rise to tort cases consist of emotional or physical hurt, namely damages which are not caused by the inappropriate use of the

\(^{75}\) For a reader unacquainted with common law, this concept can best be described as the prevention on grounds of equity of allegations or denials contradicting something previously stated, or something legally established to be the truth.
corporate entity per se. Therefore, another injury will have to be shown for
the plaintiff to have any chances at reaching the shareholder’s pockets. Such
a damage, with sufficient causal relations, could be the corporation’s
potential inability to compensate for the arisen injuries. Such an inability
would be an injury which the plaintiff has been forced to endure because of
the shareholder’s domination of the corporation. If such an incapability to
make right any damages caused to unwilling third parties can be related to
the corporation’s instrumentality, it would fulfill the third part of the
instrumentality rule, and sufficient cause for piercing the corporate veil
would exist. Consequently, courts should therefore in theory look for
undercapitalization when dealing with veil piercing in tort cases.78

3.1.2 The Alter Ego Doctrine

The earliest mention of the alter ego concept was in 1898 by Justice Taft in
Harris v. Youngstown Bridge Co.. It is a metaphor for an unacceptably close
relationship between a parent and a subsidiary corporation, resulting in a
disregard of the subsidiary’s separate corporate identity.79 The alter ego
document stipulates that the corporate veil should be pierced if there is such a
unity of ownership and interest that two allied corporations no longer can be
considered separate, and the subsidiary thus is viewed as the alter ego of the
parent. Furthermore a recognition of the corporations’ separate entities must
either sanction fraud or lead to an inequitable result. The doctrine is closely
intertwined with the instrumentality theory and usually leads to the same
results.80

3.1.3 The Identity Doctrine

The identity rule is to be perceived as a complement to the instrumentality
rule.81 The rule states that if the independence of a corporation, due to “a
unity of interest and ownership”, cannot be considered to have commenced
or has ended, it would “defeat justice and equity” if the fiction of a separate
identity was recognized and the entity was allowed to avoid liability for “an
operation conducted by one corporation for the benefit of the whole
enterprise”.82 What the identity rule stipulates is essentially another
circumstance which indicate instrumentality in a subsidiary corporation. If it
is obvious that a subsidiary merely was used as an expendable pawn in
transactions which in fact were of advantage to the whole group of
corporations of which the pawn is a part of, it should be looked beyond the
subsidiary’s corporate persona.

The reader may perceive the identity doctrine and the alter ego doctrine to
be remarkably similar, even alike. Such reasoning would place the reader in
the company of a number of legal scholars, notably Philip I Blumberg, who

81 Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 558.
82 Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 558.
has concluded that “the identity doctrine is much the same” [in comparison to the alter ego doctrine]. Furthermore he has concluded that “Although their formulations differed, the variants [the instrumentality, alter ego and identity doctrines] were substantially the same”. They are however not exactly the same thing, as they are phrased somewhat differently, and are accordingly used separately.

### 3.1.4 Judge McHugh’s Amendment of the Third Prong

In *Laya v. Erin Homes, Inc.* the standard three prong instrumentality test was somewhat altered by Judge McHugh. While the first prong remained unscathed, the second query stipulated that an inequitable result would occur if the actions would be treated as solely those of the corporation. Though the real transformation lies not in the marvelously simple rephrasing of the standard second and third queries into a single concise one, but in that the third part came to declare a principle best described as caveat creditor. McHugh’s third prong stated that a party who under the circumstances could reasonably be expected to conduct an investigation of the credit of a corporation before entering into a contract, will be charged with the knowledge such an investigation would have yielded. McHugh elaborated his point by writing that this additional criterion, which must be fulfilled to pierce the corporate veil in a breach of contracts case, would apply in particular to parties which are “capable of protecting themselves”, mentioning banks and lending institutions as examples.

Judge McHugh’s test was applied again in *Kinney Shoe Corporation v. Polan*. In the first instance the veil had not been pierced because the District Court deemed that the plaintiff had assumed the risk of undercapitalization. Nonetheless, Judge Chapman of the Court of Appeals stated that the third prong, to be precise McHugh’s altered third prong, “is permissive and not mandatory”. He went on to declare that the situation at hand did not call for the application of such a third criterion if the court was searching for an equitable solution. He concludes his reasoning by stating that the defendant failed to correctly maintain the corporation, as there was no capital and no adherence to corporate formalities. This could not be excused by that the plaintiff should have known better.

### 3.1.5 In Conclusion

It can be said that for a corporate veil to be pierced, there are three conditions which have to be fulfilled. First of all there has to exist, as Vandekerckhove expresses it, an excessive control or lack of separate

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83 Blumberg, (1993a), p. 84.
87 Kinney Shoe Corporation v. Polan, 939 F.2d 209, 212.
existence. A similar criterion, the dominance of a subservient corporation by a dominant party, has also been identified by Krendl and Krendl. This first condition demands that the subsidiary or controlled corporation has been dominated and controlled to such an extent by a parent corporation or shareholder, that the corporation can be considered an instrumentality. Vandekerckhove mentions a wide assortment of metaphors which are used for such a dominated corporation which fulfill the criteria just as well. For example: alter ego, agency, department, sham, shell and tool. The main criterion is thus that the corporation should have been used by the shareholder or parent corporation to such an extent that it can be considered an integrated component and that it thus lacks a separate existence.

The second criterion identified by Vandekerckhove is inequitable conduct. The domination of the corporation is not on its own a sufficient ground to pierce the corporate veil. The parent corporation or the shareholder must moreover have participated in fraudulent, illegal or inappropriate activities. There must be some kind of abuse of the corporate entity. Krendl and Krendl also discern a requirement of the same nature, stating that there should exist some form of improper purposes or acts. According to them such an improper purpose would allow for the corporate entity to be disregarded on grounds of equity. They mention misrepresentations and joint improper acts as examples. The latter meaning a cooperative effort of the parent or shareholder and the dominated corporation which cause the plaintiff unjust injury.

Thirdly, it must be certain that the domination and inappropriate activities actually caused the plaintiff’s injuries. That is, there has to be causation. Krendl and Krendl express it as that the injury to the plaintiff must be reasonably related to the defendants domination of the corporation.

3.2 US Case-law

Disregarding the corporate entity by piercing the corporate veil occurs quite frequently in the United States. Merely between 1930 and 1985 there were 2000 cases in which corporate veil piercing was deliberated, and there are no signs of this trend having slowed down since, making it the most litigated legal issue in corporate law. I have chosen seven cases in total on their merits of deliberating extensively on the criterions for veil piercing as well as for their development of the legal theoretical backdrop of veil piercing. Three of them are tort cases: Berkey v. Third Avenue Railway

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Company, Minton v. Cavaney, Walkovszky v. Carlton. Four of them are contract cases: DeWitt Truck Brokers, Inc. v. W. Ray Fleming Fruit Company, Perpetual Real Estate v. Michaelson Properties, Zaist v. Olson and Kinney Shoe Corporation v. Polan. The cases are presented in chronological order in order to allow the reader to follow the development of the doctrine of corporate veil piercing, as well as to present an opportunity to notice the subsequent progress in its criterions and in their application by courts.

3.2.1 Berkey v. Third Avenue Railway Company

The plaintiff, a passenger of the Forty-second Street Railway Company, was injured when traveling in one of the company’s streetcars. The Forty-second Street Railway Company was owned in whole by the Third Avenue Railway Company. The plaintiff went on to sue the Third Avenue Railway Company to recover for personal injury. For the action to be successful the subsidiary company had to be perceived as an alter ego of the parent company, it had to be shown that the subsidiary was an instrument in the hands of the dominating company.  

The Court of Appeals of New York stated that merely the fact that one company owns all of the stock in another company, does not make the parent company responsible for day to day operations. Therefore stock ownership alone was deemed an insufficient cause for placing tort liability for a subsidiary on a parent company.

The court moreover stated that it could not be ascertained that any control subjugating the subsidiary into an instrument in a consolidated railway system was exercised. The Forty-second Street Railway Company had functioned as an independent corporation and could not be considered to have been constructed “as a decoy or a blind”. Circumstances which could compromise the corporations independence were deliberated. For example, most of the board was the same for both companies, the executive officers were the same, loans had been forwarded to the subsidiary, all streetcars were marked “Third Avenue System”, though tickets bore the name of the issuing company.

The plaintiff’s case was based on the grounds that a de facto contract had been concluded between the Third Avenue Railway Company and the Forty-second Street Railway Company, permitting the parent company to run the other company’s franchise as its own. The court noted that such an agreement would be unlawful since a contract of that nature had to be approved by the Public Service Commission to be valid. The court was reluctant to deduct an illegal agreement from actions which were understandable and appropriate to stock ownership. It stated that the

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unlawful operation of a route is not to be construed from actions which could just as well be innocent as they could culpable.¹⁰²

Judge Cardozo went on to declare that it is sometimes said that a corporate entity would be ignored if a parent company operated its business through a dummy or sham subsidiary. Though he underlined that in situations which are less than obvious, were it not evident that the subsidiary is just a tool of the dominating company, the court will have to rely on “the tests of honesty and justice”.¹⁰³ The court concluded that liability could not be placed with the parent company in a situation where subsidiary had maintained a separate organization so consistently, and where an implication of cooperation between two companies would also imply the committing of a crime.¹⁰⁴ The corporate veil was thus not pierced.

3.2.2 Minton v. Cavaney

Cavaney was director, secretary and treasurer of The Seminole Hot Springs Corporation. The court considered the plans that he was to receive a third of the company’s stock, even though he never did, to provide evidence that he was an equitable owner of the corporation.¹⁰⁵ The corporation was sued in a wrongful death action, and had to pay $10’000 in damages. Since the company had no assets and could not satisfy the judgment, Minton brought action to hold Cavaney personally liable.¹⁰⁶

Judge Traynor of the Supreme Court of California stated that the equitable owners of a corporation can be held personally liable when they treat the assets of the corporation as their own, when they make it seem as if they are personally liable for the corporation’s debts, and when they provide inadequate capitalization while participating actively in the corporation’s affairs.¹⁰⁷ The court concluded that the corporation did not have adequate capitalization, neither did it have any assets. Compared to the risks the pool-operating company faced in its operations, the capital provided was insignificant. It was also concluded that Cavaney had been active in the running of the business.¹⁰⁸ What the court emphasized, using the alter ego metaphor, was thus that the corporate privilege had been abused, that the corporation had grossly inadequate capital and that Cavaney had treated the assets of the corporation as his own.¹⁰⁹ Nevertheless, the court ruled in favor of Cavaney on procedural grounds. As Cavaney had died prior to the trial he had not

¹⁰⁵ Minton v. Cavaney, 56 Cal.2d 576, 580.
¹⁰⁶ Minton v. Cavaney, 56 Cal.2d 576, 578.
¹⁰⁷ Minton v. Cavaney, 56 Cal.2d 576, 579.
¹⁰⁸ Minton v. Cavaney, 56 Cal.2d 576, 580.
¹⁰⁹ Minton v. Cavaney, 56 Cal.2d 576, 579.
participated in it, i.e. he had not been in control of the litigation, and could thus not be bound by a judgment.\textsuperscript{110}

3.2.3 DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Company

Ray Flemming Fruit Company was incorporated in 1962. It was a commission agent for fruit growers, selling produce in return for a sales commission. When fruit was sold the growers received the sales prices less the commission and less costs for the transportation from the grower to the purchaser. The only liquidity in the corporation was the sales commissions and withheld transport charges.\textsuperscript{111} Nevertheless, Flemming withdrew funds from the corporation of such amounts that their payments were made possible only by the retention of transport charges which in fact were owed to DeWitt Truck Brokers, Inc., i.e. the plaintiff. DeWitt Truck Brokers filed suit in order to make Ray Flemming personally liable for the debt of his corporation.

Judge Donald Russell made it clear that the fact that most of a corporation’s stock is owned by a single or a few individuals, does not provide a sufficient grounds for piercing the corporate veil. He nonetheless noted that substantial ownership in combination with other aspects that from a perspective originating in general fairness and equity point towards a disregard of the corporate entity, will lead courts to have little apprehension in applying the instrumentality theory and pierce the corporate veil.\textsuperscript{112} Judge Russell went on to emphasize the importance of adequate capitalization by citing JR. Gillespie’s article “The Thin Corporate Line: Loss of Limited Liability Protection”: “the obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter … during the corporation's operations”.\textsuperscript{113}

In his analysis of the Ray Flemming Fruit Company, Judge Russell notes that the corporation was “a close, one-man corporation from the very beginning”. In addition to Flemming seemingly owning 90% of the stock of the corporation, there was evidence which made it highly likely that persons identified as officers by Flemming in fact were merely front figures, uninvolved in business operations. Furthermore the court noted that corporate formalities had been completely disregarded, a stockholder’s meeting never having been held.\textsuperscript{114} As a final aspect, Judge Russell mentions the personal nature of the business operation. Apart from

\begin{itemize}
  \item \textsuperscript{110} Minton v. Cavaney, 56 Cal.2d 576, 581.
  \item \textsuperscript{111} DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Company, 540 F.2d 681, 688-689.
  \item \textsuperscript{112} DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Company, 540 F.2d 681, 685.
  \item \textsuperscript{114} DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Company, 540 F.2d 681, 687-688.
\end{itemize}
Flemming, no other shareholder had ever received any payment, salary, dividend from the corporation. Neither had anyone else but Flemming exercised any control over the corporation or taken any part in the decision-making process. Russell summarized it as that the corporation was operated for Flemming’s exclusive benefit. Flemming would treat the company as his own cash register, the amount of funds withdrawn every year limited only by the amount available in the corporation. The court thus found that numerous factors of the instrumentality theory were present in the defendant’s corporation. Flemming owned all of the stock in the corporation, the corporation had inadequate funds as Flemming regularly withdrew inappropriate amounts, and corporate formalities were shunned.

Russell concludes his statement by declaring that the factors present in the case are exactly of the kind which courts have pointed out as justifying a disregard of the corporate entity on grounds of fairness and equity. The veil was thus pierced in this case and the defendant held personally liable for the debts of his corporation.

3.2.4 Perpetual Real Estate v. Michaelson Properties

Perpetual Real Estate brought suit against Michelson Properties to hold its sole shareholder Michaelson responsible for his company’s contractual liability. The plaintiff and the defendant had entered into two joint real estate ventures, in which two partnerships had been set up. The profits from these partnerships were distributed to the parent corporations. In Michaelson Properties’ case the funds were then forwarded to its sole shareholder, Michaelson. Some years after the distribution of profits, the second partnership was sued on grounds of breached warranty claims. Perpetual Real Estate paid the settled amount of $950,000 on behalf of the partnership, after which it filed action to pierce the corporate veil of Michaelson Properties on the grounds that the corporation had been Michaelson’s alter ego, an instrument of his.

Judge Wilkinson of the Court of Appeals of the fourth circuit stated that Virginian law had long recognized the legal separation of a corporation and its shareholders. Moreover he stated that the limited liability which corporations enabled supported a vital economic policy on which entrepreneurship thrived. He then stated that Virginia courts would only pierce the corporate veil in extraordinary cases.

Wilkinson continued by stating that mere domination or control of a corporation by a person is not enough to for the corporate veil to be pierced. He then went on to note that the prior instance, a district court, had not

117 Perpetual Real Estate v. Michaelson Properties, 974 F.2d 545, 546-547.
118 Perpetual Real Estate v. Michaelson Properties, 974 F.2d 545, 547-548.
found any evidence for the notion that Michaelson used the corporation to obscure fraud or conceal crime. Judge Wilkinson then concluded that the possible reason to pierce the veil would be if Michaelson had used the corporation to disguise wrongs, something which Perpetual Real Estate had failed to show. The plaintiff had knowledge of the ownership structure of its partner, it had agreed upon distributing the profits from the partnership and had not sought to limit what Michaelson Properties was allowed to do with those funds. The forwarding of profits to Michaelson was according to Wilkinson “entirely foreseeable” to the plaintiff, and could not be considered an “unfair siphoning of funds”. Judge Wilkinson concluded his opinion by writing that a creditor dealing with a corporation which is straight concerning its financial circumstances, should not be able to complain about these later on.\(^{119}\) The veil was thus not pierced.

This case can be considered an example of a practical application of Judge McHugh’s amendment of the third prong. Perpetual Real Estate had partaken extensively in the distribution of funds from the partnerships and thus had a broad knowledge of the plaintiff’s financial affairs.

### 3.2.5 Walkovszky v. Carlton

Walkovszky was run down by a cab owned by a corporation owned by Carlton. Carlton owned ten corporations, each in turn owning two cabs. Each cab carried only the minimum liability insurance required by law. Judge Fuld of the Court of Appeals of New York began by stating that it is permitted to organize a business in a certain way only to avoid personal liability. However he went on to note that courts will “pierce the corporate veil when necessary to prevent fraud or achieve equity”.

The court remarked on the uncertainty concerning what causes Walkovszky sought personal liability. He had alleged that Carlton organized his operation in a way which made “an unlawful attempt at defrauding members of the general public who might be injured by the cabs” as well as claiming that “none of the corporations had a separate existence of their own”.\(^{120}\) Fuld therefore declared that a difference must be made between claiming that a corporation in reality is a piece of a large corporate operation, and claiming that a corporation in fact is a sham and nothing more than an extension of the owner’s capacities. In the former situation, piercing the corporate veil would result in that a larger corporate entity would be held liable. In the latter case it would lead to that the owner would be held personally liable. As Judge Fuld phrased it: “Either the stockholder is conducting the business in his individual capacity or he is not”.\(^{121}\) Since the court could not distinguish any “sufficiently particularized statements” that Carlton was conducting the business in his individual capacity it did not investigate that matter any further. Instead it focused on the question

\(^{119}\) Perpetual Real Estate v. Michaelson Properties, 974 F.2d 545, 549-550.

\(^{120}\) Walkovszky v. Carlton, 18 N.Y.2d 414, 416, 418; 223 N.E.2d 6

\(^{121}\) Walkovszky v. Carlton, 18 N.Y.2d 414, 419; 223 N.E.2d 6
whether the corporation was undercapitalized, a cause which they could identify in the plaintiff’s action.\textsuperscript{122}

Fuld declared that the court could not sidestep the corporate form just because the assets of the corporation and the mandatory insurance coverage were not enough to satisfy a desired recovery. Fuld wrote that if Carlton was held personally liable even though he had incorporated his business and carried the insurance coverage demanded, this would affect all other cabs, whose operations were organized similarly, as well.\textsuperscript{123} He went on to deliberate that even though it might be a sound principle to require that certain corporations carry insurance which provide adequate coverage for potential victims, it was not up to the courts to decide this, but to the Legislature. Fuld concluded that it was not fraudulent of Carlton to conduct his business with minimum insurance coverage.\textsuperscript{124} The corporate veil was thus not pierced. As the cab in question was owned by a corporation which in turn was wholly owned by Carlton, a perception by the court that the corporation was undercapitalized would most probably have fulfilled the instrumentality criterion which would have led to a piercing of the veil.

\textbf{3.2.6 Zaist v. Olson}

Martin Olson had incorporated four firms, three of which, Martin Olson, Inc., New London, Inc. and Viking, Inc., owned lands on which real estate was developed. The fourth corporation, East Haven, Inc. did not own any pieces of land. As Olson contracted personally with the plaintiffs to work on his first development, they were told to send their bills to East Haven, Inc. Later on the plaintiffs were contracted directly by East Haven, Inc. to do work on projects situated on lands owned by Olson’s three other corporations.\textsuperscript{125} As Olson informed the plaintiffs that due to the financial standing of East Haven, Inc. it could not settle its payments for some time, the plaintiffs sued to hold Martin Olson, Martin Olson, Inc. and East Haven, Inc. liable for the unpaid debt.\textsuperscript{126}

Associate Justice Alcorn of the Supreme Court of Connecticut phrased the question before the court to be if the plaintiffs could be allowed “\textit{to look beyond East Haven, the corporate entity with which they dealt, to Olson and Olson, Inc., for a recovery of the amount due them}”.\textsuperscript{127} First the court noted that Olson, Inc. did not have any stock ownership in East Haven, though Olson himself controlled both of them, as well as he was president, treasurer and director of both. The court made note of that it was not his holding of the mentioned positions that determined his control of the corporations, instead it was the manner in which he used these positions.\textsuperscript{128}

\begin{footnotesize}
\begin{enumerate}[label=\textsuperscript{\arabic*},ref=\textsuperscript{\arabic*},style=inline]
\item Walkovszky v. Carlton, 18 N.Y.2d 414, 420; 223 N.E.2d 6
\item Walkovszky v. Carlton, 18 N.Y.2d 414, 417; 223 N.E.2d 6
\item Walkovszky v. Carlton, 18 N.Y.2d 414, 421; 223 N.E.2d 6
\item Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 555.
\item Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 553, 556.
\item Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 557.
\item Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 558.
\end{enumerate}
\end{footnotesize}
The court went on to apply both the instrumentality rule and the identity rule, finding the latter a complement to the former. Concerning the instrumentality rule the court concluded that East Haven was dominated by Olson to such a degree that it had no separate mind, will or existence of its own. This control was then used to act unjustly against the rights of the plaintiffs, which caused the loss which the plaintiffs are complaining of. Thus, all three prongs of the instrumentality rule were concluded to be fulfilled.\(^\text{129}\)

Moving on to the identity rule, the court clarified that it stated that if “there was such a unity of interest and ownership that the independence of the corporations had in fact ceased or had never begun”, the corporate entity would be disregarded so that liability could be extracted for actions “conducted by one corporation for the benefit of the whole enterprise”.\(^\text{130}\)

It was also noted by the court that Olson had founded all of the corporations and then dominated them completely. All of the corporations also shared the same office. Furthermore the lands on which the plaintiffs worked all ended up in the ownership of Olson personally or in Olson, Inc.. It was also noted that corporate formalities, with few exceptions, had been consistently ignored. East Haven, Inc. was also considered to be inadequately capitalized as it had insufficient funds of its own, and did not generate any funds through its business operations. Neither did East Haven have any stake in the projects for which it contracted the plaintiffs. The court concluded that its only purpose what to be used by Olson and Olson, Inc.. Therefore the corporate veil was pierced.\(^\text{131}\)

**3.2.7 Kinney Shoe Corporation v. Polan**

Kinney Shoe Corporation had a leasehold interest in a building which it had used as a manufacturing site up until June 1983. Polan had formed the corporations Industrial and Polan Industries, Inc. in 1984. In December 1984 Industrial began to sublease the building from Kinney Shoe Corporation. In April 1985 Industrial began to sublease the building to Polan Industries, Inc., for half of the rent negotiated between Industrial and Kinney Shoe Corporation. Both the original lease and the sublease to Polan Industries, Inc. were signed by Polan. Apart from the very first rent payment which had been paid by Polan personally, no payments were made to Industrial or Kinney Shoe Corporation, neither by Polan or by Polan Industries, Inc. Kinney Shoe Corporation sued and received a judgment against Industrial for the unpaid rent. Kinney then sued to hold Polan personally liable for Industrial’s obligations. The District Court for the Southern District of West Virginia refused to pierce the corporate veil. Kinney appealed to the Court of Appeals of the Fourth Circuit.\(^\text{132}\)

\(^{129}\) Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 553, 556.

\(^{130}\) Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 558.

\(^{131}\) Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 558-559.

\(^{132}\) Kinney Shoe Corporation v. Polan, 939 F.2d 209, 210-211.
In determining whether the corporate veil should be pierced, Judge Chapman referred to the two-pronged test presented in *Laya v. Erin Homes, Inc.*, a concise version of the instrumentality theory. The first query of that test is whether there is such a unity of interest and ownership that the corporation and the shareholder no longer possess separate personalities. The second question is whether there would be an equitable result if the actions were deemed to be those of the corporation itself.\(^\text{133}\)

In answering the first prong of the test, Judge Chapman placed significant emphasis on the undercapitalization of Industrial. Chapman noted that the corporation in fact did not have any capital whatsoever, as Polan had not contributed any to it. It was also underlined that Industrial had not observed any corporate formalities. There were no elected officers, nor had any minutes been kept. Concerning the second question of the test, Judge Chapman perceived the placing of Industrial as a firewall between Kinney Shoe Corporation and Polan Industries, Inc. as a blatant attempt to hinder Kinney from being able to reach at the corporation with assets. Chapman stated that it was obvious that Industrial was nothing more than a paper curtain to shield Polan and Polan Industries, Inc. from liability. Judge Chapman therefore considered the stage to be set for the achievement of an equitable result by piercing the corporate veil, and thus the second prong was regarded as fulfilled as well.\(^\text{134}\)

The court also delved into a potential third prong mentioned by Judge McHugh in *Laya v. Erin Homes, Inc.*. In that case the court had stated that if it would be reasonable for a party to investigate the financial situation of a corporation before entering into a contract with it, that party would have to bear the burden of the knowledge such an investigation would have yielded. The judge mentions the example that an investigation would have shown that a corporation is undercapitalized. In such a situation a creditor not having conducted such an inquiry even though he reasonably could have been expected to do so, will not be able to exploit this lack of funds in a quest to pierce the corporate veil. Concerning the potential third prong Judge Chapman reasoned that Industrial was nothing more than a shell, since nothing was invested into the corporation it cannot be expected to carry the characteristics of a corporation, therefore its owner cannot expect to enjoy the protection the corporate entity usually yields. He concluded his reasoning by stating that since Polan failed to adhere to corporate formalities and thus could not enjoy limited liability, he should not be able to enjoy it anyway just because “Kinney should have known better”. Therefore the corporate veil was pierced and Polan was held personally liable for the debt of Industrial.\(^\text{135}\)

\(^{133}\) Kinney Shoe Corporation v. Polan, 939 F.2d 209, 211.

\(^{134}\) Kinney Shoe Corporation v. Polan, 939 F.2d 209, 212.

\(^{135}\) Kinney Shoe Corporation v. Polan, 939 F.2d 209, 212-213.
3.3 In Sweden

There have been endeavors concerning the legislation of corporate veil piercing in Sweden. In 1987 a governmental report was presented as a result of a process which was begun in 1981. The report stated that while larger creditors would not need a legislation of veil piercing, smaller creditors could benefit from it.136 The report also declared that concerning involuntary creditors, a legislation would not provide any increased security as the compensation would depend wholly on the shareholders financial situation.137 The report concluded by advocating rules which clarified the legal situation, but which would only be applied in extraordinary cases.138

This suggestion did not go home well with the Council on Legislation, a supervisory body overseeing potential new legislation. In 1991 it stated that legislating on veil piercing would be quite unnecessary as case-law already has introduced the concept. It also declared that legislation could potentially increase legal unpredictability for businesses as the criterions would be unsatisfactorily specified. Overall the council distanced itself from any kind of legislation of corporate veil piercing.139 No legislation was subsequently passed.

In 1994 another report on the plausibility of legislating veil piercing was commissioned by the new government. When presented in 2001 it focused wholly on the plausibility of a general rule on veil piercing, which it considered the only feasible option. The other alternatives, a rule focusing on certain specified situations and a torts rule were considered not to offer the necessary broad legal support for veil piercing. The committee which produced the report acknowledged difficulties in specifying the circumstances which would precipitate veil piercing. In particular, the committee identified problems when attempting to create a rule on the capitalization of corporations, something which was considered a likely requisite. The committee concluded that it could not phrase a suitable rule on capitalization as any choice of words would present ample opportunities for extensive interpretations. Furthermore, the committee pointed out that without a criterion focusing on the inappropriateness of certain corporate actions, a piercing rule would have a much too extensive range of application. Though with such a criterion courts would be given significant latitude in deciding what is inappropriate, and thus it would give rise to an increase in judicial insecurity. The report was concluded with the committee expressing the opinion that there was no necessity for a legislation of corporate veil piercing.140 In fact it thought that the need for such regulation was even lesser now than it was in 1987 due to a large number of regulations which tightened the legal supervision of corporations. Taken

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136 SOU 1987:59, s. 94.
137 SOU 1987:59, s. 95.
138 SOU 1987:59, s. 97.
139 SOU 2001:1, s. 284.
140 SOU 2001:1, s. 285-286.
together the committee declared that if found it hard to justify a legislation of corporate veil piercing.\textsuperscript{141}

In 2004 the subject was deliberated by the government. It began by declaring that limited liability was a key characteristic of fundamental importance, and as such was to continue to exist. It then stated that the problems associated with a legislation of veil piercing, specifically worsening the possibilities for entrepreneurial efforts, prompted caution in restricting the principle of limited liability. Moreover the government remarked that there were significant difficulties in creating a general legal rule on veil piercing.\textsuperscript{142} It also referred to the mention of the Legal Council of the potential dangers to judicial security that such a rule could pose. Furthermore it noted that legislation of veil piercing was quite rare from an international perspective, and had not been included in the Council Regulation (EC) No 2157/2001 on the Statute for a European Company. The government concluded by stating that it considered the negative aspects of such regulation to outweigh any reasons in favor.\textsuperscript{143}

When deliberating whether to pierce the corporate veil Swedish courts consider factors which are essentially the same as those mentioned by the Powell Rule. A comprehensive account of these factors can be found in NJA 1947 s. 647. This case is probably the most notable veil piercing case in Sweden, as is it the first one.\textsuperscript{144} Bergström and Samuelsson have identified three factors mentioned in this case:\textsuperscript{145}

1. Few shareholders.
2. The operation of the corporation is dependent in relation to its parent corporation.
3. Undercapitalization.

In a report preceding a legislative overhaul of the Swedish corporate code in 1987, it was stated that a legislated possibility to pierce the corporate veil was not considered necessary for large creditors such as banks, lending institutions and large suppliers. This viewpoint was justified by the assertion that larger actors will grant credit after having carefully scrutinized the financial prospects of the recipient corporation. It was stated that if such a creditor foregoes demanding proper security for its loan, its actions must be considered to be an expression of risk-taking. Nonetheless, it was acknowledged that smaller creditors such as minor suppliers could benefit from a regulated veil piercing. Since small businesses seldom have the possibility to conduct thorough credit and financial analyses of their clients, nor do they usually receive dividends from bankruptcies, it was perceived that they could stand to gain from an increased measure of legal certainty.\textsuperscript{146}

\textsuperscript{141} SOU 2001:1, s. 288.
\textsuperscript{142} Prop. 2004/05:85, s. 207.
\textsuperscript{143} Prop. 2004/05:85, s. 208
\textsuperscript{144} SOU 2001:1, s. 280.
\textsuperscript{146} SOU 1987:59, s. 94.
Even though veil piercing never was integrated into legislation, the deliberations presented in the legislative report had an impact on the rulings of Swedish courts. In NJA 1992 s. 375, the Himlebolaget case, the court stated that since the creditor bank had unrestricted access to the defaulting corporation’s finances, as well as it had ample opportunity to demand satisfying security for its loans during negotiations, the corporate veil would not be pierced since the actions of the bank reflected risk taking.\textsuperscript{147}

It has also been expressed, notably in case-law, that the actions of the corporation must be considered to have clearly and disloyally violated the interests of creditors.\textsuperscript{148} This can be considered to be the Swedish adaption of proximate cause. The inappropriate acts of the corporation must have had some negative effect on creditors.

### 3.4 Swedish Case-law

This section will deal with cases were Swedish courts have used or deliberated piercing the corporate veil. NJA 1947 s. 647 was a tort case, while NJA 1975 s. 45, NJA 1982 s. 244 and NJA 1992 s. 375 were all contract cases.

#### 3.4.1 NJA 1947 s. 647 – The Dam Case

A dam across an outlet of lake Båven was owned by a corporation, Nyköpingsåns kraftintressenters aktiebolag, formed by the City of Nyköping and four other corporations which all owned hydropower plants downstream from another outlet of lake Båven. During a reconstruction of the dam the corporation had erected an unlawful provisional dam above the original location. The spillways of the temporary installment turned out to have an insufficient capacity to deal with an unforeseen increase in the amount of water, causing water levels to rise 21.96 meters in two days. As farmlands adjoining lake Båven experienced substantial damages, an affected farmer filed suit against the corporation and was awarded compensation. When he attempted to collect these damages it was discovered that the corporation had no assets and had gone into bankruptcy, prompting him to sue to hold the shareholding corporations liable. The Supreme Court stated that the corporation had been formed solely to acquire the dam and utilize the possibilities of regulating the water flow to the benefit of the shareholders. It also noted that just that had been done, which had caused damage to the plaintiff.

Furthermore the court remarked that all outstanding shares were owned by the five parties, that the capital of the corporation was diminutive, and that any costs encountered by the corporation were covered on an ad hoc basis.

\textsuperscript{147} NJA 1992 s. 375, 397.
\textsuperscript{148} NJA 1982 s. 244, s. 260.
by capital contributions from the shareholders. The Supreme Court concluded its judgment by declaring that the corporation had merely functioned as the executive organ of the five shareholders for the regulation of water, and that it therefore had not conducted an independent operation. The corporate veil was thus pierced.

### 3.4.2 NJA 1975 s. 45 – The Holmenbolaget Case

Two corporations, Bilbolaget and Holmenbolaget struck a deal stating that Bilbolaget would obtain all assets of Holmenbolaget as well as accept all its debt. Furthermore, Holmenbolaget was now to conduct its business on a commission basis for Bilbolaget. A few years later this agreement was cancelled, meaning that Holmenbolaget now was to conduct business separately from Bilbolaget. As Holmenbolaget was put into bankruptcy shortly later, it was discovered that it lacked assets of any kind. This prompted creditors to file suit in order to hold Bilbolaget liable for the unresolved debt.

The Supreme Court stated that since all shares in Holmenbolaget were owned by the same person who controlled Bilbolaget, both companies were controlled by the same person. Furthermore the agreement implying that Holmenbolaget would function as a separate business, had not had those effects. The court went to remind that the purpose of a commissioner corporation is that it conducts business in its own name, but on behalf of the parent corporation. The commissioner corporation is completely dependent of the parent who controls the commissioner and to which all excess funds, as well as accrued debt, are transferred. The court moreover declared that the funds in Holmenbolaget were insufficient for it to be able to conduct business independently. Any capital contributions made by Bilbolaget had been transferred back at the end of every fiscal year. The Supreme Court concluded by stating that Bilbolaget was either to be considered the actual operator of Holmenbolaget’s business or to be involved to such a degree that it could not escape liability for Holmenbolaget’s debt. The corporate veil was thus pierced.

### 3.4.3 NJA 1982 s. 244 – The Byggma Case

A corporation, Byggma Syd Aktiebolag, was the parent company of a constellation of corporations which all carried the name Byggma Syd, though in combination with the name of the city in which they operated, e.g. Byggma Syd i Falkenberg Aktiebolag. As Byggma Syd AB went into bankruptcy, creditors consisting of suppliers sued to hold it liable for debt which formally belonged to subsidiaries.

The Supreme Court began by stating that Byggma Syd was the formal employer of all employees in the group of corporations, any inflowing funds

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149 NJA 1975 s. 45, s. 62.
150 NJA 1975 s. 45, s. 63.
151 NJA 1982 s. 244, s. 245.
to the subsidiaries were transferred to Byggma Syd, and any debt accrued by a subsidiary was accounted for by Byggma Syd as its own. The court concluded that the annual report of Byggma Syd would have creditors believe that Byggma Syd was liable for all payments to suppliers.\footnote{NJA 1982 s. 244, s. 265.}

The Supreme Court furthermore stated that deciding importance in determining the question of liability was to be given to the routines to which Byggma Syd adhered to in its conducting of business with suppliers. Creditors had been informed that regardless of which subsidiary it actually delivered to, invoices were to be sent to the parent company. The court deemed that under these circumstances, the viewpoint of creditors that Byggma Syd was the corporation liable for the payments, was justified. Furthermore it stated that Byggma Syd should have realized that such a procedure concerning the payments of invoices, must have given rise to a idea among its subsidiaries that Byggma Syd accepted liability for payments.\footnote{NJA 1982 s. 244, s. 265-266.} The court stated that taken together Byggma Syd could not escape the obligation to pay the suppliers of its subsidiaries.

### 3.4.4 NJA 1992 s. 375 – The Himlebolaget Case

The municipality of Varberg created a foundation which had as its purpose to conduct tourism-related businesses. The foundation became a major shareholder in two corporations, Leklandsbolaget and Himlebolaget, also active in the tourism industry. When the two corporations later entered into bankruptcy, a bank which had forwarded credit to them, sued to hold the municipality of Varberg liable for unsettled debt of Himlebolaget.\footnote{NJA 1992 s. 375, 375-377.}

The only court to present its assessment of the possibilities to pierce the corporate veil was the court of first instance, the other two higher instances simply referred to its deliberations. The court stated that in Swedish case law piercing the corporate veil has been deemed possible if a corporation has a very limited number of shareholders, it has operated a business which can be considered dependent on the business operations of its shareholders, the purpose of its business was rather to further the interests of its shareholders than to generate a profit, and if it can be considered inadequately capitalized taking into account its potential liabilities.\footnote{NJA 1992 s. 375, 395.}

The court went to declare that according to the factors mentioned it would be possible to pierce the corporate veil and make the municipality liable. The court elaborated its line of thought by pointing at the lack of capital in the foundation as well as in Himlebolaget. Furthermore, since the purpose of the foundation had not been sufficiently specified, the municipality could be considered the de facto shareholder of Holmenbolaget. In addition, the municipality, the foundation and Holmenbolaget all had the same purpose with their operations, which was to further tourism and recreational
activities in the municipality. The court also stated that it seemed as if the operations of all entities was highly integrated. It mentioned that leading positions in the different units were occupied by the same individuals. It went on to state that a municipality which had created a group of corporations in order to further a project, which then failed, should not be able to escape liability for accrued debt just because it ran operations through a number of corporations instead of just one.\textsuperscript{156}

Having concluded that piercing the corporate veil would be a possible course of action, the court went on to evaluate a restriction to veil piercing. It stated that a shareholder should not be held liable for the debt of his corporations, if he has done enough to inform creditors of the financial state of the corporation.\textsuperscript{157} The court then declared that the creditor bank was constantly aware of the factors which speak in favor of piercing the corporate veil. The bank had complete insight in the financial aspects of the corporation. Therefore the bank’s position was concluded to differ remarkably from the position of other creditors that had been given little reason by the impression of corporate operations to investigate the financial stability of its debtor corporations. In addition, it was deemed that there had been possibilities for the bank to secure its debt or to demand guaranties when negotiating the loans. The court did not pierce the corporate veil.\textsuperscript{158}

### 3.5 Comparative analysis of US and Swedish Case-law

When applying veil piercing courts in the United States and in Sweden consider circumstances which are very much alike, and quite expectedly so. Corporate veil piercing is not a national phenomena with regional varieties. It is a doctrine which has evolved from the widespread usage of an organizational form, corporations, which can be considered nearly identically regulated concerning its key characteristics in most countries.

Both US and Swedish courts lay emphasis on the dependence, instrumentality if you will, of the corporation in its assessments of the applicability of veil piercing. Both countries consider the same aspects in establishing whether a corporation is an instrumentality. Even though the list of circumstances mentioned by Powell can be regarded as more extensive than the three circumstances distinguished by Bergström and Samuelsson in \textit{NJA 1947 s. 647}, the essence of both catalogs is the same. In fact, the second point in the latter list; \textit{The operation of the corporation is dependent in relation to its parent corporation}, can with little interpretative effort encompass a broad array of the circumstances mentioned by Powell.

Concerning the criterions applied by courts in the United States and Sweden, a few similarities, even though not surprising ones, are discernable.

\textsuperscript{156} NJA 1992 s. 375, 396.
\textsuperscript{157} NJA 1992 s. 375, 396.
\textsuperscript{158} NJA 1992 s. 375, 397.
To begin with, both US and Swedish courts place great emphasis on undercapitalization in corporations. Since undercapitalization can be considered the quintessential reason for piercing the corporate veil, as there would be no reason to go after the pockets of shareholder if your claims are satisfied by the subsidiary, the sharing of this factor is not surprising, though it still warrants mention because of its commanding importance in the case law of both nations.

Furthermore, both US and Swedish courts take into account the defendant corporation’s adherence to corporate formalities. US courts however seem to consider it a heavier factor, it having been stated in case law that undercapitalization and failure to comply with formalities, if causing unjustness, may be reason enough to pierce the corporate veil. Swedish courts on the other hand commonly mention inability to adhere to corporate formalities in more brief phrasings.

Even though case law expresses that the mere existence of few shareholders is not sufficient grounds for veil piercing in the United States, courts have been proven to be more prone to pierce the fewer shareholders a corporation has. This legal inclination is shared by Swedish courts, which however have approached the question of the importance of the number of shareholders somewhat differently, by clearly stating that few shareholders is a factor which speaks in favor of veil piercing. Simply the existence of instrumentality or domination is not ground enough to pierce the corporate veil, neither in the United States nor in Sweden. In the former some sort of inappropriate behavior must be ascribed to the defendant. In Sweden courts consider whether there is evidence of any disloyal behavior on the defendant’s part. Moreover, courts in both countries demand a causal relationship between the instrumentality combined with the inappropriate or disloyal behavior, and the injury or damage caused to the plaintiff, in order for corporate veil piercing to be considered.

The utilization of corporate veil piercing by courts in the United States and in Sweden also shares the resemblance in the courts’ application of a should-have-known-better rule. Both in Laya v. Erin Homes and in Kinney Shoe Corporation v. Polan, the courts deliberate on the implications of the plaintiff’s knowledge of internal circumstances in the defendant corporation. The courts’ line of reasoning is that if the claimant had a comprehension of, or access to information concerning the circumstances which caused his loss, he may not pierce the corporate veil on the very same grounds, as he should have known better in his endeavors with the corporation in question. Swedish courts have employed the very same reasoning in NJA 1992 s. 375 – The Himlebolaget Case, where the creditor bank was considered to have been aware of all circumstances which were brought forward in support of veil piercing.

4 A Law and Economics Analysis of Veil-Piercing

To pierce the corporate veil, to ignore limited liability, arguably the most important trait of the corporation, can seem like madness given the numerous economic advantages that the corporate form possesses. However, it must be recalled that piercing the corporate veil occurs when the corporate form has been inappropriately utilized. As the reader will know by now, signs of such improper usage are close corporations with few shareholders, business operations dependent in various ways on a dominant party, disregard of corporate formalities and undercapitalization. All these factors indicate a firm directed in a way which is incompatible with the purpose of the corporate form, this purpose being to create a separate, independent, sufficiently funded entity with which to operate a business or venture.

This segment will conduct a law and economics analysis of the criterions for piercing the corporate veil and of the application of veil piercing in contract and tort cases. We will consider whether the criterions applied by courts make sense from an economic point of view. Do the courts’ reasoning adhere, or at least come to the same results as if the criterions were applied strictly in line with economic theory? Furthermore an economic analysis will be carried out on the application of the doctrine of corporate veil piercing in tort and contract cases. What are the economic implications of piercing the corporate veil in such suits? Can such a practice be in accordance with economic theory?

4.1 The Criterions for Veil Piercing

As has been mentioned, the instrumentality of a corporation is defined as that a corporation is not operated for its own benefit, but rather that it used to further the interests of a dominating, controlling party. Instrumentality is to be considered a group of factors, in contrast to the individual circumstances which it consists of. According to Thompson’s study, when instrumentality is deemed present by courts, veil piercing follows in 97,33% of cases. In contrast, when instrumentality was not mentioned as a present factor by courts, the corporate veil was never pierced. Thus, instrumentality is to be viewed as a major factor in determining whether a corporate veil shall be pierced or not. Obviously then, it is important to establish whether courts adopt an approach to instrumentality which is in concordance with the rationale of law and economics.

The individual factors which courts reflect on when resolving whether instrumentality is at hand, specifically Powell’s eleven circumstances, can

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be categorized under three themes: the absence of independence from a dominating party, the disregard of formalities and inadequate capitalization.

4.1.1 Absence of Independence

There is an absence of independence when a corporation is intimately linked with a dominating party in a way which refuses the corporation any autonomous existence, purpose or self-sufficiency. Not only the instrumentality theory focuses on the dependence of a corporation on a dominating entity, so does the identity rule.

This asserts the importance which is allocated to a corporations dependency in determining whether its veil warrants a piercing. In my opinion this weight is assigned rightfully so. The point of forming a corporation is that it should essentially function on its own. Of course, corporations are not always completely independent entities. Ties to parent corporations may be strong and close, and business operations may be intertwined with those of the parent corporations. However, as long as the subsidiary is a functioning entity when on its own, the intention of the corporate organizational form is upheld. By creating a corporation which by all measures is an operating part of its parent corporation, the shareholders have in fact created a second wall of limited liability between themselves and their corporation’s business operations.

The rationale of creating a corporation is to take advantage of its beneficial characteristics, among them limited liability. The price of these advantages is the adherence to certain principles governing the use of the corporate form. Since the corporate entity has been constructed with the intention of it being used as a risk restricting method of enterprise, it is an exploitation to instead use it to further reduce risk.

From a law and economics perspective such usage of a corporation would result in an economically inefficient allocation of capital as it would create a capital to risk deficiency. When a risky business venture is incorporated, yet remains an integral part of another incorporated business unit or project and can in fact be considered dominated by the latter, its risk is really a part of the latter undertaking. If that risk is not accounted for correctly in the latter enterprise, the rewards do not consider the risks which for all intents and purposes are faced. This would attract an inefficient amount of capital, considering what would be invested had all risks been internalized into the venture and thereby have been made visible. Investors would place too much funds in the risk hiding venture, fooled by the potential rewards, at the expense of other projects in need of capital, which would have warranted investments had all risk been accounted for correctly and assumed.

4.1.2 Disregard of Formalities

Corporate formalities encompasses the holding of proper annual meetings with minutes being kept and the general adherence to formal protocol. In my
opinion the disregard of formalities is to be considered merely a symptom of some larger defect in a corporation. By this I mean that it should not be given too much weight as a circumstance which on its own points towards instrumentality. Rather, it should be seen as an indication of the prevalence of other weightier factors, or a confirmation of suspicions, based on other factors, that a corporation is merely a sham entity not meant to be taken seriously.

If courts were to consider inadequate adherence to corporate formalities an important precursor of instrumentality, it would inadvertently give corporations with access to more funds an advantage over more cash strapped corporations, as the former would be able to afford allocating time and labor to satisfy the requirements. Allotting illiquid corporations with such a competitive disadvantage is definitely not in line with economic theory. Not only would start ups, recently initiated ventures and small businesses, all notoriously low on funds, be given a harder time getting started, barriers to entry would be raised all across the board. This could initiate a shift away from the conducting of business in corporations, to a greater utilization of organizational forms which have less formal requirements. This would mean that the advantages which are to be had through the corporate form would be foregone, as would all potential wealth gains to society.

Fortunately, courts seem to reason the same way. Thompson discovered that informalities were mentioned in only 20% of contract cases which were pierced. Furthermore, the citing of disregard of corporate formalities by courts was followed by veil piercing in 67% of cases.164

4.1.3 Inadequate Capitalization

Undercapitalization is sometimes mentioned as the primary reason for piercing the corporate veil.165 However its application comes with some issues. Those troubles are very much of the same kind as for the minimum capital requirements used to battle moral hazard. First off, it is uncertain how little funds there must be for a corporation to actually be undercapitalized. Usually this issue is resolved by stating that there must be sufficient capital for the corporation to be able to carry out its stated purpose.166 Rationally, this should be determined by analyzing the industry’s average level of capitalization. However, this also presents a few complications. It is quite possible that the industry is by and large mature. The existing corporations might be long established and have acquired their capital, the amount of which is to be used as a measuring stick, over a long period of time. Demanding that, for example a newcomer, can present the same amount of funds as other time-honored corporations would be unreasonable. Moreover, such a practice would in effect be raising barriers to entry, consequently making it harder for potential competition to enter the

165 Krendl and Krendl, (1978), p. 34.
industry and allowing existing corporations to set their own terms. All to the loss of consumers facing less options and almost certainly higher prices.

When determining what level of funds is sufficient, legislators and courts alike must tread lightly. Such a sanctioned governmental, or in fact court-ordered, stipulation is an interference both with the free market forces and the free will of entrepreneurs and investors. A corporation could be undercapitalized simply because investors have decided to extract some of the profits generated. Should investors not be allowed to reap the fruits of their labor in any quantity they want and are able to? If some industry suddenly, due to demands on the levels of capitalization, were to be marked as over regulated and smothering investor's yields, investments into that particular line of business would drop drastically. Such disinterest will immediately, affect spending on research and development if such are conducted, hampering technological and scientific advances at unknown costs. It should be carefully considered whether courts at all should be allowed near such decisions, simply because there might be a lack in the competence needed to make informed assessments.\textsuperscript{167}

Another possibility is that investors have found that capital invested in a certain business does not yield the desired rate of return anymore and have therefore shifted this capital to some other business. Such a decision is an example of natural, as well as rational business reasoning. Capital will find its way to the highest yielding recipient, i.e. the receiver of investments will, if the wheels of the market are allowed to spin on their own, value capital the most. This recipient will be able to pay the most for this capital because his business will yield the most, and will therefore be the economically optimal destination for this capital. Society will benefit if capital is injected into the highest yielding ventures. Denying investors the right to freely reallocate their capital would imperfect market mechanisms by forcing inefficiency upon it. In the end society will pay for this inefficiency through foregone wealth gains.

Personally I think a good measure for adequate capitalization would be that the corporation can afford to maintain its operations and honor all entered contracts. However, even when applying such a wide measure, the possible explanations for finding little funds in the corporate treasury are plentiful. Such an explanation, which deserves to be presented, is that a corporation has encountered losses. Quite possibly it was believed that it could keep the operation humming, as well as it could honor all contracts, up until the company for some reason ran into financial difficulties and drained its funds.

Of course there is another side to the coin. When undercapitalization exists in a corporation, and it has come about due to the fraudulent behavior of its shareholders, there should be little obstacles in the way of piercing the corporate veil. Economically inefficient risk taking feeds on purposeful

undercapitalization since little is risked.\textsuperscript{168} Deceitful undercapitalization also exposes creditors to risks which they have not signed up for, giving rise to negative externalities. Moreover, concerning stipulated requirements on capitalization, it has to be said that it would be absolutely unreasonable if extremely risky businesses could be conducted with just marginal capital. Courts must naturally balance these public interests with those of the market.

Taken together, applying the circumstance of undercapitalization is an awkward procedure. My own opinion is that it would be best if it were applied cautiously. Preferably, only in situations where it is indisputable that the corporation in fact did not have enough funds for whatever operations it conducted and that the lack of funds arose due to dishonest circumstances. When such a situation arises courts should in my opinion feel little restriction in piercing the corporate veil. Undercapitalization in the deceitful sense is economically inefficient and levies externalities on the corporation’s creditors. According to Thompson’s study, when courts mentioned the existence of undercapitalization in their opinions, veils were pierced 73,33\% of times, indicating that undercapitalization is a weighty factor.\textsuperscript{169} However, since undercapitalization was mentioned by courts in only 19\% of contract cases, and only in 13\% of tort cases, its importance as a circumstance seems negligible. Thompson’s research implies that courts are as cautious about referring to undercapitalization as I am, though when its existence has been established they see no objection in piercing an economically inefficient entity.\textsuperscript{170}

In \textit{Laya v. Erin Homes, Inc.} Judge McHugh stated that a good method to determine the adequate amount of capitalization in a corporation would be to compare the capitalization of the corporation in question with the average industry-wide ratios. He in particular mentions current ratios, acid-test ratios and debt/equity ratios.\textsuperscript{171} He continues to define grossly inadequate capitalization as a substantial deficiency of capital compared with the level of capitalization considered to be necessary by financial analysts.\textsuperscript{172}

In my opinion Judge McHugh’s approach to determining sufficient capitalization is exemplary. Courts should adopt a systematic and rational approach at establishing whether a corporation possesses enough funds. Especially in torts cases, it cannot be demanded of a corporation that it should enough funds on hand to cover any potential liabilities. More often than not, corporations have developed an industry relevant best practice regarding their capitalization ratios. Since corporations in general are not in the business of swindling their creditors, injuring clients and third parties

\textsuperscript{171} Current ratio = current assets / current liabilities.
\textsuperscript{172} Acid-test ratio, also quick ratio = (cash + marketable securities + accounts receivables) / current liabilities.
\textsuperscript{172} Debt / equity ratio = debt / equity.

and then taking off with the money, such a practice would, on average, reflect an economically efficient rate of capitalization that yields the most beneficial rate of return. It is when a corporation has a capitalization which is notably inferior to the standard ratio and this condition can be considered to be due to disloyal and unfair circumstances which disregard the interest of creditors, that the corporate veil, in my opinion, may be pierced. Note that I use the word notably. Some leeway should be given to corporations as their funds naturally will fluctuate with the current state of their business activities.

4.2 Close and Public Corporations

Close corporations have no publicly traded stock and typically, although not always, have few shareholders. In general such corporations are operated by the mostly the same people that own them. Note that this is in general, a close corporation may be just as large or even larger, and have just as many shareholders as a publicly traded corporation, which is its opposite. According to a study of 1600 veil piercing cases between 1930 and 1985 conducted by Robert B. Thompson, the number of shareholders is inversely proportional to the propensity of courts to pierce the corporate veil. His research shows that if a corporation had just one shareholder, the veil was pierced in an average of 49.64% of cases. Two or three shareholders changed that percentage to 46.22%, while corporations with three or more shareholders were pierced in only 34.98% of cases. For public corporations the piercing rate went down to nil.\textsuperscript{173}

Many of the benefits of operating a business in a limited liability corporate form are not enjoyed by closed corporations. Separating ownership and control in noncomplex organizations is not economically optimal since the best decision makers will control the firm, and if they are not the owners, moral hazard ensues and monitoring costs rise. Thus, the owners of closed corporations, i.e. the contributors of capital, will often be the very same individuals that are the best decision makers and the ones that are in control of the business. Therefore the economic advantages of organizing small businesses as limited liability firms are marginal at best, since it will not decrease moral hazard nor monitoring costs. Problems which barely exist to any greater extent in noncomplex organizations anyway.

Furthermore, close corporations will neither utilize the capital markets, nor will they generally allow the unshackled transfer of shares. Consequently the capital markets’ inherent monitoring mechanism will be foregone. Outside shareholders will not be allowed to control the actions of the corporation as they are unable to purchase shares in the company, and neither will there exist any threat of a take-over or merger if managers misbehave and act inefficiently. The fact that shares are not freely transferable also means that efficient risk bearing will be harder to achieve. Risk averse shareholders will most likely not have access to a simply exit

strategy, conversely, risk tolerant investor will not be able to invest straightforwardly in shares of a close corporation which matches their risk profile.

Public corporations, on the other hand, take full advantage of all the economic benefits that the corporation’s characteristics offers. Limited liability plays a much larger role in the organization of public corporations, not least as it enables the diversification and efficient bearing of risk through the transfer of shares on capital markets.\textsuperscript{174}

Considering all the economic advantages that the corporate form and its limited liability offer, perks which close corporations reap little benefits from while public corporation enjoy them to the fullest, it is quite logical that the obstacles to remove the limited liability should be lower for close corporations than for public corporations. Thus, as veil piercing should be easier to implement it should consequently also be applied more often by courts when the defendant is a close corporation. This is exactly what it is according to Thompson’s study. Just as Easterbrook and Fischel concluded, there is an economic logic to the distinction by courts between close and public corporations.\textsuperscript{175}

4.3 Corporate and Individual Defendants

In Thompson’s study the suits where the defendant is a corporate shareholder, roughly comprise half of all cases.\textsuperscript{176} These are cases where creditors of a subsidiary try to reach the assets of its corporate parent or sibling, but also the rarer situations where creditors try to reach subsidiaries through parent corporations.

When a veil is pierced in order to reach corporate assets there is not a complete disregard of the notion of limited liability, since the personal wealth of individual investors is not reached directly. Thus, there is no creation of unlimited liability for these investors. The funds they have at stake are still constrained by what they have invested in the reached corporate shareholder. This renders the possibility to diversify investments to still be untouched as the holdings of investor’s in the corporate shareholder can be one of many. The fact that liability remains limited and is not being overruled, means that all beneficial qualities are still available for investors.

What furthermore makes piercing a subsidiary’s veil less severe, is that certain qualities of limited liability carrying economic advantages, are lost through the creation of subsidiaries. Easterbrook and Fischel state that moral hazard is a bigger issue in subsidiaries than it is in their parent

corporations.\textsuperscript{177} They explain this by the weak incentives subsidiary managers have to insure their business operations, a result of them often holding positions in parent corporations as well. If the subsidiary fails, they still have jobs, thus no big deal. In publicly held corporations on the other hand, managers will want to make sure that the corporation does not fail and take their job with it, usually their only one. Thus their incentives to insure are much greater. The rationale is that since subsidiaries, very much like close corporations, stand to gain less from using the limited liability form to organize their business operations, hurdles to pierce a subsidiary’s veil should not be set that high since the negative consequences and the foregone benefits are smaller.

Logically therefore, the corporate veil should be pierced more often when a corporate shareholder is attempted to be reached, than when individual shareholders are attempted to be reached. Strangely enough, Thompson discovered that the veil was pierced an average of 43.13\% of times when shareholders were individuals, and only 37.21\% of times when shareholders were incorporated.\textsuperscript{178} A possible, economically sensible, explanation for these results has been put forward by Easterbrook and Fischel. They state that a higher propensity of courts to pierce the veil of subsidiary corporations in order to reach corporate shareholders would result in a competitive advantage given to smaller firms. They suggest that if the veils of subsidiaries were pierced consistently, firms which are not owned by another corporation would incur lower operational costs as they would be the only organizations which could proficiently limit liability. Such an outcome would not only forego the benefits of scale associated with larger corporations, such as their improved suitability to purchase insurance, but it would also compel the creditors of subsidiaries to monitor not only the actual borrowing corporation but also its parent, in effect foregoing the creditors’ monitoring abilities.\textsuperscript{179}

### 4.4 Contract Cases

Contract cases are those where the relationship between the plaintiff and the defendant originates in a contractual agreement. The creditor in such an arrangement is voluntary, meaning that he agreed to accept a certain amount of risk in exchange for a compensation. Examples of such voluntary creditors are banks and lending institutions that in exchange for an interest loan a corporation money and accept the risk that the firm might default. Other examples are suppliers which accept delayed payment and in return can do business with the corporation as well as charge a few extra percentages on the sales price.

Generally in contract cases the plaintiff has not received everything which is owed to him, usually the repayment of a loan or the payment for services or

\textsuperscript{177} Easterbrook and Fischel, (1996), p. 56-57.
products and is therefore trying to reach beyond the broke corporation to an entity with more funds. The defendants have simply not honored entered agreements. Pacta sunt servanda is an essential part of business-related interactions. Without the certainty that an entered agreement will be upheld and honored, if not by the counter party at least by the courts, trade and economic activity will quickly diminish in size and the business climate will get harsher. Two parties doing business together will either demand payment up front or demand securities for their exposed positions. Consequently businesses will need much more liquidity in order to conduct business. This will increase the overall capital intensity in businesses, and thus the rate of return will decrease. Society will incur wealth losses as the rate of economic development slows down. Therefore it is essential for economic activity and for economic progress to continue, that it is certain that contracts will be enforced.

By this logic courts should not hesitate too long to pierce the corporate veil, since both the reliability of economic transactions as well as economic progress is at stake. However, courts must, as always when piercing the corporate veil, weigh the costs of piercing against the costs of not piercing. It must be remembered that another essential part of a functional economic system is the prerogative of businesses to fail, no strings attached. When a business venture is undertaken all involved parties know, or at least should know, the associated risks. The business might turn out to be financially unsustainable, either resulting in bankruptcy, or prompting its shareholders to end the project.

Given this, it is far from obvious which costs exceed which, it depends fully on the circumstances. Courts, in my opinion, need to determine whether debts have remained unpaid due to deceitful circumstances or merely due to a straightforward business failure. In the former instance courts should consider veil piercing more of an option. In the latter situation the obstacles to veil piercing should be considered somewhat taller. From an economic perspective courts also need to take monitoring costs into account. Court judgments should optimally set a course of applying corporate veil piercing to the disadvantage of the party with the lowest monitoring costs. Altogether, courts should be wary in applying veil piercing apart from in apparent cases.

In Zaist v. Olson, as you will know, the corporate veil was pierced partly since it was considered that the corporation was used, among other things, to commit fraud or wrong. In my opinion, the court is walking a thin line in this case. It seems that up until the whole constellation of corporations owned by Olson ran into financial difficulties, the pierced corporation paid all its bills on time and in full.\(^{180}\) The scenario was thus not that of Kinney Shoe Corporation v. Polan were the parent corporations continued to operate and the subsidiary merely was expended. This somehow indicates that Olson wanted to fulfill his obligations to his creditors. If he really

\(^{180}\) Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 561.
wanted to avoid paying them he would have bankrupted East Haven long before, quite possibly before a large payment was due. Against these speculations, which they of course are, it can be asserted that East Haven operated as if it merely was the accounting department of the constellation, and that its debts therefore should be considered to be that of the constellation as well. The situation was very much the same in *NJA 1982 s. 244*, a corporation separate of the actual end users of deliveries, was used to pay invoices of suppliers.

Limited liability, as the reader surely knows by now, is a mechanism for limiting the amount of money which is at risk of being lost due to creditor’s claims. Its purpose often becomes clear in bankruptcies. However, there is no point in having and enforcing limited liability if there is nothing to actually limit liability to. The two pierced corporations mentioned, simply functioned as a middle hand between company accounts, safely tucked away in the parent corporation, and creditors. In both cases the business operations in which the pierced corporations were involved were the same as those of the parent corporation. The pierced corporations were merely the units in their respective corporate groups which handled payments.

It can be asked if the payment of products and services which a business operation then uses, adds value to, or resells, is not the main purpose of having funds in a corporate entity. If a corporation did not have to pay for anything but could just sell products it acquired at no cost, there would be no point in placing any money in company accounts. The pierced corporations thus handled the most important purpose of having funds in a corporation, i.e. paying creditors. So, when the corporation goes bankrupt, should limited liability all the sudden slam shut the door to the company funds? The same funds which the corporations had complete access to as long as business was fine?

From an economic point of view it is ineffective and unreasonable that a corporation which for all intents and purposes is a part of another corporate entity, should not be encompassed by the taking of risk associated with the latter. Particularly so if the separated corporation has to shoulder the burden of being responsible for payments, which I consider the most important reason for capitalizing a corporation, which in turn can be considered the act of risk taking. Olson had not taken any risk when creating East Haven, limited liability therefore does not serve any purpose in being applied to this corporation. In my opinion any obstacles to setting aside limited liability should therefore be considerably lower if existing at all. If corporations could be formed and business operations undertaken without any financial risk to shareholders, many economically inefficient businesses would be initiated. This would divert labor, and capital to some extent as East Haven did pay its operating expenses for a period of time, from ventures with a higher rate of return which are societally more desirable from an economic point of view.
Even though I agree with the dissenting Associate Justice Cotter in *Zaist v. Olson*, who stated that “The practice of disregarding the corporate entity should be undertaken with great caution”, it is obvious to me that limited liability should only protect those which make an honest attempt at fulfilling its membership criterions.\(^\text{181}\) These criterions being that there should be something to limit liability to, thus I think it was justified by the court to apply such importance as it did to the undercapitalization of East Haven. I am however somewhat surprised that the court in *Zaist v. Olson* did not elaborate on the identity rule to the same extent as the Swedish Supreme Court did in *NJA 1982 s. 244*. To me it is clear that East Haven merely was the hand which was busy handing out money while the entity’s other hand, Olson, was receiving money.

Even though the criterions for corporate veil piercing are fulfilled, the defendant may escape liability if the plaintiff had such knowledge of the corporation’s financial circumstances, that its inability to meet its obligations cannot have come as a surprise. This would also be the case if the plaintiff had the possibility to conduct an investigation, which would have yielded such knowledge about the financial standing of the corporation. This additional criterion was introduced by Judge McHugh in *Laya v. Erin Homes, Inc.*. Courts both in the United States and in Sweden have applied such reasoning in veil piercing cases. From a law and economics point of view such a line of thought makes perfect sense. When the creditor is aware of the financial operations posing a risk to the corporation’s solvency, he can take steps to neutralize or reduce this risk exposure, externality if you will. Obviously then, the burden of this externality should be levied on the creditor, as he can take steps to protect himself at the lowest cost.

### 4.5 Tort Cases

One of the benefits of limited liability is that it shifts risks away from the corporation onto creditors which have negotiated a compensation for this risk. Such is the case when a corporation borrows money. In exchange for a percentage the creditor accepts the risk that the venture might fail and that the debtor may not be able to repay his loan. What makes tort cases so much different from this scenario is that in the former the creditor, i.e. the injured party, has neither negotiated nor has he accepted any likelihood of injury. The injured party has therefore impossibly received any compensation for his unwilling acceptance of risk.

By shifting risk and not incurring a cost for it, the corporation has in fact created a negative externality which has not been neutralized. What this in turn will cause is that the marginal private benefit will exceed the marginal social benefit, or conversely, the marginal social cost will exceed the marginal private cost.\(^\text{182}\) When the price of producing a good does not fully

\(^{181}\) Zaist v. Olson, 154 Conn. 563, 227 A.2d 552, 561.

reflect the cost of its consumption, there will be an over production of it. The production process will then appropriate more resources than is economically optimal. An efficiency loss is consequently incurred by society.

Consider that a corporation is in a risky line of business. Meaning that there is a high probability of injury caused to a third unwilling party. Since the corporation will not compensate this third party for the taking of risk of something going wrong, the corporation will incur profits which do not mirror reality. The corporation will respond to these profits by continuing its partaking in the risky operations which are made profitable only through the un-internalization of the negative externalities.

What originally causes the corporation to be unable to perceive the full costs of its production is, as has been mentioned, limited liability. Since the corporation only risks what it is in the corporate treasury at the time, the full extent of the cost of a potential injury will not be felt. The discrepancy between incurred costs and the full cost is covered by creditors, though in this case involuntary creditors. The knowledge of the origins of the problem presents us with the necessary objectives to deal with the problem. If corporations were made fully liable for injuries inflicted on third parties, either by always piercing the corporate veil in tort cases or excluding tort cases altogether from the reaches of limited liability, the problem would immediately be eliminated. Corporations would instead purchase tort insurance, the premium would then reflect the likelihood of an injury occurring. The insurer could also demand contractual concessions limiting unreasonable risk taking by the corporation in order for it to receive insurance.

There is, however, a catch. First of all, if the corporate veil is consistently pierced in every tort case, it is true that the compensation to the injured party no longer is limited by the depths of the corporation’s pockets, it is however limited by the depths of the shareholder’s pockets. The reimbursement of the injured party is made contingent of the wealth of the shareholders. Such a situation cannot be considered as providing tort victims with a safe compensation, since it is quite possible that both the corporation and its shareholders are completely broke. Also, as Krendl and Krendl have pointed out, such a practice would imply that the interests of injured parties would be placed ahead of society’s interest in limited liability. Making certain that shareholders will have to pay for potential torts will incur all the negative effects unlimited liability has on investments and entrepreneurship. It would place an incredibly dampening effect on investor’s willingness to supply capital to high risk ventures. Such ventures can generally claim to have a higher net present values than other investments, which explains why investors would consider risky investments in the first place. Capital would thus be diverted from ventures with high net present values and consequently large potential wealth gains for society, to investments

promising low risks, low likelihood of potential tort claims, and accordingly lower net present value. Society will therefore forego the potential wealth gains which are to be had from encouraging investments in riskier businesses.

Personally I think that neither unlimited liability in tort cases nor consistently piercing the corporate veil are ways to go. In my opinion cautiously selected veil piercing would however be optimal. It is obvious that in certain situations the concept of limited liability will give rise to undesired levels of risk taking which are not kept in check neither by creditors nor insurers. It is also just as obvious that limited liability on the whole is highly beneficial to society. It provides wealth gains and encourages risk taking. Risk taking in moderation is also very advantageous to society, quite contrary to what aficionados of unlimited liability will have you believe. Considering all these aspects, the best solution seems to be a compromise struck between society’s interest in the economic advantages of limited liability, tort victims’ desire to be compensated for their injuries, and the negative externalities, with its inefficiency losses, created by excessive risk taking.

Such a compromise would best be created and upheld if the preservation of limited liability was considered to be the norm, piercing was applied only if the victims otherwise would go empty handed or unacceptably compensated, and if the corporate form had been used in manners which clearly gave rise to negative externalities. What I am endorsing is thus a strong-form limited liability allowing society to reap most of its benefits, though with the exceptions of insupportable situations were piercing would be applied cautiously.

According to Robert B Thompson’s research courts pierced the corporate veil 30.97% of times when dealing with tort cases, compared to 41.98% of times when handling contract cases.\textsuperscript{184} These results contradict much of mainstream corporate legal theory. Commonly, scholars reason that since tort victims are unwilling creditors, the obstacles to pierce the corporate veil should be lower. This line of thought is justified by it being a method to combat moral hazard and to come to terms with negative externalities. However, it is doubtful if the costs of imposing a harsh standard of veil piercing and consequently quasi-limited liability concerning tort cases really are smaller than those encountered by the weakening of the structure of limited liability. History speaks in favor of limited liability, as does economic theory, courts should therefore tread lightly and not be carried away. Seemingly they have done a good job so far.

In \textit{Minton v. Cavaney} it was undisputed that the defendant corporation had not been adequately capitalized to any measure. It owned no assets whatsoever. In my opinion the court’s judgment to pierce the corporate veil was in line with law and economics. In the case at hand it was obvious that

\textsuperscript{184} Thompson, Robert B., (1991), p. 1058.
the shareholders had made no attempt at providing funds to the corporation, in fact the corporation could not even pay its rents, its main operating cost. As Cavaney clearly had not taken any risk in forming the corporation, why should limited liability then protect him? As the corporation operated a swimming pool, a line of business were contact with the public is abundant, certain demands can be made of the size of the corporation’s funds. Visitors to the corporation’s facilities are clearly bearers of negative externalities, as the risk of injury must be considered a plausible threat, which the corporation cannot provide any compensation for as it lacks funds.

In NJA 1947 s. 647 the pierced corporation’s operation directly served the interest of the shareholder’s respective undertakings. In my opinion it is obvious that an business which to a large extent is a part of another business operation, should be encompassed by the risk taken in operating the latter. Otherwise, if this practice was accepted, shareholders could in fact completely eliminate their risk by incorporating all different branches of their business and only maintain adequate capitalization in the incorporated accounting department. Such a practice is extremely inefficient from an economic point of view as businesses which in fact have large costs associated with them are kept operating even though they actually are financially unsustainable. In NJA 1947 s. 647 it must also be remembered that he corporation was in the business of operating a dam. A venture which quite evidently can induce large damages when something goes wrong. It is my opinion that in lines of businesses were it is foreseeable that accidents may have enormous and dire consequences, courts may apply, with caution of course, a harsher measure concerning whether the capitalization is enough. This is needed to ensure that the cost of negative externalities are not placed on unwilling third parties. Thus, I think the court acted in line with a law and economics perspective in piercing the corporate veil.

4.6 In Conclusion

Even though corporate veil piercing at first glance might be considered directly inconsistent with economic theory and rationale, proper scrutiny from a law and economics perspective of its criterions and application has clearly shown that it can work in favor of economic efficiency and maintain consistency with law and economics.

The main purpose of this thesis is to conduct law and economics analyses of the criterions for corporate veil piercing, as well as of the application of veil piercing by courts. The analysis of the criterions has shown that corporate veil piercing can in fact improve economic efficiency under certain circumstances. Considering the independence criterion, it is clear that the possibility of using veil piercing to see past a sham limited liability wall, created by a corporation which for all intents and purposes is an integrated part of a parent corporation, will contribute to a more accurate representation of the risks faced by the parent corporation. As investors would be more aware of the risks they would allocate capital in economically efficient amounts.
Concerning the corporate formalities criterion I share the apparent apprehension of courts in using it as a heavy criterion for veil piercing. It cannot be considered optimal to base the disregard of limited liability mainly on a factor which could indicate the administrational unawareness of its owner as much as it can indicate improper circumstances. Furthermore, it would disproportionately affect companies with smaller financial resources relative to companies with larger resources, as the latter more easily could acquire professional assistance in fulfilling a few formalities.

When it comes to the capitalization criterion, the possibility of veil piercing encourages adequate contributions of capital to corporations, since when push comes to shove the same amount, if not more, will be clawed back by creditors. Obviously this is positive from an economic perspective for a number of reasons. First of all enterprises will necessitate an economically efficient amount invested in relation to the risk involved, meaning that the cost of risk is represented more accurately. Second, all externalities will be internalized as the investments demanded by projects will reflect their costs, which will ensue in societal wealth gains. Taken together, this will result in that only projects were the potential rewards exceed the costs will attract funding, contributing to an economically efficient allocation of capital which would be possible without the doctrine of corporate veil piercing.

Concerning the merits of corporate veil piercing given different types of corporations, close or public, it is economically intuitive that the veil is never pierced in public corporations. Public corporations make use of the beneficial traits of the corporate form, i.e. the separation of ownership and control, the utilization of capital markets, the transferability of shares, to a much greater extent than do non-complex organizations. Weakening the public corporate form with a Sword of Damocles in the shape of corporate veil piercing will thus have much greater economic disadvantages than doing the same to close corporations. It can even be argued that veil piercing of public corporations would be a meaningless procedure as it would not directly influence the behavior of such companies. Those in charge of close corporations are often the sole shareholders, meaning that the possibility of veil piercing would introduce a very real opportunity cost, which would encourage the desired economically efficient behavior. In contrast, those in charge of public corporations would not be affected as much by the possibility of veil piercing as they often are not the sole or even a major shareholder, as public corporation often make use of the possibility of separating ownership and control. This separation is not as common among close corporations as the benefits to be had by such an arrangement are limited for corporation with few shareholders. Thus, veil piercing does not influence the behavior of public corporations to the same extent as with close corporations, rendering it an unattractive measure.

In contract cases, corporate veil piercing functions as a measure of last resort for creditors and counterparties. If the contracting corporation does not honor its obligations, corporate veil piercing can possibly present a
means to forcefully implement the terms of the contract, or at least receive monetary compensation. Obviously, any legal institution which reinforces the authority of contracts and agreements is beneficial from an economic perspective. As predictability increases transaction costs will decrease, encouraging commerce which provides society with wealth gains. Furthermore, unfulfilled obligations and disregarded contracts impose a cost on the other party which would remain external unless corporate veil piercing were available. Veil piercing then functions as an attempt to satisfy the agreement by force, possibly internalizing the externalities of the uncompleted agreement.

Concerning contract cases, Judge McHugh’s amendment of the third prong establishes a rule stating that a party, who could reasonably be expected to carry out an investigation of the financial condition of a corporation before entering into a contract with said party, will be burdened with the knowledge such an inquiry would have produced. According to Judge McHugh this rule will be applied in particular to parties having the capacity of conducting such a research, for example banks and credit institutions. Swedish courts have applied a comparable rule in a case where a plaintiff corporation had full insight into the defendant corporation’s finances. It can thus be concluded that for veil piercing to be a possibility, the plaintiff may not be fully aware of the circumstances preceding the inability of the defendant corporation to meet its financial obligations.

From a law and economics point of view, Judge McHugh’s rule is satisfactory. As the creditor is aware of the possible externality, constituted of the corporation’s unmet obligations, he can take actions to reduce this externality. The creditor might for example purchase insurance, demand collateral or include a risk-compensating premium in the negotiated price. As an informed creditor has such a wide array of measures at his disposal with which he may reduce his exposure to risk, he should naturally be assigned the burden of internalizing the externality. It can be argued that if an informed creditor has not taken any steps to hedge or minimize his risk exposure, he has done so by choice and should not receive any restitution. On the other hand, if the informed creditor has taken steps to reduce his risk exposure, a corporate veil piercing would in effect result in that he receives compensation twice, which would be unreasonable as well as highly inefficient and costly.

In tort cases, the internalization of externalities is the foremost argument in favor of corporate veil piercing. When unwilling third parties are inflicted with costs for benefits received by somebody else an externality arises. Entitled a market failure, it is economically inefficient to say the least. Coming to terms with externalities, something which can be done with the doctrine of corporate veil piercing, implies wealth gains for society.

What corporate veil piercing essentially achieves is the restoration of a fair representation of risks and associated costs. It is appropriate to reiterate the incredible benefits of limited liability as a vehicle for economic progress,
development and wealth creation. It encourages entrepreneurial risk taking by which society is propelled forward. Its inherent encouragement of risk taking can however give rise to excessive risk taking. Make no mistake, risk taking is absolutely essential for economic progress, though when it becomes excessive, it is not as desirable from an economic point of view, quite the contrary.

Consider a corporation in which 100 dollars has been invested. Suppose that the same corporation is given the choice of two ventures. The first one will yield a 15 dollar return with a probability of 50%, and a loss of 10 dollars with a probability of 50%. The second venture offers a 50 dollar return with a probability of 70%, and a loss of 150 dollars with a probability of 30%. The expected values of the investments are 2.5 dollars for the first, and -10 dollars for the second. Considering the expected values of the investments, the corporation should clearly choose option one. However, since limited liability will restrict the potential downside in any venture, the corporations will only incur 100 dollars of the potential 150 dollar loss in the second venture. Recalculating the expected value of the second venture gives it an expected value of 5 dollars, prompting the corporation to choose it instead of option one.

This example illustrates the predicament with limited liability. Now, it would not be desirable to force the corporation in the example to take the full loss into consideration as that would in fact imply unlimited liability. Neither is it what corporate veil piercing is attempting to achieve. Instead, corporate veil piercing is applied in the most blatant cases of disregard of risks, costs and of the principles which govern the corporate entity. Once again, risk taking is good from an economic point of view, but there are certain limits.

However, putting its unexpected merits aside, it would in my opinion not be wise to legislate concerning veil piercing. Not only is it impractical to attempt to phrase a general rule which could be applied satisfyingly to a wide spectrum of situations, but legislative action would also risk weakening one of the fundamental pillars of economic progress. There should be no infringement on the absoluteness of limited liability. Corporate veil piercing should remain a rare exception, utilized only under extraordinary circumstances. This role is maintained best if it remains a product of case law, and is applied cautiously by courts which consider all perceivable factors.

Since veil piercing is a breach of a proven economically efficient institution which has provided enormous societal wealth gains, it must be emphasized that it is of the utmost importance that courts take economic theory into strict consideration when deciding on its application. So far courts both in Sweden and in the United States have succeeded quite well in doing so, hopefully they will maintain their economically sound rationale.
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