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Limited Liability and Corporate Groups

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LIMITED LIABILITY AND CORPORATE GROUPS*

Phillip I. Blumberg**

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The substance of this Article will form part of P. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* (January 1987), which is the third volume of the series on the Law of Corporate Groups (Little, Brown & Co.).

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I. INTRODUCTION

The limited liability of the corporate shareholder is a traditional cornerstone both in Anglo-American corporation law and in the corporation law of the civil system. The doctrine of limited liability protects the ultimate investor in the

enterprise from the liabilities of the enterprise in excess of the investor's capital investment. When applied to corporate groups (*i.e.*, the parent and its subsidiaries collectively conducting a business enterprise) limited liability protects not only the ultimate investors from the debts of the enterprise, but also each of the corporations into which the enterprise has been fragmented. Each corporation is protected from liability for obligations of the other fragments of the enterprise. Limited liability for the enterprise has become limited liability for each of the successive tiers within the enterprise. According to traditional doctrine, such corporate groups enjoy the same benefits of limited liability as the common law has historically afforded to the individual investor in a corporate enterprise.

Today, multinational corporations organized in the form of a parent corporation with dozens or even hundreds of subsidiary corporations¹ conduct most of the world's business. Limited liability has been carried unthinkingly beyond the original objective² of insulating the ultimate investor from the debts of the enterprise. Limited liability now enables a corporate group organized in tiers of companies to insulate each corporate tier of the group, and thus, achieve layers of insulation for the parent corporation from liability for the obligations of its numerous subsidiaries. In light of recent environmental disasters of worldwide dimensions, reexamination of the traditional doctrine of limited liability as applied to corporate groups has emerged as an issue of major importance.

Although limited liability has received increasing academic attention in recent years from scholars primarily interested in the application of economics to the law, these discussions have given only secondary attention to the special problems presented by corporate groups. Further, scholarly analysis has failed to review the historical and legal roots of limited liability of corporate groups. This Article constitutes the first attempt at a comprehensive discussion of the legal, historical, and economic dimensions of the problem.

In summary, the Article makes five conclusions. First, limited liability did not spring irresistably from the concept of the corporation as a separate legal

1. In 1982, the 1,000 largest American industrial corporations had an average of 48 subsidiaries each. See P. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* 464-68 (1983). Mobil Oil Corporation, to take an extreme example, operated in 62 different countries through 525 subsidiaries. *Id.* at 465; Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 428 (1980).

Professor Hadden reports that British-based multinationals are even more complex. His study of five large British groups (British Petroleum, Unilever, Bowater, Rank Organization, and Reckitt & Colman) reveals an "incredible complexity" involving "an intricate network of sub-holding companies, operating subsidiaries, sub-sidiaries and service companies." British Petroleum has 1200 to 1300 subsidiaries and Unilever has 800 subsidiaries. Hadden, *Inside Corporate Groups*, 12 INT'L J. SOC. L. 271, 273 (1984). Another British scholar has estimated that the average number of subsidiaries in the top fifty British companies in 1981 was 230. See R. TRICKER, *CORPORATE GOVERNANCE*, CH. 3 (1984), cited in T. HADDEN, R. FORBES & R. SIMMONDS, *CANADIAN BUSINESS ORGANIZATION LAW* 618 (1984).

2. As shown hereinafter, limited liability became firmly established as the general rule in the United States by 1830, while the power of a corporation, to acquire and own shares of another corporation, and thus to form corporate groups, generally was not available until after 1889. Although subsidiary corporations were not unknown earlier, they occurred only as a result of express provisions in the special charters to the parent corporation. The application of the doctrine of limited liability to insulate parent corporations from liability as well as the ultimate investors apparently occurred unthinkingly as a consequence of the recognition of the separate legal identity of a corporation from its shareholders. The author has found no cases of the period that discuss the significance of such double insulation from liability.

person. Substantial industrial development took place both in England and in the United States under legal systems imposing liability on shareholders for corporate obligations before limited liability emerged in the United States around 1825 and in England in 1855. Limited liability is a statutory development that represents the triumph of the rising political power of business interests.

Second, even after the general acceptance of limited liability, important pockets of unlimited shareholder liability, pro rata liability, or double and even triple shareholder liability survived in the United States until the Great Depression of 1929-1932. Whether or not limited liability is the preferable legal rule, this history of the development of limited liability demonstrates that limited liability is not essential for large scale economic activity.

Third, limited liability came relatively late on the scene, but even so, it was firmly established before the dramatic change in the law that permitted corporations generally to acquire shares in other corporations, and thus to form corporate groups. In the United States, corporations generally were not permitted to own shares of other corporations until late in the nineteenth century. With this development, described as a "turning point in American business history,"³ major business was soon transformed into large complexes of affiliated corporations collectively conducting the business of the enterprise. In the corporate group, limited liability for the corporate components of the enterprise, as well as for the ultimate investors, followed automatically. This development appeared to have followed without any recognition that the principle was receiving a dramatic extension.

Fourth, in the judgment of almost all economic analysts, limited liability serves a number of valuable purposes for the ultimate investor by creating a more efficient economic system. Most of these theoretical advantages, however, are valid only when limited liability is interposed for the protection of the ultimate investors in the enterprise. In most cases, these considerations simply become irrelevant when limited liability is interposed for the protection of corporate shareholders who comprise the upstream tiers in a multi-tiered corporate group.

Finally, limited liability that insulates shareholders, particularly parent corporations, from liability for the claims of involuntary creditors of the controlled corporation causes even economists convinced of the utility of limited liability generally to concede that limited liability raises serious problems because it enables the enterprise to externalize its costs. Tort creditors are the classic example of involuntary creditors, but such externalization occurs in the case of every transaction where parties are not in a practical position to negotiate credit terms. The term "involuntary creditors" thus includes many trade creditors, consumers, and workers as well as tort creditors. The groups adversely affected by limited liability, unfortunately, are numerous.

In brief, limited liability, like any other legal rule, serves certain underlying policies that are intended to achieve certain objectives. In circumstances in which the application of limited liability no longer appears to serve such policies or contribute to such objectives, limited liability, like any other legal rule that does

3. See A. CHANDLER, *STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE AMERICAN CORPORATE ENTERPRISE* 30 (1962).

not serve its presumed purposes, must be reexamined critically. This reexamination is particularly important in the case of corporate groups where entity law, the traditional view of corporation law, is already in the process of erosion in areas where imposition of substantive liability and rejection of limited liability generally is not involved, such as procedure and bankruptcy.⁴ Entity law was firmly part of the corporation law well before the emergence of limited liability, but the principle of limited liability strongly reinforced it and clearly has been responsible for its continued survival. With increasing signs portending the collapse of entity law in its application to components of corporate groups in a number of areas, reexamination of limited liability appears all the more useful.

The most pressing worldwide concerns with the insulation of multinational parent corporations from liability for the acts of their subsidiaries relate to torts of a magnitude and widespread impact unimaginable a few years ago: oil spills in the English Channel affecting miles of coastline, the disaster in Bhopal killing or injuring thousands of nearby residents, and dangerous products impairing the health of large classes of workers and consumers. This combination of multinational corporate groups and complex torts is another factor making the reexamination of the application of limited liability to corporate groups even more vital. In light of such recent disasters focusing worldwide attention on the responsibility of foreign multinational enterprises for the conduct of their subsidiaries, the problem has moved from the academic to the popular arena.

II. HISTORY OF LIMITED LIABILITY

The traditional view of the corporation in Anglo-American law, as well as in other Western legal systems, has firmly embraced entity law: the concept that a corporation is a separate legal person with its own rights and obligations, distinct from those of its shareholders. The concept of the corporation as a separate legal entity ultimately led to the acceptance of the very different doctrine of limited liability: the rule that shareholders are not liable for the obligations of the corporation beyond their capital investment.

Despite widespread confusion on the matter, it is clear that the entity view of the corporation rests essentially on philosophical notions and that this view was firmly established well before acceptance of the principle of limited liability. Limited liability emerged at a much later stage in the development of the corporation. It arose in the wake of the acceptance of the entity concept, but not as a necessary consequence.

The principle of limited liability is associated with the dramatic growth of economic activity in the United States, and has received extravagant praise as a beneficent policy of profound economic implications.⁵ Notwithstanding more

4. See P. BLUMBERG, *supra* note 1; P. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROBLEMS IN THE BANKRUPTCY OR REORGANIZATION OF PARENT & SUBSIDIARY CORPORATIONS INCLUDING THE LAW OF CORPORATE GUARANTIES* (1985).

5. President Nicholas Murray Butler of Columbia University opined that "the limited liability corporation is the greatest single invention of modern times." See N. BUTLER, *WHY SHOULD WE CHANGE OUR FORM OF GOVERNMENT?* 82 (1912). President Charles W. Eliot of Harvard University concurred, terming limited liability as "by far the most effective legal invention for business purposes made in the nineteenth century." See Cook, "Watered Stock"—Commissions—"Blue Sky Laws"

critical evaluation in recent analyses,⁶ such sweeping acceptance fairly reflects the conventional wisdom of the legal community and the view widely held by the bench in approaching problems involving the liability of shareholders, including parent corporations, for the obligations of a corporation.

The concept of limited liability and the strong pressure for its implementation have firmly shaped the view of Anglo-American law on the acceptance of entity law. A corporation law that turns on the concept of entity could have been reached solely in reliance on the philosophical concepts underlying the view of the corporation as a separate legal person, but it is inconceivable that judicial application of the doctrine of entity would have been so strong. Accordingly, any examination of the imposition of substantive liability upon parent corporations for the obligations of their subsidiaries requires understanding of the place of limited liability in corporate history and corporate law.

A. The Emergence of Limited Liability in England (1855)⁷

1. Early Development

At the time of the American Revolution, English corporation law, emerging from its misty historical origins in ecclesiastical and public corporations and reflecting concepts derived from medieval versions⁸ of Roman law,⁹ was still in

- *Stock Without Par Value*, 19 MICH. L. REV. 583 n.4 (1921). *The Economist* provides a final example: "The economic historian of the future may assign to the nameless inventor of the principle of limited liability . . . a place of honor with Watt and Stephenson, and other pioneers of the Industrial Revolution." B. HUNT, *THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND, 1800-1867*, at 116 (1936) (quoting *The Economist*, Dec. 18, 1926).

6. See generally LIMITED LIABILITY AND THE CORPORATION (T. Orhnial ed. 1982); Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Halpern, Trebilcock & Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980); Meiners, Mofsky & Tollison, *Piercing the Veil of Limited Liability*, 4 J. CORP. L. 351 (1979).

7. See generally C. COOKE, *CORPORATION, TRUST AND COMPANY* 76-111 (1950); A. DUBOIS, *THE ENGLISH BUSINESS COMPANY AFTER THE BUBBLE ACT 1720-1800* (1938); L. GOWER, *PRINCIPLES OF MODERN COMPANY LAW* 25-41 (4th ed. 1979); 3 W. HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 482-89 (5th ed. 1973); 8 W. HOLDSWORTH, *supra*, at 193-222; B. HUNT, *supra* note 5; 1 F. POLLOCK & F. MAITLAND, *THE HISTORY OF ENGLISH LAW* 487, 493 (2d ed. 1968); Minchinton, *Chartered Companies and Limited Liability, in LIMITED LIABILITY AND THE CORPORATION* 137, 142 (T. Orhnial ed. 1982); Shannon, *The Coming of General Limited Liability*, 2 J. ECON. HIST. 267 (1932) [hereinafter cited as *Shannon I*]; Shannon, *The First Five Thousand Limited Companies and Their Duration*, 2 J. ECON. HIST. 396 (1932) [hereinafter cited as *Shannon II*].

8. See W. BUCKLAND, *ROMAN LAW AND COMMON LAW* 54 (F. Lawson ed. 2d ed. 1965) (English theory of corporations mainly derived from medieval interpretations of Roman law); Carr, *Early Forms of Corporations, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY* 161 (1909); Williston, *History of the Law of Business Corporations Before 1800* (pt. 2), 2 HARV. L. REV. 149, 164 (1888) (early English law of corporations borrowed almost entirely from Roman law).

9. There is some question as to the extent that the Romans had accepted the concept of the corporate personality separate from its shareholders. Those scholars that assert that the concept of the corporation as a separate legal person was established rely on Ulpian's maxim: *Si quid universitate debetur singuli non debetur; nec quod debet universitas singuli debent*. (Where anything is owing to a corporation, it is not due to the individual members of the same, nor do the latter owe what the entire association does.) DIG. OF JUST., tit. iv, § 7(1) in 3 S. SCOTT, *THE CIVIL LAW* 32 (1932). See Perrott, *Changes In Attitude to Limited Liability—the European Experience, in LIMITED LIABILITY AND THE CORPORATION* 81, 85-87 (T. Orhnial ed. 1982) [hereinafter cited as Perrott].

Others conclude that the concept of the corporation as a juridical person was "foreign to

the process of completing its slow evolution in the elimination of direct shareholder liability for corporate obligations.¹⁰ Holdsworth and Gower conclude that direct liability, in the absence of charter provision, for shareholders of commercial corporations had ceased by the end of the sixteenth century.¹¹ Other scholars place the date much later. DuBois, for example, concludes that, limited liability was of slight importance at this time, and that the relation between incorporation and limited liability was still equivocal.¹² The Handlins concur, asserting that limited liability was still a fuzzy question at the end of the eighteenth century.¹³

The evidence from the legal commentary of the time also provides support for the later date. Hobbes, writing in 1654, referred to the unlimited liability of members of "a body politic of merchants."¹⁴ Similarly, neither Sir Edward

antiquity" although they recognize that the Romans, as illustrated by the maxim, recognized that for some purposes the totality of the members of a corporate body had rights and duties different from those of the individual members. See P. DUFF, *PERSONALITY IN ROMAN PRIVATE LAW* 35-37 (1938, reprint 1971) (the Ulpian maxim is the "high water mark of Roman thought on legal personality"); T. HADDEN, R. FORBES & R. SIMMONDS, *supra* note 1, at 9; H. JOLOWICZ, *ROMAN FOUNDATIONS OF MODERN LAW* 129-34 (1957); M. KASER, *ROMAN PRIVATE LAW* § 17, at 77 (R. Dannenberg trans. 2d ed. 1968).

It is not at all clear whether the Roman law also included limited liability. Numerous scholars so assert. See, e.g., A. BERLE, JR., *STUDIES IN THE LAW OF CORPORATION FINANCE* 3 (1928); W. BURDICK, *THE PRINCIPLES OF ROMAN LAW* 274, 291 (1938); A. CONARD, *CORPORATIONS IN PERSPECTIVE* 424 (1976); 1 F. POLLOCK & F. MAITLAND, *supra* note 7, at 487. Savigny and Williston disagree. See 2 Savigny, *System des heutigen romischen rechts* § 92, in W. RATTINGTON, *JURAL RELATIONS; THE ROMAN LAW OF PERSONS AS SUBJECTS OF JURAL RELATIONS: BEING A TRANSLATION OF THE SECOND BOOK OF SAVIGNY'S SYSTEM OF MODERN ROMAN LAW* 220 (1884) (1978 reprint); Williston, *supra* note 8, at 160-61. See also Pertott, *supra* at 85-87. The existence of both direct and indirect shareholder liability in the very early English law strongly suggests that limited liability was not an element of the medieval version of the Roman law accepted by the English legal system. See Handlin & Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 10 n.52 (1945) ("paucity of material and the uncertainty concerning the general character of Roman corporations render the drawing of analogies hazardous") [hereinafter cited as Handlin & Handlin, *Origins*.]

10. Shareholder liability includes direct liability of shareholders for the obligations of the corporation and indirect liability through the liability of shareholders to the corporation for an assessment (or in the old English usage, a leviation) to provide the corporation with funds required for payment of the corporation's obligations.

11. See 3 W. HOLDSWORTH, *supra* note 7, at 484; L. GOWER, *supra* note 7, at 26. Cf. Williston, *supra* note 8, at 161-62 (direct liability continued through the seventeenth century) (citing *Edmunds v. Brown & Tillard*, 83 Eng. Rep. 385 (1668); *City of London*, 86 Eng. Rep. 226 (1680); *Salmon v. Hamborough Co.*, 22 Eng. Rep. 763 (1671)). The Handlins, however, point out that the *Edmonds* case on which Williston relies involved shareholder liability after dissolution, which is a different issue. See Handlin & Handlin, *Origins*, *supra* note 9, at 1, 12 n.53. There is support for this view that direct liability had come to an end at this time. The charter of the Bank of England issued in 1694 provided for personal liability of the individual incorporators if the bank borrowed more than 1,200,000 pounds, clearly implying that there was no direct liability in the absence of such an express provision in the charter. 5 & 6 W. & M., ch. 20, § 26 (1694). This view is supported further by a 1692 petition for incorporation of persons seeking to separate the liability of the corporation from the liability of its members, see 8 W. HOLDSWORTH, *supra* note 7, at 203 n.5, and a 1695 prospectus of promoters of the Million Bank advising that a subscriber was not liable for the bank's debts beyond the subscriber's stock investment. See Minchinton, *supra* note 7, at 142.

12. A. DuBois, *supra* note 7, at 94.

13. Handlin & Handlin, *Origins*, *supra* note 9, at 12. See also Minchinton, *supra* note 7, at 154 (absence of limited liability in the absence of a charter provision was not clear until well into the nineteenth century).

14. T. HOBBS, *LEVIATHAN* 175 (M. Oakeshott ed. 1962).

Coke, writing in 1612, nor Blackstone, writing in 1765, nor Kyd, writing in 1792, listed limited liability among the essential attributes of the corporation.¹⁵

In the late eighteenth century, the Crown was still following an inconsistent course. It was issuing some charters that expressly provided for direct shareholder liability; other charters expressly provided that shareholders were not to be directly liable.¹⁶ Most charters simply were silent, and it had become accepted increasingly that in the absence of charter provision, shareholders were not directly liable.¹⁷ Thus, in 1784, the English Attorney General, Lloyd Kenyon (soon to become Master of the Rolls and the first Baron Kenyon) could advise confidently in a private opinion that in the event of incorporation, "the Corporate stock alone would be answerable to the engagements, and the individuals who may compose the corporation would not be liable in their private characters."¹⁸

Similarly, indirect liability, albeit surviving as a matter of legal principle, was also coming to an end as a practical matter. The power of the corporation, resting on charter provision¹⁹ or on past practice, to levy assessments on shareholders, was a remedy creditors could enforce.²⁰ The creditors' remedy, however,

15. 3 E. COKE, FIRST PART OF THE INSTITUTE OF THE LAWS OF ENGLAND OR A COMMENTARY UPON LITTLETON 6, 412 (1628); 2 E. COKE, *supra* at 250a. See also SUTTON'S HOSPITAL, 77 Eng. Rep. 960, 970-71 (1612); 1 W. BLACKSTONE, COMMENTARIES 470 (1st ed. 1765); 2 S. KYD, CORPORATIONS 103 (1793).

16. By the second half of the eighteenth century, limited liability, which had not been particularly important earlier, was becoming an increasingly important consideration to investors and promoters. DuBois reports that by this time, persons seeking charters were including limited liability as a motive for incorporation. See A. DuBois, *supra* note 7, at 95-97. Six such petitions were filed from 1768 to 1789. Three acts of incorporation granting charters in the period from 1764 to 1791, in fact, contained express provisions for the limited liability of the members. At the same time, other charter applications and acts granting charters contained provisions imposing direct liability on members, but DuBois concludes that such provisions were "clearly considered an exception to the usual corporation practice." *Id.* at 97.

17. See *supra* note 11.

18. Kenyon, *Case and Opinion of Jan. 29, 1784*, Boulton & Watt MSS., Birmingham Collection, Assay Office, cited in A. DuBois, *supra* note 7, at 95-96 n.66. Four years later, having moved to the bench, Kenyon repeated his opinion in *Russell v. Men Dwelling in Devon*, 100 Eng. Rep. 359 (1788), a case that involved a public corporation.

19. The power to levy assessments or levitations upon members beyond the basic investment appeared prominently in charters. See A. DuBois, *supra* note 7, at 98-103; 8 W. HOLDSWORTH, *supra* note 7, at 204.

20. In 1671, the House of Lords had approved a remedy in equity that allowed creditors to compel a corporation to make assessments (or levitations) on its shareholders required for the payment of corporate debts. *Salmon v. Hamborough Co.*, 22 Eng. Rep. 763 (1671). The creditors had a judgment against the corporation. The House of Lords held that in the event that the judgment was not satisfied, the creditors could levy. *Id.* at 764. A note in a subsequent case states that the default was not remedied, and the levitations were in fact made. *Harvey v. East India Co.*, 23 Eng. Rep. 856, 856 (1700). See C. COOKE, *supra* note 7, at 77; Williston, *supra* note 8, at 161-62. This view is held by most scholars. See, e.g., C. COOKE, *supra* note 7, at 78-79; L. GOWER, *supra* note 7, at 26; Williston, *supra* note 8, at 161; Handlin & Handlin, *Origins*, *supra* note 9, at 13. Dodd and Jenkins have a contrary view. Professor Dodd questions the applicability of *Salmon* in cases not involving dissolved corporations, in cases not involving an express provision or an accepted practice of levitations, or the imposition of liability beyond forfeiture of the shares. Compare E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 85-86, 369 (1954) with 8 W. HOLDSWORTH, *supra* note 7, at 204; C. COOKE, *supra* note 7, at 77-78; Williston, *supra* note 8, at 161-62; and Handlin & Handlin, *Origins*, *supra* note 9, at 13. Jenkins confines *Salmon* to cases of "lifting the veil" in the presence of fraud. See Jenkins, *Skinning the Pantomime Horse: Two Early Cases on Limited Liability*, 34 CAMBRIDGE L.J. 308, 312-21 (1978).

depended on the corporation's power, express or implied, to make assessments; a levy was feasible if the charter provided for assessments, or at least if the charter was silent, and permitted an argument based on practice. However, if the corporate charter expressly limited a corporation's power to assess, the rights of creditors to impose indirect liability on shareholders through assessments did not exist. Thus, it comes as no surprise that clauses prohibiting assessments beyond the basic capital subscription price began to appear in charters and quickly became "common and efficacious."²¹ As a result, indirect liability in England became increasingly less important.

Finally, corporation law on liability played only a minor role in the English commercial experience because commercial activity was handled increasingly by joint stock companies, not corporations. Corporate charters had been difficult and expensive to obtain.²² For example, during the entire eighteenth century, the English government had chartered only a half dozen corporations for manufacturing and "hardly more" for other businesses.²³ As a result, corporations were used extensively only for banks, fire and marine insurance, water companies, and canals.²⁴ The relevant English law in this area, accordingly, is company law, or the law applicable to joint stock companies, not corporation law.

2. The Predominance of Joint Stock Companies

Growing commercial enterprises increasingly turned to joint stock associations with transferable shares as an alternative to the corporate form.²⁵ Such companies multiplied and became the predominant form for the conduct of business activity. By 1844, there were almost 1,000 joint stock associations including banks.²⁶ Some associations had surprisingly widespread ownership of their shares. As early as 1808, the Birmingham Flour and Bread Company had 8,000 shareholders.²⁷ Originally conceived as a form of partnership,²⁸ the joint stock association developed into an unincorporated association organized under a deed of settlement, with trustees owning the stock and holding it for the benefit of the members,²⁹ who held transferable shares. In an effort to limit member

21. See 8 W. HOLDSWORTH, *supra* note 7, at 199-205.

22. See Shannon I, *supra* note 7, at 267-68 ("a method expensive, cumbersome in procedure and uncertain of success"); Todd, *Some Aspects of Joint Stock Companies, 1844-1900*, 4 ECON. HIST. REV. 46, 50 n.40 (1932); 8 W. HOLDSWORTH, *supra* note 7, at 221.

23. See Handlin & Handlin, *Origins*, *supra* note 9, at 3.

24. See C. COOKE, *supra* note 7, at 91; L. GOWER, *supra* note 7, at 32. Cf. 2 A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 756 (1776) (Liberty Classics ed., R. Campbell, A. Skinner & W. Todd eds. 1976) (Bk. V, pt. III, art. I).

25. In the wake of the speculative mania leading to the South Sea Bubble collapse, Parliament enacted the Bubble Act, 6 Geo. 1, ch. 18, § 18 (1719), to prevent the development of joint stock companies with transferable shares. Wretchedly drafted and virtually "unintelligible," the Act was ineffective. See Shannon I, *supra* note 7, at 269. Ultimately, the Act was repealed in 1825. 6 Geo. 4, ch. 91 (1825).

26. See B. HUNT, *supra* note 5, at 87.

27. See T. HADDEN, COMPANY LAW AND CAPITALISM 17 (2d ed. 1977).

28. See L. GOWER, *supra* note 7, at 35; 8 W. HOLDSWORTH, *supra* note 7, at 208, 213, 215; Todd, *supra* note 22, at 49.

29. Members of a joint stock association are partners with partnership liability. They are also deemed to be shareholders, and alternatively may be called shareholders. To avoid confusion, they are referred to as members.

liability arising from the partnership form of the organization, it became common for the deeds of settlement to include clauses limiting the power of the company to make calls on members and limiting members' liability to the amount of their stock interest. These clauses disposed of liability *inter se* and of indirect member liability through assessments³⁰ although they could not terminate liability of members to third parties.³¹

Joint stock associations generally attempted to achieve limited liability of members for debts to third parties through such measures as inserting the term "limited" after the joint stock company name, including an appropriate legend on company stationery, and using limitation of liability clauses in their contracts. Beginning in the early nineteenth century, insurance policies issued by joint stock insurance companies began to contain clauses limiting liability to company capital.³² A few decades later all insurance policies issued by joint stock insurance companies are reported to have included such clauses.³³ Numerous trading companies followed suit, and similarly, inserted such clauses in their contracts.³⁴ Although the validity of the contractual limitation as a question of law was not settled for some time,³⁵ the commercial practice was unmistakable. In this manner, joint stock associations under deeds of settlement attempted to achieve the advantages of incorporation, without a charter.³⁶ Notwithstanding the unsolved legal questions, joint stock associations flourished, as corporate charters continued to be difficult and expensive to obtain.³⁷ Further, the considerable practical difficulties of enforcing personal liability under the archaic procedure of the time tempered the theoretical exposure of members.³⁸

30. *Rex v. Dodd*, 103 Eng. Rep. 670, 674 (1808) (Ellenborough, L.) (dictum). However, the matter was not definitively settled until almost 50 years later. *In re Athenaeum Life Assurance Soc.*, 70 Eng. Rep. 216 (1858), 70 Eng. Rep. 347 (1859). Another device to lessen liability as a practice, not as a legal matter was the insertion of a provision in the deed of settlement that required liquidation of the company while its capital was still sufficient to pay all its debts. See B. HUNT, *supra* note 5, at 99.

31. A number of commentators note that cumbersome procedural requirements for suits against members of joint stock companies in their capacity as partners provided de facto protection against member liability in widely held companies because of the difficulties of suing and levying execution on members of a fluctuating group. See L. GOWER, *supra* note 7, at 36, 40; Diamond, *Corporate Personality and Limited Liability*, in *LIMITED LIABILITY AND THE CORPORATION* 22, 31 (T. Orhnlial ed. 1983); Perrott, *supra* note 9, at 81, 96.

32. See A. DuBois, *supra* note 7, at 223.

33. See B. HUNT, *supra* note 5, at 110; *Shannon II*, *supra* note 7, at 399 n.3 (suggesting insurance companies accordingly had little need for limited liability).

34. See C. COOKE, *supra* note 7, at 282; T. HADDEN, *supra* note 27, at 11-12; B. HUNT, *supra* note 5, at 100.

35. Eventually, a series of cases from 1849 to 1852 upheld as a matter of contract law, the enforceability of clauses in insurance policies that limited liability under the policy to the capital of the company. *Hassell v. Merchant Traders' Ship, Loan & Ins. Ass'n.*, 154 Eng. Rep. 1322, 1323 (1850); *Hallett v. Dowdall*, 118 Eng. Rep. 1, 17-34 (1852); *Halkett v. Merchant Traders' Ship Loan & Ins. Ass'n*, 116 Eng. Rep. 1530, 1531 (1849). See *In re European Assurance Society (Grains case)*, 1 Ch. D. 307, 322 (1875); C. COOKE, *supra*, note 7, at 87.

36. Maitland points out that if the state had not finally yielded and made general incorporation available with limited liability, English commercial activity probably would have been conducted by joint stock associations contracting wherever possible for limited liability. See 3 F. MAITLAND, *TRUSTS AND CORPORATIONS IN COLLECTED PAPERS* 321, 342 (H. Fisher ed. 1911, reissued 1975).

37. See C. COOKE, *supra* note 7, at 109.

38. See L. GOWER, *supra* note 7, at 36, 40; T. HADDEN, R. FORBES & R. SIMMONDS, *supra* note

3. *The Continuing Political Struggle Over Limited Liability*

For three decades after the United States generally had accepted limited liability, limited liability continued to be a highly controversial political issue in England,³⁹ vigorously debated against a rising tide of industrialization. Widespread hostility toward limited liability⁴⁰ as well as antagonism toward wholesale incorporation contended with ever more demanding business pressures for charters and limited liability.⁴¹ For decades, the outcome of the struggle was uncertain with each of the contending forces temporarily achieving some success.

In 1844, under Gladstone's leadership, the forces opposing limited liability temporarily gained the upper hand. The Joint Stock Companies Registration, Incorporation, and Regulation Act, 1844⁴² which permitted general incorporation,⁴³ imposed unlimited liability on members for unsatisfied corporate judgments.⁴⁴ Members that made payments to company creditors had the right to contribution from their fellow members.⁴⁵ The 1844 Act also prohibited *charter* provisions that limited liability, but was silent with respect to like provisions in *contracts* with third parties.

Although Hunt reports that from 1844 to 1856 almost 1,000 unlimited companies registered under the 1844 Act,⁴⁶ it proved unworkable. It failed to solve the problem of evasion through transfer of shares. The 1844 Act was also perceived as having retarded investment by more wealthy investors because of their concern that creditors would first proceed against them in preference to less wealthy members.⁴⁷

1, at 13-15. Cf. *Van Sandau v. Moore*, 38 Eng. Rep. 171 (1826) (300 parties in litigation for decades), cited in T. HADDEN, R. FORBES & R. SIMMONDS, *supra* note 1, at 13. This de facto limitation on liability led to much improved collection procedures involving a court appointed master to oversee liquidation and the collection from shareholders in The Joint Stock Companies Winding Up Act, 1848, 11 & 12 Vict., ch. 45. See Amsler, Bartlett & Bolton, *Thoughts of Some British Economists on Early Limited Liability and Corporate Legislation*, 13 HIST. POL. ECON. 774, 779 (1981).

39. See generally C. COOKE, *supra* note 7; L. GOWER, *supra* note 7; T. HADDEN, *supra* note 27; B. HUNT, *supra* note 5; Perrott, *supra* note 9; Shannon I, *supra* note 7; Shannon II, *supra* note 7; Todd, *supra* note 22.

40. See Shannon I, *supra* note 7, at 269. Such hostility was reflected in a flurry of prosecutions under the Bubble Act, 6 Geo. 1, ch. 18, § 18 (1719), from 1807 to 1811, and again in 1821. See B. HUNT, *supra* note 5, at 17-21. E.g., *Rex v. Dodd*, 103 Eng. Rep. 670 (1808); *Rex v. Buck*, 170 Eng. Rep. 1052 (1808); *Rex v. Stratton*, 170 Eng. Rep. 1053 (1808); *Rex v. Webb*, 104 Eng. Rep. 658 (1811); *Josephs v. Pebrer*, 107 Eng. Rep. 870 (1825).

41. For example, during the boom of 1824, there were as many as 250 private bills pending in Parliament providing for charters or privileges of some kind. See B. HUNT, *supra* note 5, at 32.

42. 7 & 8 Vict., ch. 110 (1844).

43. The 1844 Act has been hailed as the first general incorporation statute. See Perrott, *supra* note 9, at 100. However, New York had the distinction of enacting the first general incorporation statute. Act of Mar. 22, 1811, ch. 67, N.Y. Laws 111. See *infra* note 133.

44. Creditors were required to first pursue their remedies against the corporation. See L. GOWER, *supra* note 7, at 41.

45. 7 & 8 Vict., ch. 110, § 67 (1844). The Act also provided for contribution from the company, and the member was entitled to proceed against other members only after "due diligence" to obtain satisfaction from the company. *Id.* § 66.

46. See B. HUNT, *supra*, note 5, at 114.

47. See T. HADDEN, *supra* note 27, at 16.

Accordingly, the 1844 Act did not finally dispose of limited liability as a political issue, and the political struggle continued unabated.⁴⁸ On one hand, limited liability was urged as essential for accumulation of the substantial capital investment required by the growing industrial order. On the other hand, limited liability was criticized as speculative and fraudulent, and thus would lead to uneconomic promotions.⁴⁹

The Depression of 1845-1848 and public acceptance of limited liability for railways helped tilt the balance toward limited liability.⁵⁰ The railways were among the most successful of the growing English industries.⁵¹ They resembled the large modern business enterprises that were to follow. Their need for heavy capital investment led to an increasingly larger number of shareholders and widespread distribution of the shares. In turn, the distribution of shares led to the development of active security markets throughout England.⁵² The distribution of shares also inevitably resulted in less participation by members in the management of the enterprise and the separation of investors from managers. Finally, the railways' exposure to heavy tort liability could not be eliminated by contractual limitations and public notice. In light of these facts, few questioned the validity of limited liability for railways.⁵³ Acceptance of limited liability for the railways foreshadowed the ultimate acceptance of limited liability generally.⁵⁴

Finally, Parliament enacted the Limited Liability Act, 1855⁵⁵ and the Joint Stock Companies Act, 1856.⁵⁶ These statutes authorized general limited liability and thus ended the debate. They provided for registration of all existing unincorporated joint stock associations, registration of new companies, and limited liability for the members of all registering companies.⁵⁷ Although the 1855 and 1856 Acts excluded banks and insurance companies, banks were later included in 1857 and 1858⁵⁸ and insurance companies in 1862.⁵⁹ The Companies Act,

48. It is not without interest that the economists of the time were divided on the issue. See Amsler, Bartlett & Bolton, *supra* note 38, at 779-92; Ekelund & Tollison, *Mercantilist Origins of the Corporation*, 11 BELL J. ECON. 715, 729 n.7 (1980).

Thorstein Veblen suggests a different explanation than political or economic forces for the reluctance of the English to accept limited liability. He suggests that such reluctance was rooted in philosophical considerations, and that it flowed from attachment to the principles of "natural liberty" and "free contract." Liability was viewed as a personal attribute of the member of the enterprise from which a person was not competent to divest himself. See T. VEULEN, *THEORY OF BUSINESS ENTERPRISE* 280 n.1 (1904, reissued 1973).

49. See Shannon I, *supra* note 7, at 284-85.

50. See L. GOWER, *supra* note 7, at 43; Perrott, *supra* note 9, at 100.

51. See B. HUNT, *supra* note 5, at 102.

52. See B. HUNT, *supra* note 5, at 105-12.

53. Hunt, however, notes that the speculation in railway shares in the 1840's led to some criticism of limited liability for railways as well. *Id.* at 126 n.65.

54. See Shannon I, *supra* note 7, at 286-87; Hicks, *Limited Liability: The Pros and the Cons*, in *LIMITED LIABILITY AND THE CORPORATION* 11, 12 (T. Ornhial ed. 1982).

55. 18 & 19 Vict., ch. 133 (1855).

56. 19 & 20 Vict., ch. 47 (1856).

57. *Id.* § 3. See Todd, *supra* note 22.

58. Joint Stock Banking Companies Act, 1857, 20 & 21 Vict., ch. 49 (providing registration for banks); The Joint Stock Banking Companies Limited Liability Act, 1858, 21 & 22 Vict., ch. 91 (providing limited liability for banks). See C. COOKE, *supra* note 7, at 163-68.

59. The Companies Act, 1862, 25 & 26 Vict., ch. 89.

1862⁶⁰ generally restated the earlier statutes and lasted as the basic statute until The Companies Act of 1908.⁶¹

Thus, after decades of dispute, general incorporation and limited liability were definitively accepted in the English law. Laissez-faire had triumphed.⁶² The process had been far from inevitable, and adoption came only after a long struggle.

4. Summary

Several important aspects in the English experience should be noted. First, the ultimate triumph of limited liability did not come until more than one hundred years after the onset of the Industrial Revolution and decades after limited liability had become common in the United States. Second, unlike its United States counterpart, the modern English business company evolved from the joint stock association organized under a deed of settlement, rather than from a grant of incorporation from the state; it thus owes more to partnership principles than to a rule based on corporate personality.⁶³ Finally, the English experience leaves no doubt that the extension of limited liability reflected a deliberate political decision in the face of commercial pressures to achieve economic objectives, rather than an inevitable conceptual derivation from the separate nature of the entity.

Limited liability was not an essential component of the English legal system under which the first one hundred years of the Industrial Revolution flourished. Nor was it an inevitable component of the capitalist economic system. English industrial activity increased enormously under a legal rule imposing liability on shareholders.

Scholars disagree on the impact of the absence of limited liability on the growth of the English economy during the first half of the 19th century. Cooke discusses assertions that the unavailability of limited liability in England during this period discouraged investment in England and led to heavy investment by English investors in South American government loans.⁶⁴ He criticizes this view, suggesting that the higher rate of return available on foreign government loans was a more likely explanation. He emphasizes that the investing public showed no sign of hesitating to support enterprises conducted by unincorporated joint stock companies. Maitland also discounted the significance of unlimited liability.⁶⁵

On the other hand, there was a "very striking" increase in the number of companies registered following the adoption of limited liability.⁶⁶ During the seven years following the adoption of limited liability (1855-1862), 2,479 companies registered under the 1855 Act compared with only 956 companies com-

60. *Id.*

61. The Companies Act, 1908, 8 Edw. 7, ch. 69.

62. See L. GOWER, *supra* note 7, at 47-48; B. HUNT, *supra* note 5, at 158-59.

63. See Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1371-72 (1956).

64. See C. COOKE, *supra* note 7, at 102-03.

65. See 3 F. MAITLAND, *supra* note 36, at 342.

66. Todd, *supra* note 22, at 62-64. Todd attributes the increase in part to limited liability but also to rising trade prosperity. *Id.* at 64 n.1. He also points out that many of the new companies were formed for speculating purposes and never came into operation. *Id.* at 69.

pleting registration in the previous eleven years during which the 1844 Act with unlimited liability had been effective.⁶⁷ This appears to demonstrate the significance of limited liability as an incentive to commercial activity.⁶⁸ Further, despite the efforts of the lawyers to achieve limited liability as a matter of contract for joint stock association members through clauses in the deeds of settlement, contractual provisions, and notice to the public, the fact remains that limited liability as a matter of statute was widely perceived by business interests as highly desirable, and commercial pressures for statutory limited liability had continued. As long as statutory liability was perceived to be important but was unavailable, there must have been some significant deterrence to investment.

Other fundamental factors appear to have been the increasing distribution of share ownership and the declining role of shareholder participation in management. Enterprises were becoming increasingly larger. As the number of shareholders substantially increased, shareholders became less involved in the conduct of the enterprise and became solely investors. This process had started as early as the seventeenth century with the development of free assignability of shares of joint stock associations, a process that the Bubble Act⁶⁹ had been unable to bring to an end. Professor Hadden reports that "by the middle of the *seventeenth* century the ownership of a share had clearly come to be regarded as a matter of financial rather than personal participation."⁷⁰ By the end of the seventeenth century, there was a flourishing public market both in London and in the provinces for the shares of all the major English companies.⁷¹ An indication of the level of trading activity is provided by the fact that in 1697, the Parliament passed a statute regulating the licensing of brokers.⁷² Professor Perrott adds that in the eighteenth century, free transferability of shares was more important than limited liability.⁷³ Under these circumstances, the lack of utility and fairness in imposing liability on investors for the acts of the managers became recognized increasingly.⁷⁴

The adoption of the 1862 Act⁷⁵ ushered in a period of speculation and security frauds⁷⁶ that ultimately led to what has been described as the most severe panic in the history of the London financial community.⁷⁷ Thus, Anthony Trollope (1815-1882), that perceptive observer of the English scene, described the speculative fever as "dishonesty magnificent in its proportions, and climbing into high places."⁷⁸ Although the adoption of limited liability had contributed to the very excesses which its opponents had warned, there was no repudiation

67. See Shannon 1, *supra* note 7, at 290.

68. Compare the English experience with the different experience in Massachusetts. See *infra* text accompanying note 139.

69. 6 Geo. 1, ch. 18, § 18 (1719). See *supra* note 25.

70. See T. HADDEN, *supra* note 27, at 12 (emphasis added).

71. See B. HUNT, *supra* note 5, at 105-12.

72. 8 & 9 Will. 3, ch. 32 (1697). See T. HADDEN, R. FORBES & R. SIMMONDS, *supra* note 1, at 11-12.

73. See Perrott, *supra* note 9, at 98-102.

74. See C. COOKE, *supra* note 7, at 111.

75. The Limited Liability Act, 1862, 25 & 26 Vict., ch. 96.

76. See Levi, 33 J. STAT. SOC. (London) 1 (1870) (extent of frauds and panicked speculation), cited in Amsler, Bartlett & Bolton, *supra* note 38, at 789.

77. See B. HUNT, *supra* note 5, at 153-55.

78. See A. TROLLOPE, AUTOBIOGRAPHY 294-95 (1883, reissued 1947).

of limited liability. Once adopted, limited liability became a settled principle of English company law.

B. *The Emergence of Limited Liability in American Law (1830)*⁷⁹

Until 1776, the English experience provided the American colonies with an embryonic legal framework for business.⁸⁰ Following the American Revolution, however, the new American nation departed from its English legal inheritance that had rested in part on the corporation, primarily municipal and governmental rather than commercial, and in part on the unincorporated joint stock association.

In England, Parliament's reluctance to grant corporate charters led to the emergence of the joint stock association as the common form for the conduct of business. The United States, however, followed a different route. Following the Revolution, the incorporating power moved to the thirteen states. The state legislatures did not share the English Parliamentary reluctance to grant corporate charters, and the special acts of incorporation were granted much more readily than in England. As a result, more than 300 American business corporations were formed between 1783 and 1801.⁸¹ Thus, in the new American nation, the corporation, not the joint stock association, became the predominant form.⁸²

In this early stage, American corporate charters were granted readily, first for corporations with public functions such as bridges, canals, turnpikes, and subsequently, for financial institutions such as banks and insurance companies. Charters for manufacturing companies were another matter. Few manufacturing charters were granted in the first thirty years of the new nation. As relations

79. See generally 2 J. DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS*, NO. 4, EIGHTEENTH CENTURY BUSINESS CORPORATIONS IN THE UNITED STATES (1917, reissued 1965); E. DODD, *supra* note 20; O. HANDLIN & M. HANDLIN, *COMMONWEALTH: A STUDY OF THE ROLE OF GOVERNMENT IN THE AMERICAN ECONOMY: MASSACHUSETTS, 1774-1861* (rev. ed. 1969) [hereinafter cited as O. HANDLIN & M. HANDLIN, *COMMONWEALTH*]; J. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970* (1970); S. LIVERMORE, *EARLY AMERICAN LAND COMPANIES* (1939, reissued 1968) [hereinafter cited as S. LIVERMORE, *LAND COMPANIES*]; Dodd, *The Evolution of Limited Liability in American Industry, Massachusetts*, 61 HARV. L. REV. 1351 (1948); Handlin & Handlin, *Origins*, *supra* note 9; Livermore, *Unlimited Liability in Early American Corporations*, 43 J. POL. ECON. 674 (1935) [hereinafter cited as Livermore, *Corporations*].

For histories of the development in Connecticut and Maryland respectively, see E. GRANT, *YANKEE DREAMERS & DOERS* (1973); Blandi, *Maryland Business Corporations 1783-1852*, 52 JOHNS HOPKINS U. STUD. HIST. & POL. SCI. 301 (1934).

80. GOWER, *supra* note 63, at 1370.

81. See 2 J. DAVIS, *supra* note 79, at 27; E. DODD, *supra* note 20, at 11; Handlin & Handlin, *Origins*, *supra* note 9, at 4; J. HURST, *supra* note 79, at 14.

82. See E. DODD, *supra* note 20, at 367; J. HURST, *supra* note 79, at 8. Baldwin and the Handlins suggest that although the Bubble Act had some deterrent influence, it was not significant. Its influence ended with the Revolution, before the growth of the factory system and the movement for business charters. See Handlin & Handlin, *Origins*, *supra* note 9, at 5; Baldwin, *History of the Law of Private Corporations in the Colonies and States*, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 236, 249 (1909).

The unincorporated joint stock association, then so prominent in the English commercial world, was not unknown in the new American nation, but it was much less important, except in the special case of land companies. See E. DODD, *supra* note 20, at 367; S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 9-36; Gower, *supra* note 63, at 1372; Livermore, *Corporations*, *supra* note 79, at 674-75 n.2, 676. Davis reports only one incorporated land company. He suggests that a possible explanation is the absence of a widespread distribution of members. See 2 J. DAVIS, *supra* note 79, at 289.

with England deteriorated during the early nineteenth century, American readiness to depend on European manufactured goods disappeared, and manufacturing became an increasingly important political weapon, particularly in New England. The early reluctance to issue manufacturing charters changed; thus from 1808-1815, 128 manufacturing corporations were formed in Massachusetts alone.⁸³

1. Direct Shareholder Liability

As the corporate form became available more readily, businessmen used it increasingly, primarily to achieve perpetuity of existence and ready transferability of shares.⁸⁴ Except for financial enterprises such as banks and insurance companies, limited liability was still of slight importance.⁸⁵ It was almost unknown in Massachusetts where the Handlins report that during the first thirty years of its existence not a single act of incorporation or petition for incorporation even mentioned limited liability.⁸⁶ On the other hand, in New York, there were at least three early instances of limited liability,⁸⁷ and in Maryland, the applicants for a manufacturing charter in 1789 sought limited liability.⁸⁸

By the start of the nineteenth century, direct shareholder liability was still common. In Massachusetts, about half of the early charters imposed full direct liability on shareholders for corporate debts; the others were silent. None provided for limited liability.⁸⁹ In Connecticut, New Hampshire, and Vermont, as well as Massachusetts, numerous charters of this early period also provided for direct liability of shareholders.⁹⁰ Similarly, New York charters for manufacturing businesses, with rare exceptions, provided for direct shareholder liability. New York

83. See O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 107-21, 127; Baldwin, *supra* note 82, at 236, 250.

84. For the primacy of the factors of free assignability and duration of existence, rather than limited liability, as incentives for incorporation, see J. HURST, *supra* note 79, at 9, 28; S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 236, 254; Ekelund & Tollison, *supra* note 48, at 720; Livermore, *Corporations*, *supra* note 79, at 676. Clark asserts that the principal advantage was seen as the ability to sue and collect debts. 1 V. CLARK, *HISTORY OF MANUFACTURERS IN THE UNITED STATES 1607-1860*, at 456 (1929). The English experience was similar. Perrott, *supra* note 9, at 98-102.

85. See J. HURST, *supra* note 79, at 9; S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 236, 254; Livermore, *Corporations*, *supra* note 79, at 676. Davis, however, is alone in asserting that limited liability was "a principal object desired through incorporation." 2 J. DAVIS, *supra* note 79, at 317. Livermore explains that this comment applies only to banks and insurance companies. S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 236 n.50.

86. See Handlin & Handlin, *Origins*, *supra* note 9, at 10.

87. In 1789, The Bank of New York was organized in New York with limited liability. Similarly, in 1786, a New York joint stock association, The Associated Iron Manufacturing Company of the City and County of New York, received a charter with seven years duration that provided for limited liability. See 2 J. DAVIS, *supra* note 79, at 260; S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 269. The Hamilton Manufacturing Society (Albany Glass Works) also received a charter providing for limited liability. See *id.* at 269-70.

88. The 1789 charter application of the Baltimore Manufacturing Company sought limited liability. See 2 J. DAVIS, *supra* note 79, at 267-68; Blandi, *supra* note 79, at 28.

89. See E. DODD, *supra* note 20, at 227, 373; Livermore, *Corporations*, *supra* note 79, at 677-78.

90. See E. DODD, *supra* note 20, at 398, 409, 412, 419; S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 264-67; Livermore, *Corporations*, *supra* note 79, at 679-81.

charters for other industries were quite different.⁹¹ Early bank charters, including the Bank of New York, provided for limited liability. Corporate charters for companies with public functions, such as canal, bridge, water, and turnpike companies, similarly provided for limited liability, while insurance and bank charters typically provided for double liability.⁹² The Maryland experience was somewhat different. The State of Maryland itself invested in some new corporations, particularly banks, and this investment made the imposition of liability on shareholders more difficult. Of the early manufacturing charters, only three (issued between 1823 and 1825) provided for full direct liability and only two (issued in 1822) for double liability.⁹³

2. Indirect Shareholder Liability

Indirect shareholder liability through assessments was also a reality and assessments were common.⁹⁴ In the early stages of corporate development, corporations could make assessments without limit; the Middlesex Canal Company, for example, had 100 assessments.⁹⁵ Charters typically provided for wide powers to levy assessments and thus for indirect shareholder liability.⁹⁶ Some charters were silent, but even in these cases the corporations made assessments.⁹⁷ It was soon held, however, that no assessment could be made unless authorized by charter, contract, or statute.⁹⁸

Although the corporate power to levy assessments remained unquestioned, there was some uncertainty as to the American remedies available to creditors. As previously noted, in the view of most scholars, the House of Lords in the *Salmon* case had fashioned an English remedy in equity under which creditors could compel a corporation in default to levy the assessment necessary for the payment of the judgment debt.⁹⁹ In South Carolina, *Hume v. Winyaw & Wando*

91. See E. DODD, *supra* note 20, at 365; Livermore, *Corporations*, *supra* note 79, at 683-84. But see 2 J. DAVIS, *supra* note 79, at 279.

92. See Livermore, *Corporations*, *supra* note 79, at 683-84.

93. Blandi, *supra* note 79, at 18, 44-45, 51 (Maryland invested in shares of ten banks as early as 1816).

94. Professor Dodd cautions against confusing assessments for the unpaid portion of the stock subscription with assessments for capital contributions in addition to the full issuance price for the shares. See E. DODD, *supra* note 20, at 74. This warning is particularly important because of the practice at that time of requiring payment at the outset of only a small portion of the purchase price of the shares.

95. See *id.* at 13, citing C. ROBERTS, *MIDDLESEX CANAL, 1793-1860* (1938); O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 141. It must be recognized, however, that shareholders had the right to avoid assessments by forfeiting their stock. *Middlesex Turnpike Co. v. Swan*, 10 Mass. 384, 387 (1813).

96. See O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, 15 108, 124, 144-45.

97. See Handlin & Handlin, *Origins*, *supra* note 9, at 14. This occurred in England as well. See A. DuBois, *supra* note 7, at 102.

98. *Franklin Glass Co. v. White*, 14 Mass. 286, 288 (1817); *Commonwealth v. Blue-Hill Turnpike Corp.*, 5 Mass. 420, 422 (1809); *Tippetts v. Walker*, 4 Mass. 596, 597 (1808). See J. ANGELL & S. AMES, *TREATISES ON THE LAW OF PRIVATE CORPORATIONS* AGGREGATE § 544 (9th ed. 1871).

99. *Salmon v. Hamborough Co.*, 22 Eng. Rep. 763 (1671). See *supra* note 20.

*Canal Company*¹⁰⁰ followed *Salmon* and upheld the right of creditors in equity to compel corporate assessments on shareholders for their benefit.¹⁰¹ Similarly at this time, several New York cases, in dicta,¹⁰² and a Georgia case¹⁰³ upheld the right of creditors to enforce shareholders' obligations to the corporation in equity. In Massachusetts, however, the legislature had failed to create a court of equity; and an equitable remedy was unavailable.¹⁰⁴

3. The Growth of Manufacturing Corporations

Statutory development in the Northeastern states was strongly influenced by the rapidly growing industrialization that followed the introduction of the power loom, the growth of the factory system, and the elimination of manufactured imports by the Embargo Act of 1807 and the Non-Intercourse Act of 1809.¹⁰⁵ By 1810, for example, the Connecticut legislature was flooded with requests by manufacturers for charters.¹⁰⁶ this "intensive and rapid development"¹⁰⁷ was accelerated by the War of 1812 and encouraged by the Tariff Act of 1816.¹⁰⁸ Under the explosive influence of the new mechanical technology and the factory system, the New England textile industry grew at a remarkable rate. In comparison to only seven Arkwright mills in the United States in 1800, there were 100,000 textile workers in New England by 1815.¹⁰⁹ The number of spindles increased from 8,000 in 1807, to 191,000 in 1820, to 1,250,000 in 1831; the factory consumption of wool soared from 400,000 pounds in 1810 to 15,000,000 pounds in 1830.¹¹⁰ This growth made for attractive investment opportunities, and business promoters eagerly sought manufacturing charters, preferably with limited liability, but charters in any event.

100. 1 CAROLINA L. J. 217 (1830). The assessments were pursuant to a resolution of the members "having the effect and operation of a bye-law [sic]" which the court held "obligatory" on all members. *Id.* at 228. In the *Hume* case, the assessments on shareholders are reported to have gone beyond "the amount of their capital stock." See *Hightower v. Thornton*, 8 Ga. 486, 493, 499 (1850).

101. *Id.* at 225.

102. *Briggs v. Penniman*, 8 Cow. 386, 395-96 (N.Y. 1826); *Slee v. Bloom*, 19 Johns. 456, 483-84 (N.Y. 1822). See E. DODD, *supra* note 20, at 64, 88.

103. *Hightower v. Thornton*, 8 Ga. 486 (1850). See *Briggs v. Penniman*, 8 Cow. 386 (N.Y. 1826); *Slee v. Bloom*, 19 Johns. 456 (N.Y. 1822). See also E. DODD, *supra* note 20, at 64, 88.

104. In the *Blue-Hill Turnpike* case, Chief Justice Parsons deplored the court's inability to grant relief for this reason. *Commonwealth v. Blue-Hill Turnpike Corp.*, 5 Mass. 420, 426 (1809).

105. See 1 V. CLARK, *supra* note 84, at 266-67.

Prior to the Revolution, colonial industrial development had been hampered by English restrictions. England had prohibited the export of machinery to the Colonies. 23 Geo. 2, ch. 24 (1756); 14 Geo. 3, ch. 71 (1774). It had also banned the emigration of mechanics. See E. GRANT, *supra* note 79, at 6. Professor Bruchey asserts, however, that the relatively undeveloped nature of the economy, rather than British opposition, explains the paucity of business corporations in the colonial periods. See S. BRUCHEY, *THE ROOTS OF AMERICAN ECONOMIC GROWTH 1607-1861*, at 71 (1965, reprinted 1968).

106. See E. GRANT, *supra* note 79, at 114.

107. See W. SMITH & A. COLE, *FLUCTUATIONS IN AMERICAN BUSINESS 1790-1860*, at 5 (1969).

108. 3 Stat. ch. 107 (1816). The Act imposed a 25 percent tariff on cotton and wool imports. See 1 V. CLARK, *supra* note 84, at 266-67; E. GRANT, *supra* note 79, at 115.

109. See 2 J. BISHOP, *HISTORY OF AMERICAN MANUFACTURES FROM 1608 TO 1860*, at 213-14 (3d ed. 1868); E. DODD, *supra* note 20, at 368.

110. See S. BRUCHEY, *supra* note 105, at 87-90.

When first faced with increased demand for manufacturing company charters, the legislatures that had already approved the use of the corporate form for public purposes were reluctant to grant charters for manufacturing. As business pressure increased, the New England states eventually yielded and granted charters for manufacturing, but not with limited liability. In Massachusetts, for example, the 1809¹¹¹ and 1822¹¹² statutes imposed direct liability on shareholders of manufacturing companies, while New York charters for public function companies typically provided for limited liability and bank and insurance company charters typically provided only for double liability.

The growth of the manufacturing corporation reflects the rapid growth of New England industry. For example, in the twenty years before 1809, Massachusetts, the most industrialized state, granted only ten charters. Eleven charters were granted in 1809 alone, and by 1815, 115 textile companies had obtained charters in addition to numerous other manufacturing corporations. From 1808 to 1815, New York issued 165 manufacturing company charters.¹¹³ In 1823, eight states had a total of 557 manufacturing corporations; New York with 203 and Massachusetts with 161 were the leaders.¹¹⁴ By 1830, the United States as a whole had nearly 1,900 corporations, including 600 in manufacturing and mining.¹¹⁵ The increase in the number of corporations did not occur without arousing considerable hostility. In 1821, for example, the New York constitutional convention amended the New York Constitution to require approval of corporate charters by a two-thirds vote in each house of the legislature.¹¹⁶

4. *The Shift to Limited Liability*

a. *Judicial Development*

A cardinal legal question at the beginning of the nineteenth century was whether shareholders were directly liable for corporate debts if the charter was silent on shareholder liability. No answer is available. Professor Dodd states that eighteenth century thought in the United States on this question was "almost non-existent,"¹¹⁷ the Handlins note that it was really just a hypothetical question at this time,¹¹⁸ and Davis reports that he was unable to find a single creditor

111. Act of March 3, 1809, ch. 65, § 6, 1806-1809 Mass. Laws 464, 466.

112. Act of Jan. 28, 1822, ch. 38, 1818-1822 Mass. Laws 619.

113. See S. BRUCHEY, *supra* note 105, at 130.

114. See I V. CLARK, *supra* note 84, at 266-67.

115. See E. DODD, *supra* note 20, at 11,368. The growth in states, other than New York and Massachusetts, was much slower. Thus, from 1800 to 1820, Maryland issued only 17 manufacturing charters, New Jersey 12, and Ohio 3. G. EVANS, *BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943* (1948); Blandi, *supra* note 79, at 14. Pennsylvania issued only 15 manufacturing charters by 1820. See Miller, *A Note on the History of Business Corporations in Pennsylvania, 1800-1860*, 55 Q. J. ECON. 150, 156-57 (1940). Connecticut was more active with 38 manufacturing company charters by 1820. See E. GRANT, *supra* note 79, at 85.

116. See 2 J. KENT, *COMMENTARIES ON AMERICAN LAW* 272 (13th ed. 1884) (change intended "to check the improvident increase").

Clark reports that in 1826 mechanics in Philadelphia protested against the grant of incorporation to Vulcan Iron Works. The corporation was seen as a vehicle to permit the enrichment of investors "without risk of their private fortunes." I V. CLARK, *supra* note 84, at 281-82.

117. See E. DODD, *supra* note 20, at 120.

118. Handlin & Handlin, *Origins*, *supra* note 9, at 16-17.

loss from a business failure in the twenty years after the Revolution.¹¹⁹ This situation changed in the opening decades of the nineteenth century a period with numerous reports of business failures.¹²⁰

This fundamental issue was soon resolved in the first quarter of the nineteenth century. Both the Massachusetts courts¹²¹ and Justice Story sitting as a federal circuit court Judge in *Wood v. Dummer*¹²² held that shareholders were not directly liable for corporate debts unless the statute or charter expressly so provided. The courts pointed to the numerous charters of the time that imposed direct liability as confirmation that, in the absence of such a provision, shareholders were not directly liable. Similarly, in 1816, Chief Justice Tilghman of Pennsylvania stated that shareholders were not personally liable.¹²³ The absence of direct shareholder liability if not expressly imposed by statute or charter imperceptibly became accepted law. Thus, both Dane writing in 1824, and Angell and Ames writing in 1832, took the absence of direct shareholder liability in such circumstances for granted.¹²⁴

At the same time, the Massachusetts courts, influenced by the wording of the Massachusetts statutes, concluded that in the absence of express charter provision, there was no indirect liability via assessments as well.¹²⁵ Connecticut similarly held that in the absence of express or implied authorization for assessments in the charter, there was no inherent power to assess.¹²⁶ More than a decade later, however, South Carolina was still upholding indirect shareholder liability through assessments.¹²⁷

b. Legislative Development

As industry continued its rapid growth, industrialists, whose political influence increased as their economic power grew, pressed for the extension to

119. See 2 J. DAVIS, *supra* note 79, at 294.

120. Clark reports that in the depressed period of 1816, every textile mill in New England shut down. See 1 V. CLARK, *supra* note 84, at 378. Many bank failures had occurred in Maryland by 1818. See Blandi, *supra* note 79, at 43. Grant similarly reports that with the wave of manufacturing enterprises, the percentage of failures in Connecticut became high, including one occasion where a Connecticut manufacturer was jailed for debt in 1822. See E. GRANT, *supra* note 79, at 114.

121. *Nichols v. Thomas*, 4 Mass. 232, 233-35 (1808); *Spear v. Grant*, 16 Mass. 9, 12 (1819). Cf. *Tippett v. Walker*, 4 Mass. 595, 597 (1808).

122. 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944) ("The individual stockholders are not liable for the debts of the banks in their private capacities. The charter relieves them from personal responsibility, and substitutes the capital stock in its stead.") (Story, J.).

123. See *Myers v. Irwin*, 2 Serg. & Rawle 368, 371 (Pa. 1816) ("personal responsibility of a stockholder is inconsistent with the nature of a body corporate").

124. J. ANGELL & S. AMES, *supra* note 98, at 349. See O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 147, citing N. DANE, *A GENERAL ABRIDGMENT AND DIGEST OF AMERICAN LAW* 472 (1824).

125. *Franklin Glass Co. v. White*, 14 Mass. 286, 288-89 (1817); *Andover & Medford Turnpike Corp. v. Gould*, 6 Mass. 39, 42-45 (1809). See O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 158; Dodd, Book Review, 61 HARV. L. REV. 555, 558-59 (1948). The courts were influenced by the statutory provision that shares were to be forfeited in the event of a failure to pay an assessment and construed this to be the exclusive remedy. See E. DODD, *supra* note 20, at 88-90; O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 141-42.

126. *Marlborough Mfg. Co. v. Smith*, 2 Conn. 579, 583-84 (1818). Influenced by the Massachusetts and Connecticut decisions, Livermore contends that the interest of historians in assessments represents only historical hindsight. S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 280. This argument, however, goes too far.

127. *Hume v. Winyaw & Wando Canal Co.*, 1 CAROLINA L.J. 217 (1830).

manufacturing companies of the limitations on shareholder liability that already had been accepted for companies with public function or financial objectives. These efforts gradually met with success, and states began to enact statutes that provided limited liability for manufacturing companies.

New Hampshire¹²⁸ in 1816, and Connecticut¹²⁹ in 1818, adopted limited liability for manufacturing companies. Maine¹³⁰ followed suit in 1823. The stage then moved to Massachusetts where businessmen and political figures argued that these other New England states were attracting capital investment as a result of their more liberal statutes.¹³¹ The depression of 1829 gave further impetus to the business campaign. In 1830, Massachusetts adopted a statute that provided limited liability.¹³² Although special incorporation was still required, it was freely granted.

New York in 1811,¹³³ and New Jersey in 1816,¹³⁴ adopted statutes for the incorporation of manufacturing companies that provided for double liability; ultimately, these statutes were replaced by limited liability statutes. Rhode Island, second only to Massachusetts with respect to industrialization, was the last New England state to yield. Limited liability for Rhode Island manufacturing companies was not enacted until 1847.¹³⁵

The Pennsylvania experience was unique. Pennsylvania was reluctant to grant any charters to manufacturing companies. When rare Pennsylvania charters

128. Professor Dodd reports that New Hampshire accepted limited liability in substantially all charters granted after 1816 although a general limited liability statute was not enacted until 1837. Act of July 6, 1837, ch. 322, § 14, 1835-1839 N.H. Laws 297, 299. The act was similar to the Massachusetts 1830 statute. See E. DODD, *supra* note 20, at 396-99; Dodd, *supra* note 79, at 1375-76.

New Hampshire reverted briefly to unlimited liability from 1842 to 1846 before finally embracing limited liability. See Act of June 24, 1842, ch. 1, § 12, 1842 N.H. Laws 605, 607, E. DODD, *supra* note 20, at 404.

129. Act of May Session, 1818, ch. 8, 1818 Conn. Pub. Acts 305.

130. Act of Feb. 5, 1823, ch. 221, § 1, 1823 Me. Laws 929.

131. See E. DODD, *supra* note 20, at 378-81; Livermore, *Corporations*, *supra* note 79, at 677. Two scholars of the period report that a contemporary article complained that the rule of unlimited liability was driving "millions of capital into the neighboring states for investment." See J. ANGELL & S. AMES, *supra* note 98, at 362, referring to 4 Am. Jurist 307. Similar assertions were made in Maryland. See Blandi, *supra* note 79, at 55.

132. Act of Feb. 23, 1830, ch. 53, § 8, 1830 Mass. Acts 325, 329.

133. Act of Mar. 22, 1811, ch. 67, § 7, 1811 N.Y. Laws 111, 113. The statute provided for shareholder liability "to the extent of their respective shares and no further." *Id.* This language might have been construed to provide for pro rata liability. The California and Georgia courts, as well as Livermore, so misread the statute. See *Larrabee v. Baldwin*, 35 Cal. 155, 161 (1868); *Branch v. Baker*, 53 Ga. 502 (1874); *Lane v. Harris*, 16 Ga. 217 (1854); S. LIVERMORE, *LAND COMPANIES*, *supra* note 79, at 261. The New York courts, however, construed the statute as providing for double liability. See *Slee v. Bloom*, 19 Johns. 456, 483-85 (N.Y. 1822); *Briggs v. Penniman*, 8 Cow. 387, 396 (N.Y. 1826); Howard, *Stockholders' Liability under the New York Act of March 22, 1811*, 46 J. POL. ECON. 499 (1938).

The 1811 Act was the world's first general incorporation statute, although general incorporation statutes in the United States generally were not enacted until decades later. See Dix, *Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation*, 53 Nw. U.L. Rev. 478, 479 (1958). England in 1844 and France in 1867 enacted general incorporation statutes on a national level.

134. 40th Gen. Assembly, 2d sitting, 1816 N.J. Laws 77.

135. Act of June Session 1847, R.I. Acts & Resolves 30.

were issued,¹³⁶ they typically were silent on limited liability. With the change in judicial attitudes, incorporation came to mean limited liability. Limited liability became the rule in Canada in 1850, long after its general acceptance in the United States, but still a few years ahead of its acceptance in England.¹³⁷

Notwithstanding general acceptance of limited liability in the United States, most states imposed some form of qualified personal liability upon shareholders; these survivals, which continued well into the twentieth century, are reviewed later in this Article. This survival was not an insignificant matter. Thus, Chancellor Kent lamented: "The tendency of legislatures and of judicial decisions is to increase the personal liability of stockholders . . . and to give [corporations] more and more the characteristics of partnerships with some of the powers and privileges of corporations."¹³⁸

5. The Significance of Competing Legal Rules on Economic Development

Thus, for several decades, there was a remarkable juxtaposition of conflicting legal rules on limited liability in neighboring states. During the decade prior to 1830, Massachusetts and Rhode Island had unlimited liability while New Hampshire, Connecticut, and Maine had limited liability. Such a contrast could be expected to provide a fertile field for comparison of the impact of conflicting legal rules on liability upon the pace of economic development.

In fact, there is little sign that the different legal rules on shareholder liability adversely affected economic development in Massachusetts and Rhode Island during this period. Although activity in New Hampshire and Connecticut is reported to have been stimulated somewhat by the change to limited liability, these states, nevertheless, continued to lag behind Massachusetts and Rhode Island. Similarly, there was no discernable increase in incorporations when Massachusetts abandoned unlimited liability for limited liability in 1830.¹³⁹ Nor was there any significant impact on Rhode Island during 1830 to 1847 when it was the only state in New England still operating under unlimited liability.¹⁴⁰ Notwithstanding its less hospitable policy to business, Rhode Island retained its position as the second most active state in textiles. The change of liability rule in neighboring states did not have an impact that was important enough to offset other factors.

Professor Dodd concludes that the experiences of Massachusetts until 1830, Rhode Island until 1847, and England until 1855, show that the factory system

136. Pennsylvania issued only nine manufacturing charters by 1815, and only 15 by 1820. See Miller, *supra* note 115, at 156-57.

137. Joint Stock Companies Act, 1850, 13 & 14 Vict., ch. 28 (Can.) See B. WELLING, *CORPORATE LAW IN CANADA* 96-97 (1984).

138. See J. KENT, *supra* note 116, at 272-74 n.d.

139. This is illustrated by the number of incorporations in Massachusetts from 1828-1832:

1828, 23; 1829, 18; 1830 (enactment of limited liability), 4; 1831, 20; 1832, 18. See E. DODD, *supra* note 20, at 383.

It is also confirmed by the number of manufacturing charters issued per decade: 1820-29, 146; 1830-35, 100. See O. HANDLIN & M. HANDLIN, *COMMONWEALTH*, *supra* note 79, at 162.

The foregoing contrasts with the contemporary complaints that Massachusetts was losing capital investment to other states as a result of its policy on limited liability. See *supra* note 131.

140. Rhode Island enacted a limited liability statute in 1847. Act of June Session, 1847, R.I. Acts & Resolves 30.

can grow under a corporate framework featuring unlimited liability, but that it probably does not grow as fast as under limited liability.¹⁴¹ Unlimited liability may have slowed the extent of the distribution of shareownership. In view of the still relatively limited capital needs of the time, this slower growth probably made little difference. Professor Bruchey suggests that the industrial techniques that required large amounts of capital were not developed until after 1835.¹⁴² On the other hand, as capital needs of the new capitalist order became larger and larger, this factor would have become increasingly significant.

6. Summary

The political struggle regarding limited liability did not fade away immediately with the initial adoption of limited liability for manufacturing companies. There were repeated attempts to revive unlimited liability, but they ultimately failed. Michigan in 1837,¹⁴³ New Hampshire in 1842,¹⁴⁴ Wisconsin in 1849,¹⁴⁵ and Pennsylvania in 1853¹⁴⁶ briefly turned to unlimited liability, but soon returned to limited liability. Isolated special charters during this period also provided for unlimited liability, but these too came to an end by the 1850's.

During this period, the Jacksonians were seeking to liberalize the corporation laws through the enactment of both general incorporation and unlimited liability provisions.¹⁴⁷ In the close political struggle with the interests pressing for limited liability, the Jacksonians proved unable to gain both their objectives, and ultimately had to choose between them. They opted for general incorporation, and unlimited liability fell by the wayside.

Thus, in the United States, limited liability was not perceived as an essential attribute of the corporation,¹⁴⁸ and its acceptance was far from inevitable. It emerged after the initial period of industrialization and came as a political response to economic and political pressures, rather than as a necessary consequence of the entity concept.

C. The Emergence of Limited Liability in the Civil Law (1808)

Under the influence of France, limited liability was accepted on the Continent earlier than in the Anglo-American world. On the other hand, general incorporation statutes were enacted somewhat later. At the beginning of the nineteenth

141. See E. DODD, *supra* note 20, at 436.

142. S. BRUCHEY, *supra* note 105, at 139.

143. Act of Mar. 22, 1837, ch. 121, § 7, 1837 Mich. Laws 285, 286.

144. E.g., Act of June 24, 1842, ch. 1, § 12, 1842 N.H. Laws 605, 607.

145. WIS. REV. STAT. ch. 51, § 11 (1849), *repealed by* Act of Apr. 2, 1853.

146. E.g., Act of Apr. 18, 1853, ch. 335, § 13, 1853 Pa. Laws 567, 571.

147. See E. DODD, *supra* note 20, at 384-87. Butler suggests that general incorporation occurred when the economic rents obtainable from state monopolies in corporate privileges decreased with the development of a national free market in corporate privileges as a result of the expansion of interstate commerce and the decision in *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869). See Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129, 136-37 (1985).

148. Thus, neither Chief Justice Marshall nor Justice Washington, in *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636-37, 657-58 (1819), nor Chief Justice Nelson, in *Thomas v. Dakin*, 22 Wend. 9, 71 (N.Y. 1839), mention unlimited liability as a corporate attribute in their discussions of corporations.

century, in France as in England, members of joint stock companies had unlimited direct liability for the debts of the company; they also were subject to calls from the company.¹⁴⁹ In 1807, a brief and inadequate statute, the Napoleonic *Code de Commerce*¹⁵⁰ provided for limited liability for stock corporations such as the *sociétés anonymes*. This general enactment of limited liability, the first in the Western world, promptly spread throughout Europe.¹⁵¹ It was extended by force of arms to a number of German provinces, Prussia, Italy, the Low Countries, and Switzerland.¹⁵² Limited liability survived the fall of Napoleon with the adoption by various German states of local statutes modeled after the *Code de Commerce*; the French Code also constituted the basis of the provincial Italian legislation during the first half of the nineteenth century and of the Spanish Code of 1829.¹⁵³ Thus, limited liability generally was embraced by the civil law earlier than in either the United States or England.

Without general incorporation, limited liability in France did not lead to rapid growth in the number of corporations. From the initial adoption of the Napoleonic *Code de Commerce* and the introduction of limited liability in 1807 to the adoption of the monumental corporation statute of 1867,¹⁵⁴ the French Government granted only 642 charters.¹⁵⁵ In just the eight years after the 1867 Act providing for general incorporation, 798 charters were issued in Paris alone, or more than had been issued in the entire country during the previous sixty years.¹⁵⁶ With the introduction of general incorporation in France in 1867, general incorporation rapidly spread throughout Europe.¹⁵⁷

D. Later Survivals of Shareholder Liability

In the United States, despite the acceptance of limited liability in the early nineteenth century, there were isolated survivals of shareholder liability for corporate obligations.¹⁵⁸ Although in some cases, survival of shareholder liability continued for almost a century, it had no significant influence on the development of the law in this area and has disappeared almost entirely. Nevertheless, the persistence of isolated pockets of shareholder liability is not without interest. Among other things, it provides a fertile area for empirical examination to determine what impact, if any, the change in the legal rule on liability actually had on business activity. Unfortunately, although there are a number of theoretical

149. See C. FREEDEMAN, *JOINT STOCK ENTERPRISES IN FRANCE, 1807-1867*, at 17 (1979).

150. See C. COM. art. 33 (1807) (France).

151. A. CONRAD, *Company Laws of the European Countries from an American Viewpoint* in *HARMONIZATION OF EUROPEAN COMPANY LAW* 45-46 (C. Schimthoff ed. 1972); A. KUHN, *COMPARATIVE STUDIES OF THE LAW OF CORPORATIONS* 56 (1912, reprinted 1968).

152. See D. SERUZIER, *HISTORICAL SUMMARY OF THE FRENCH CODES* 140-52 (D. Combe transl. 1979). The code was introduced "by way of the French army," which Seruzier cites as "evidence of the determined and practical French mind." *Id.* at 140.

153. See A. KUHN, *supra* note 151, at 65-69, 85-86, 90; Macharzina, *Corporate Forms and Limited Liability in German Company Law*, in *LIMITED LIABILITY AND THE CORPORATION* 44, 48 (T. Orhnial ed. 1982).

154. *Loi Sur Les Sociétés*, July 24, 1867, 1867 D.P. 4, 169

155. See C. FREEDEMAN, *supra* note 149, at 145-97.

156. See Minchinton, *supra* note 7, at 146-47.

157. See C. FREEDEMAN, *supra* note 149, at 144.

158. See E. DODD & R. BAKER, *CASES AND MATERIALS ON CORPORATIONS* 1044-48 (1st ed. 1940).

analyses of limited liability by economists, none has dealt with this aspect of the problem.¹⁵⁹ Even without empirical studies, it is hard to conclude that the absence of limited liability in these special cases had serious consequences with respect to entrepreneurial risk taking, capital investment, and general business activity that most scholars have assumed.

1. *Pro Rata Shareholder Liability in California (1849-1931)*

One of the most important survivals of shareholder liability occurred in California from 1849 to 1931. The California experience is particularly interesting because it continued at an advanced stage of commercial and industrial development for more than three quarters of a century, well into comparatively recent times.

The California Constitutions of 1849¹⁶⁰ and 1879¹⁶¹ and implementing statutes¹⁶² imposed on shareholders pro rata liability for all corporate debts and obligations

159. Meiners, Mofsky, and Tollison refer to the Massachusetts experience of 1809-1830 but not to any of the subsequent developments. Meiners, Mofsky & Tollison, *supra* note 6, at 362.

160. CAL. CONST. OF 1849, art. IV, § 36. As part of the first constitution of California, § 36 provided: "Each stockholder of a corporation or joint stock association shall be individually and personally liable for his proportion of all its debts and liabilities."

161. CAL. CONST. OF 1879, art. XII, § 3 (replaced the 1849 Constitution; repealed 1930). Section 3 provided:

Each stockholder of a corporation or joint-stock association shall be individually and personally liable for such proportion of all its debts and liabilities contracted or incurred during the time he was a stockholder, as the amount of stock or shares owned by him bears to the whole of the subscribed capital stock or shares of the corporation or association.

162. Act of Apr. 22, 1850, ch. 128, § 32, 1850 Cal. Stat. 347, 350, as amended by the Act of Apr. 27, 1863, ch. 518, § 1, 1863 Cal. Stat. 766. Section 32 provided:

Each stockholder of any corporation shall be severally individually and personally liable for such proportion of all its debts and liabilities as the amount of stock owned by him in such corporation bears to the whole of the capital stock of the corporation, for the recovery of which joint and several actions may be instituted and prosecuted; and in any such action against any of the stockholders of a corporation, the court shall ascertain and determine the proportion of the debt which is the subject of the suit for which each of the stockholders who are defendants in the action are severally liable, and judgment shall be given severally in conformity therewith. If any stockholder in a corporation shall pay his proportion of any debt due by such corporation he shall be released and discharged from any further individual or personal liability for such debt.

For a very different formulation of pro rata liability, see Act of Apr. 14, 1853, ch. 65, § 16, 1853 Cal. Stat. 87, 90, as amended by Act of Apr. 27, 1863, ch. 460, § 1, 1863 Cal. Stat. 736-37, applicable only to mining corporations, *infra* note 167.

CAL. CIVIL CODE § 322 (repealed 1931) which superseded the Act of 1850 provided:

Each stockholder of a corporation is individually and personally liable for such proportion of its debts and liabilities as the amount of such stock or shares owned by him bears to the whole of the subscribed capital stock . . . and for a like proportion only of each debt or claim against the corporation. Any creditor of the corporation may institute joint or several actions against any of its stockholders, for the proportion of his claim payable by each, and in such action the court must ascertain the proportion

incurred while they were shareholders.¹⁶³ California law imposed liability on all shareholders both of corporations incorporated under California law, without regard to the law of the jurisdiction in which the debt was incurred, and foreign corporations doing business in California with respect to debts arising in California.¹⁶⁴ Direct shareholder liability thus survived in California from 1849 to 1931 in an economic world overwhelmingly committed to limited liability.

California law imposed liability on a shareholder for the shareholder's proportion of the total debts of the corporation. It was a direct, primary obligation that any creditor could assert directly against the shareholder without first instituting an action against the corporation.¹⁶⁵ After 1850, the California general corporation statutes provided for pro rata liability for which the shareholder was liable only for the proportion of each creditor's claim represented by the shareholder's proportional ownership of the stock of the corporation.¹⁶⁶ The California Act of 1853¹⁶⁷ applicable only to mining corporations, however,

of the claim or debt for which each defendant is liable, and a several judgment may be rendered against each, in conformity therewith.

The liability of each stockholder of a corporation formed, under the laws of any other State or Territory of the United States, or of any foreign country, and doing business within this State, shall be the same as the liability of a stockholder of a corporation created under the constitution and laws of this State.

163. See generally 2 H. MARSH, CALIFORNIA CORPORATION LAW § 15.13 (2d ed. 1983) (the best available summary description of the California experience); Hohfeld, *Nature of Stockholders' Individual Liability for Corporation Debts*, 9 COLUM. L. REV. 285 (1909).

164. *Thomas v. Matthiessen*, 232 U.S. 221 (1914); CAL. CONST., art. XII, § 15 (1879) (repealed 1930); *Pinney v. Nelson*, 183 U.S. 144 (1901); CAL. CIVIL CODE § 322, (repealed 1931). See Hohfeld, *supra* note 163, at 319-20.

165. *Anderson v. Schloesser*, 153 Cal. 219, 222 (1908); *Knowles v. Sandercock*, 107 Cal. 629, 642 (1895); *Hyman v. Coleman*, 82 Cal. 650, 653 (1890). See, e.g., *Morrow v. Superior Court*, 64 Cal. 383, 386 (1883).

166. *Gardiner v. Bank of Napa*, 160 Cal. 577, 586-87, 117 P. 667, 670-71 (1911); *Roebing's Sons Co. v. Butler*, 112 Cal. 677, 678-79, 45 P. 6 (1896); *Morrow v. Superior Court*, 64 Cal. 383, 385-86 (1883). It is, of course, easy to ascertain the shareholder's proportional holding in the corporation and the amount of the creditor's claim. Determination of the total amount of the debts of the corporation is a much more difficult matter. This, no doubt contributed to the change in the statute. The creditor's bill was the procedural remedy that was developed to deal with the problem. See *infra* text accompanying notes 210-12.

167. Act of Apr. 14, 1853, ch. 65, § 16, 1853 Cal. Stat. 87, 90, as amended by Act of Apr. 27, 1863, ch. 460, § 1, 1863 Cal. Stat. 736-37, applicable only to mining corporations, provided:

Each stockholder shall be individually and personally liable for his proportion of all the debts and liabilities of the company contracted or incurred during the time that he was a stockholder, for the recovery of which, joint or several actions may be instituted and prosecuted. In any such action, whether joint or several, it shall be competent for the defendant or defendants, or any or either of them, . . . to offer evidence of . . . payment . . . of any debts or liabilities of such corporations; and upon proof of such payment, the same shall be taken into account, and credited to the party or parties making such payment; and judgment shall not be rendered against the . . . defendant, proving such payment for a sum exceeding the amount of his or their proportion of the debts and liabilities of such incorporations, after deducting therefrom the sums proven to have been paid . . . on account thereof.

See *Larrabee v. Baldwin*, 35 Cal. 155, 169-77 (1868). A contrary construction would have flown in the face of the second sentence of the statute. This provision, however, did not appear in the general corporation acts including the Act of 1850 or Section 322 of the California Civil Code that survived until 1931.

utilized a very different form of pro rata liability. Under this early mining corporation act, pro rata liability meant that a creditor was empowered to collect from any shareholder the entire amount of a corporate obligation, but not in excess of the shareholder's aggregate obligation, as measured by the shareholder's proportional ownership of the outstanding shares.¹⁶⁸

There were significant limitations. Contractual waivers of shareholder liability were valid. Further, the statutory period for instituting actions was very restrictive. Liability expired three years after the date on which the liability was incurred, without regard to the maturity of the obligation (even where it exceeded three years) or the date of the breach or default.¹⁶⁹ Such restrictive features obviously limited the effectiveness of the provisions.

In 1929, the statute was amended to permit corporations to obtain limited liability for their shareholders by inserting "Limited" or "Ltd." in their corporate names.¹⁷⁰ In 1930, the constitutional provision was repealed, and the 1931 General Corporation Law¹⁷¹ repealed the provisions of article 322 of the Civil Code which had implemented the constitutional provision. Subsequent corporation laws were entirely silent on the issue of shareholder liability.¹⁷²

The most interesting questions with respect to this fascinating episode in American corporate history are unanswered. For example, did this unique legal rule have any significantly adverse impact on business activity as was asserted by the forces pressing for repeal?¹⁷³ From California's rate of growth during the eighty years in which the constitutional and statutory provisions were in effect, it can be inferred that any such impact was limited; however, this inference remains to be demonstrated by economic historians.

2. Double or Triple Liability for Shareholders Generally

Double liability for shareholders (*i.e.* liability for corporate obligations in an amount equal to the par value of their shares) arose in American law during the early nineteenth century after unlimited liability had been discarded reluctantly

168. This form of pro rata liability was not unique. It was utilized in other jurisdictions as well. *E.g.*, *Hatch v. Burroughs*, 11 F. Cas. 795 (C.C.S.D. Ga. 1870) (No. 6203); *Branch v. Baker*, 53 Ga. 502 (1874); *Lane v. Harris*, 16 Ga. 217 (1854) (legislative bank charters). See generally 1 C. BEACH, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS § 154, at 280 (1891).

Since this form of pro rata liability, unlike the other, requires a determination of the total debts of the corporation in order to determine the maximum obligation of a shareholder, it appears to present serious problems of implementation as a practical matter, except as an integral part of a general insolvency or bankruptcy proceeding. Thus, in a suit to enforce bank double shareholder liability, a Massachusetts court held in 1846 that a suit by an individual creditor would not lie. The court required that either all creditors join in a single suit or that one or more creditors file a creditors' bill for the benefit of all creditors against all shareholders. *Crease v. Babcock*, 52 Mass. 557, 560 (1846).

169. 2 H. MARSH, *supra* note 163, § 15.13, at 330.

170. Act of May 23, 1929, ch. 418, § 1, 1929 Cal. Stat. 740.

171. Act of June 12, 1931, ch. 862, § 1, 1931 Cal. Stat. 1762, 1763.

172. Mr. Marsh reports that the Drafting Committee of the 1977 Act was content with the implication of limited liability arising from the nature of the corporation as a separate legal personality and the constitutional and statutory history. See 2 H. MARSH, *supra* note 163, § 15.13, at 331-32.

173. See 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 1 n.2 (1962).

in favor of general incorporation statutes. New York in its general incorporation act of 1811,¹⁷⁴ and New Jersey in 1816,¹⁷⁵ included provisions for double liability for shareholders generally. Professor Hurst reports that such explicit statutorily qualified liability for shareholders was common between 1810 to 1860.¹⁷⁶ Writing as late as 1891, Beach described such liability as applicable in nearly all states.¹⁷⁷ Although most of such statutes provided for double liability, some, as in Colorado, Maryland, and Pennsylvania, provided for triple liability.¹⁷⁸

While some statutes imposed joint and several liability, others imposed pro rata liability. Many statutes imposed statutory liability for the "debts contracted by the corporation." Initially, this provision was construed to include tort liability.¹⁷⁹ Subsequently, as limited liability became accepted as the underlying rule, the statutes were construed more strictly to exclude tort liability.¹⁸⁰ Eventually, these general statutes disappeared, while statutes imposing double liability on the shareholders of banks survived. As late as 1923, however, New York authorized the optional inclusion of a provision in the certificate of incorporation that imposed double liability.¹⁸¹

3. Double Liability for Shareholders of Banks

While the double liability statutes of general application gradually disappeared, double liability for shareholders of bank corporations survived until well into the present century. Designed as a measure of protection for bank depositors,¹⁸² such statutes had been enacted widely and survived until after the Great Depression.¹⁸³

On the federal scene, double liability for shareholders of national banks first appeared in the National Bank Act of 1864,¹⁸⁴ which was reenacted in section 23 of the Federal Reserve Act of 1913.¹⁸⁵ The federal statute applied to the actual beneficial owner or the owner of record of shares of national banks.

174. Act of March 22, 1811, ch. 67, § 7, 1811 N.Y. Laws 111, 113. See Howard, *supra* note 133.

175. 40th Gen. Assembly, 2d Sitting, 1816 N.J. Laws 77.

176. See J. HURST, *supra* note 79, at 27.

177. See 1 C. BEACH, *supra* note 168, § 143, at 268.

178. See 1 W. COOK, *THE LAW OF CORPORATIONS* 675 n.1 (8th ed. 1923).

179. *Carver v. The Braintree Mfg. Co.*, 5 F. Cas. 235 (C.C.D. Mass 1843) (No. 2,485) (Story, J.).

180. *Chase v. Curtis*, 113 U.S. 452 (1885); *Child v. Boston Iron Works*, 137 Mass. 516 (1884); *Cable v. McCune*, 26 Mo. 371 (1858). Cf. *Stanton v. Wilkeson*, 22 F. Cas. 1074, 1077 (S.D.N.Y. 1876) (No. 13,299). See W. COOK, *STOCKHOLDERS AND CORPORATION LAW* § 217 (3d ed. 1884).

181. Act of Apr. 16, 1901, ch. 354, § 54, 1901 N.Y. Laws 961, 971-72 (repealed 1923).

182. The collection rate on bank shareholder statutory assessments during the depression was 48.29%. See *Hearings on H.R. 141 before House Committee on Banking & Currency*, 71st Cong., 2d Sess. 76 (1930). As a result of such factors as this low collection rate, a 10 to 1 ratio of deposits to stock, *id.* at 16, and litigation expense, double liability provided protection for less than five percent of deposits as a practical matter. See also Legislation Note, Branch, Chain & Group Banking, 48 HARV. L. REV. 659, 669 n.77 (1935).

183. See generally 13A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 6224.1 (rev. perm. ed. 1984); Vincens, *On the Demise of Double Liability of Bank Shareholders*, 12 BUS. LAW. 275 (1957).

184. Act of June 3, 1864, ch. 106, § 12, 13 Stat. 99, 102-03 (1864).

185. Act of Dec. 23, 1913, ch. 6, § 23, 38 Stat. 251, 273 (1913) (amended 1933 and 1935; repealed 1959).

Double liability for bank shareholders was the common pattern under state law for state banks as well. As late as 1926, thirty-five states had statutes imposing double liability (and in Colorado, triple liability) on shareholders of state banks.¹⁸⁶

The development of banking groups inevitably led to the question of whether shareholders in bank holding companies were subject to the statutory double liability imposed on bank shareholders when the holding company was unable to satisfy the obligation. Only the Wisconsin double liability statute expressly imposed such liability,¹⁸⁷ and the other statutes did not deal with the issue.

In *Anderson v. Abbott*,¹⁸⁸ one of the landmark cases in the law of corporate groups, the Supreme Court of the United States held in a five to four decision that the federal statute was applicable to the shareholders of a parent corporation which held the shares of the constituent banks in the group.¹⁸⁹ In the only other case that involved this issue, *Fors v. Farrell*,¹⁹⁰ the Michigan Supreme Court reached the same result under the comparable Michigan statute.¹⁹¹

In the financial disasters of the Great Depression, double liability proved ineffective,¹⁹² and the country turned to deposit insurance as a more effective measure for the protection of depositors. In 1933 and 1935, Congress amended the National Banking Act to permit national banks to escape double liability by giving six month's notice.¹⁹³ The provision for double liability became a dead letter and finally was repealed in 1959.¹⁹⁴

The states followed suit, sometimes repealing a statute, sometimes terminating liability only for corporations that insured depositors with the Federal Deposit Insurance Corporation, gave public notice, or maintained a specified surplus.¹⁹⁵ As a practical matter, double liability for bank shareholders became a thing of the past after dominating the banking scene for three-quarters of a century.

4. Shareholder Liability for Wage Claims

Another area of surviving shareholder liability for corporate obligations involves obligations to employees. As late as the 1960's, there were as many as six states that by constitution or statute imposed some form of liability on shareholders (or insiders) for unpaid wages of corporate employees.¹⁹⁶ Today, such statutes survive only in New York¹⁹⁷

186. See Vincens, *supra* note 183, at 275.

187. Wis. STAT. § 221.56 (1933). See Legislation Note, *supra* note 182, at 669 n.77.

188. 321 U.S. 349 (1944).

189. *Id.* at 362-65.

190. 271 Mich. 358, 260 N.W. 886 (1935).

191. *Id.* at 365-75, 260 N.W. at 888-92.

192. See *Hearings on H.R. 141 before House Committee on Banking & Currency*, 71st Cong., 2d Sess. 17 (1930) ("inadequate protection to depositors" and a "great hardship to the shareholders").

193. Act of June 16, 1933, ch. 89, § 22, 48 Stat. 162, 189 (1933) (repealed 1959); Act of Aug. 23, 1935, ch. 614, § 304, 49 Stat. 684, 708 (1935) (repealed 1959).

194. Pub. L. No. 86-230, § 7, 73 Stat. 457 (1959).

195. See Vincens, *supra* note 183, at 276-78.

196. Massachusetts (repealed 1965); Michigan (repealed 1973); N.Y. BUS. CORP. LAW § 630 (McKinney Supp. 1986); Pennsylvania (repealed 1966); Tennessee (repealed 1969); Wis. STAT. § 180.40(6) (1981-82). See H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* 548-50 (3d ed. 1983).

197. N.Y. BUS. CORP. LAW § 630 (McKinney 1963 & Supp. 1986). See Brownell, *The Not-So-Limited Liability of Stockholders of New York Corporations*, 27 N.Y. ST. BAR BULL. 58 (1955);

and in Wisconsin.¹⁹⁸

The current New York statute¹⁹⁹ adopted in 1963 applies only to closely held companies. Listed companies, companies with shares that are quoted over-the-counter, and registered investment companies are excluded.²⁰⁰ Joint and several liability for salaries and wages of employees is imposed on the ten largest holders of beneficial interests.²⁰¹ The action may be brought only after a judgment has been obtained against the corporation and returned unsatisfied; shareholders who have paid more than their pro rata share are entitled to contribution from the other shareholders.²⁰² The statute applies only to New York corporations. The New York Court of Appeals has held that the statute does not apply to the shareholders of a foreign corporation doing business in New York and owing wages to New York employees.²⁰³

Under the previous New York statute, all shareholders were subject to joint and several liability, employee claims had to be filed within thirty days, and there was no express provision for contribution.²⁰⁴ These features in the older statute meant that liability fell very unevenly. Thus, in the failure of *The New York Compass*, less than fifteen of 2,300 shareholders are reported to have paid \$70,000 to settle outstanding wage claims of \$130,000.²⁰⁵ Shareholders beyond the jurisdiction of New York escaped liability. Reflecting this unfortunate experience, the 1963 amendment of the statute severely cut back the scope of the statute.

The Wisconsin statute²⁰⁶ that imposes liability for wages is a survivor of an older Wisconsin tradition that can be traced to the 1849 Wisconsin statute²⁰⁷ that imposed liability on shareholders for corporate obligations generally. It goes well beyond the New York statute in a number of respects. The Wisconsin statute applies to the following: all shareholders, not merely the ten largest; public as well as closely held corporations; and foreign corporations doing business in Wisconsin.²⁰⁸ The statutory period for suit is extended to two years. On the other hand, without regard to the amount of the wage claim, liability is limited to the aggregate par value of a shareholder's interest (or in the case of no par shares, to the amount of the consideration for which the shares were issued).²⁰⁹

Rogers & McManus, *Stockholders' Booby-Trap: Partnership Liabilities of Stockholders under Section 71, New York Stock Corporation Law*, 28 N.Y.U.L. REV. 1149 (1953); Comment, *Shareholder Liability for Wages: Section 630 of the New York Business Corporation Law*, 30 FORDHAM L. REV. 471 (1962).

198. WIS. STAT. § 180.40(6) (1981-82). See Davis, *Shareholder Liability for Claims by Employees*, 1984 WIS. L. REV. 741.

199. N.Y. BUS. CORP. LAW § 630(a),(c) (McKinney 1963 & Supp. 1986).

200. *Id.* § 630(a).

201. *Id.*

202. *Id.* § 630(a)(c).

203. *Armstrong v. Dyer*, 268 N.Y. 671, 672, 198 N.E. 551, 552 (1935) (mem.). The *Armstrong* decision construed N.Y. STOCK CORP. LAW § 71, (repealed 1963), predecessor of section 630 of the New York Business Corporation Law, which does not differ in this respect.

204. Act of May 24, 1923, ch. 787, § 71, 1923 N.Y. Laws 1377, 1406 (repealed 1963).

205. See Brownell, *supra* note 197; Rogers & McManus, *supra* note 197, at 1155; Comment, *supra* note 197, at 473, 475.

206. WIS. STAT. § 180.40(6) (1981-82); see Davis, *supra* note 198.

207. WIS. REV. STAT. ch. 51, § 12 (1849).

208. WIS. STAT. § 180.40(6) (1981-82). See *Joncas v. Krueger*, 61 Wis. 2d 529, 213 N.W.2d 1 (1973).

209. WIS. STAT. § 180.40(6) (1981-82).

5. Summary

The numerous experiences with jurisdictions imposing some form of liability on shareholders provide a valuable source of empirical data regarding the economic impact of a change in the fundamental legal rules governing the conduct of corporate enterprise. Definitive evaluation of the significance of limited liability on economic behavior must await such studies which, as noted previously, do not seem to be available.

E. Procedures for Enforcing Shareholder Liability

A historical review of the periods of American law in which liability was imposed upon shareholders for corporate obligations would not be complete without a description of the procedures developed for enforcing such liability. The theoretical reviews by economists regarding the feasibility of such a legal rule fail to discuss this aspect of the actual experience. In fact, state law passed through several stages of development before finally achieving what appears, at least on the surface, to be an effective system for enforcing such liability. The historical sources of this development and court records must be examined before any reliable judgment may be reached on the efficiency of the enforcement system.

Effective enforcement of shareholder statutory liability for corporate obligations was ultimately achieved through development of a device in equity procedure known as the creditors' bill.²¹⁰ Before the creditors' bill emerged, the law functioned under a crude system in which any creditor with an unsatisfied judgment against the corporation sued any shareholder at common law. This system proved unsatisfactory because liability was borne unequally, reflecting caprice, or whim, or a rich target.²¹¹

The equitable procedure, the creditors' bill, was developed in response to these problems. In its final form, the creditors' bill was a proceeding instituted by any creditor with an unsatisfied judgment, usually on behalf of all creditors, against the corporate debtor. It normally could be instituted only in the state of incorporation. The relief sought typically included the appointment of a receiver for the corporation, the determination of aggregate corporate liabilities unsatisfied by the assets of the corporation, and a determination of the liability per share of the shareholders for the unsatisfied obligations. Even though shareholders may not have been residents of the state of incorporation, had not been parties, and had received no notice, the judgment was *res judicata* against such shareholders as to all issues other than defenses personal to the shareholder, such as identity as a shareholder or the number of shares in fact held.²¹² With the accuracy of the shareholder's list the only basic question remaining, the subsequent proceedings against individual shareholders likely proceeded by de-

210. See generally RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 308 comment e (1971); Abbot, *Conflict of Laws and the Enforcement of the Statutory Liability of Stockholders in a Foreign Corporation*, 23 HARV. L. REV. 37 (1909).

211. See Abbot, *supra* note 210, at 41. In fact, these are the very evils that the economists enumerate in their theoretical analysis of the consequences of a rule other than limited liability. As will be seen, the subsequent development of the creditors' bill eliminated many of these features.

212. *Goss v. Carter*, 156 F. 746, 751 (5th Cir. 1907).

fault. Thus, as finally developed, the legal framework was firmly in place for obtaining both the underlying judgment and the follow-up collection judgments.

Collection suits against individual shareholders were still necessary. In view of the pro forma nature of the proceedings, they obviously presented no significant problems of practical implementation other than the burden of service of process. With the modern development of elaborate procedures for the conduct of class actions, the practical difficulties involved in the follow-up collection efforts would have been further reduced.

Because shareholder liability under statute has almost been eliminated completely, this review is only of historical interest. However, it is included to provide a more realistic description of the functioning of a judicial system with a legal rule for shareholder liability. It provides the historical and legal background for a review of the theoretical analyses of economists on the likely economic impact of shareholder liability rules.

F. Summary

For more than 150 years in the United States and Continental Europe, and for more than 100 years in England, limited liability for shareholders has been the firmly established legal principle underlying corporation law. This fundamental policy emerged after political and economic struggle. It was intended to stimulate economic activity by encouraging widespread investment in corporate shares. Such investment would result from protecting investors against liability to corporate creditors and by limiting their risk to the loss of their investment in the corporation.

The triumph of limited liability flows from concerns of policy, not from any conceptual notion of the nature of the corporation. For many years, the acceptance of the principle was uneven. In a number of areas, pockets of shareholder liability survived, demonstrating that limited liability is not an essential condition for capitalist economic activity.

Over the historical period in which these dramatic changes occurred, the form of the business firm has changed remarkably. Limited liability triumphed at a time when corporations were simple, when one corporation could not acquire and own the shares of another. Limited liability meant protection for the ultimate investor. Long after corporations were firmly established, corporations generally were first granted the power to acquire and own shares of other corporations. Major business rapidly changed form with the emergence of complex multi-tiered corporate structures that included a parent corporation and numerous affiliated corporations collectively conducting the business of the group. Limited liability no longer meant protection for the ultimate investor alone. It also meant protection for the parent corporation against liability for the obligations of its subsidiaries, even if they were conducting essential parts of a single, unitary business. Whether this development was advantageous or disadvantageous, it was neither anticipated nor intended.

This historical background should be kept in mind during the review and evaluation of the legal rules for the imposition of liability on a parent corporation for the substantive obligations of its subsidiaries, rules that rest on the pressure to implement a policy of limited liability. Similarly, this background should be kept in mind during the subsequent review of the economic analyses, which often address solely the situation of the simple corporation with ultimate investors

as shareholders. Thus, these economic analyses neglect the problems presented by corporate groups (a parent and dozens or even hundreds of subsidiary corporations) that are responsible today for the conduct of the great bulk of the economic activity in the industrialized world.

III. THE EMERGENCE OF CORPORATE GROUPS (1889)

Corporate groups emerged in the United States with the liberalization of state corporation laws that authorized corporations, generally for the first time, to acquire and own the shares of other corporations. This process commenced in New Jersey in 1889.²¹³ Thus, limited liability became established firmly in the American legal system at a time when corporate groups were relatively unknown and only ultimate investors were protected by the rule. After corporations became able to own the shares of other corporations and corporate groups arose, the controlled corporation (subsidiary) and its controlling shareholder (parent) collectively comprised and conducted the enterprise. At issue was whether the components of the enterprise, as well as the ultimate investors, were to be shielded from liability for the debts of the enterprise. The courts apparently did not recognize, and certainly did not discuss, this very different issue that emerged for the first time, an issue that went well beyond the question of liability: whether one or two legal entities were involved. Limited liability for corporate groups, one of the most important legal rules in modern economic society, appears to have emerged as an historical accident.

A. Corporate Ownership of Shares of Another Corporation

Decades after the acceptance of the concept of limited liability in the United States, corporations still lacked the power to own the shares of another corporation unless expressly authorized by statute or charter. Corporate ownership of the shares of another corporation also came late in England.

1. The American Development (1889)

The American development of corporate ownership of the shares of another corporation and the emergence of corporate groups began with the railroads. The unique operations of railroads led to the development of a system of contiguous roads connecting important centers. In turn, interlocking operations resulted in interlocking security ownership.²¹⁴ Early authorizations of stock ownership were granted to such corporations as the Baltimore & Ohio Railroad in 1832, the Pennsylvania Railroad in 1864 and the Western Union Telegraph Company in 1864.²¹⁵ Such provisions also appeared in the charters of other

213. See *infra* text accompanying note 223.

214. See W. NOYES, *TREATISE ON THE LAW OF INTERCORPORATE RELATIONS* § 271 (2d ed. 1909). Maryland banks were also authorized to invest in stocks to provide capital for other corporations, but this does not appear to include acquisitions for control. See Brandt, *supra* note 79, at 19.

215. Robinson, *The Holding Company* (pt. I), 18 YALE REV. 390, 400-01, 404 (1910).

railroad, bridge, steamship, and canal companies, but rarely in the case of manufacturing company charters.²¹⁶

The power of a corporation to own the shares of another corporation presented no question of *ultra vires* if the statute or charter so provided.²¹⁷ In the absence of an express provision in the statute or charter, it was settled that acquisition by one corporation of another corporation's shares was *ultra vires*,²¹⁸ whether the acquisition was for purposes of control or investment.²¹⁹ Several reasons were advanced. First, the doctrine of *ultra vires* was seen as a necessary barrier to the evasion of legislative limitations on corporate objectives.²²⁰ Second, courts strictly construed the legislative failure to include the power to acquire shares of another corporation in the statutory enumeration of corporate powers by holding that such failure was an indication of an intention to exclude such

216. See J. BONBRIGHT & G. MEANS, *THE HOLDING COMPANY - ITS PUBLIC SIGNIFICANCE AND ITS REGULATION* 58-65 (1932, reprinted 1969); Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125, 127-30 (1940).

217. *People ex rel. Peabody v. Chicago Gas Trust Co.*, 130 Ill. 268, 288 (1889). It was even held that in the absence of statutory authorization, a provision in the charter expressly authorizing the purchase and ownership of the stock of another corporation was ineffective to authorize such action. *Id.*

218. *E.g.*, *De La Vergne Refrigerating Mach. Co. v. German Sav. Inst.*, 175 U.S. 40, 54-55 (1899) (National Banking Act); *California Bank v. Kennedy*, 167 U.S. 362, 366-70 (1897) (National Banking Act); *Louisville & N. R.R. v. Kentucky*, 161 U.S. 677, 698 (1896); *First Nat'l Bank v. Nat'l Exch. Bank*, 92 U.S. 122, 127-28 (1875) (National Banking Act); *Sumner v. Marcy*, 23 Fed. Cas. 384, 385-86, (C.C.D. Me. 1847) (No. 13,609); *Hazelhurst v. Savannah, G. & N.A.R.R.*, 43 Ga. 14 (1871); *Central R.R. v. Collins*, 40 Ga. 582, 589-90 (1869); *Franklin Co. v. Lewiston Inst. for Sav.*, 68 Me. 43, 46 (1877); *Robotham v. Prudential Ins. Co.*, 64 N.J. Eq. 673, 682, 53 A. 842, 851 (1903); *Parsons v. Tacoma Smelting & Ref. Co.*, 65 Pac. 765, 768 (Wash. 1901). See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 541, 556 (1933) ("The power to hold stock in other corporations was not conferred or implied. The holding company was impossible.") (Brandeis, J.); S. BRICE, *TREATISE ON THE DOCTRINE OF ULTRA VIRES* 91-92 (2d Am. ed. A. Green ed. 1880); W. CLARK, *LAW OF PRIVATE CORPORATIONS* 183-86 (3d ed. I. Wormser ed. 1916); 6A W. FLETCHER, *supra* note 183, §§ 2824-26; I V. MORAWETZ, *LAW OF PRIVATE CORPORATIONS* § 431 (2d ed. 1886); 4 S. THOMPSON, *LAW OF CORPORATIONS* § 4056 (3d ed. 1927); Compton, *supra* note 216, at 131 n.14.

Maryland and Iowa were apparently alone in allowing intercorporate stock ownership in the absence of express authorization by charter or statute. Iowa: *Traer v. Lucas Prospecting Co.*, 124 Iowa 107, 116, 99 N.W. 290, 294 (1904); *White v. G. W. Marquardt & Sons*, 105 Iowa 145, 147, 74 N.W. 930, 930 (1898); *Calumet Paper Co. v. Stotts Inv. Co.*, 96 Iowa 147, 152-53, 64 N.W. 782, 783-84 (1895). Maryland: *Davis v. United States Elec. Power & Light Co.*, 77 Md. 35, 39 (1893); *Booth v. Robinson*, 55 Md. 419, 433-34 (1880). The Maryland decisions apparently rested on a misreading of the English authorities. *Id.* at 434.

One New York case took a middle ground. After terming an intercorporate stock acquisition unlawful, a lower court allowed the corporate shareholder to retain dividends but not to vote. *Milbank v. N.Y.L.E. & W.R.R.*, 64 How. Pr. 20, 27-28 (N.Y. Sup. Ct. 1882).

A few early statutes expressly prohibited corporate ownership of stock of another corporation. *E.g.*, Act of Feb. 10, 1849, § 8, 1846-1849 Ill. Laws 89; Act of Jan. 12, 1860, ch. 1, § 1, 1860 Md. Laws 1-2; Act of Mar. 22, 1811, ch. 67, § 7, 1811 N.Y. Laws 111, 113. See J. BONBRIGHT & G. MEANS, *supra* note 216, at 56 n.1.

219. Acquisitions in the ordinary course of business or by way of security were excluded from the prohibition. See 6A W. FLETCHER, *supra* note 183, § 2832, at 323; I V. MORAWETZ, *supra* note 218, § 431, at 406-07.

220. See, *e.g.*, *Franklin Co. v. Lewiston Inst. for Sav.*, 68 Me. 43, 46 (1877); I V. MORAWETZ, *supra* note 218, § 431, at 406-07.

power.²²¹ The exercise of such power without express authority was therefore *ultra vires*. Third, purchases of stock were seen as a means of acquiring control or accomplishing a monopoly.²²²

More than fifty years after limited liability for corporations had become accepted, American law authorized corporations generally to acquire and own the shares of another corporation. The change first occurred in New Jersey. During the years 1888-1893, New Jersey amended its corporation laws to authorize intercorporate stock ownership generally.²²³ Other American jurisdictions followed suit, although at a slower pace than generally recognized; by 1910, only thirteen states had adopted such statutes.²²⁴ Eventually, however, the authority of a corporation to own the shares of another corporation became universally recognized.²²⁵

The change in the law opened the way to a profound change in corporate structure. Corporations began to organize other corporations to conduct parts of their business and to acquire other corporations as an alternative method of expansion. Professor Alfred Chandler describes this change as a turning point in the evolution of American business.²²⁶ With this development, a corporation no longer represented the entire enterprise. The enterprise became increasingly fragmented among parent and subsidiary corporations. In contrast to the simple corporation with its bright line of distinction between the enterprise conducted by the corporation and the investor represented by the shareholder, the corporate group was quite different; the parent (as the shareholder) and the subsidiary collectively made up the enterprise. In the simple corporation, the insulation of the shareholder as investor from liability for the debts of the enterprise was accomplished by limited liability for the investor. In the corporate group, the extension of limited liability to the parent was not necessary to accomplish this result. The parent's shareholders already benefitted from limited liability, and insulation of the parent created a second layer of protection.

Nevertheless, dazzled by the concept of the corporation as a separate entity, the same rule apparently was applied unthinkingly and automatically to the parent corporation. Limited liability was accorded to the parent without realization that the relation of parent to subsidiary, where both comprised the

221. *De La Vergne Refrigerating Mach. Co. v. German Sav. Inst.*, 175 U.S. 40, 55 (1899); *California Bank v. Kennedy*, 167 U.S. 362, 366-67 (1897); *First Nat'l Bank v. Nat'l Exch. Bank*, 92 U.S. 122, 128 (1875).

222. 4 S. THOMPSON, *supra* note 218, §§ 4063-75.

223. Act of April 4, 1888, ch. 269, § 1, 1888 N.J. Laws 385-86; Act of April 17, 1888, ch. 295, § 1, 1888 N.J. Laws 445-46; Act of May 9, 1889, ch. 265, § 4, 1889 N.J. Laws 412, 414; Act of Mar. 14, 1893, ch. 171, § 2, 1893 N.J. Laws 301. Ironically, New Jersey repealed its authorization of intercorporate stock ownership under the influence of Woodrow Wilson in 1913. The reform lasted only four years. See J. BONBRIGHT & G. MEANS, *supra* note 216, at 57.

224. See Robinson, *The Holding Company*, (pt. 2), 19 YALE REV. 13, 29 (1910).

225. See H. BALLANTINE, CORPORATIONS § 9, at 39 (rev. ed. 1946); Freedland, *History of Holding Company Legislation in New York State: Some Doubts as to the "New Jersey First" Tradition*, 24 FORDHAM L. REV. 369, 396-97 (1955); Note, *Power of a Corporation To Purchase the Shares of Another Corporation*, 31 COLUM. L. REV. 281, 284-86 (1931).

226. See A. CHANDLER, *supra* note 3, at 30. Professor Berle concluded that with this statutory change, "corporate finance entered an entirely new phase." Berle, *Foreword to E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS*, at iv (1936).

enterprise, was markedly different from the relation of investor to the enterprise.

2. The English Experience (1867)

The development in the English law differed from the American experience because of the different English legal framework for the issuance of charters. Unlike the United States where general corporation statutes, not articles of incorporation, largely specified the powers of a corporation, the Companies Act, 1862²²⁷ provided for incorporation via the registration of companies with the company powers specified not only in the statute, but also in the company's memorandum of association. There was no comparable doctrine existing in the United States at that time. Rather, the American courts strictly limited the corporate powers in the charter to those authorized, expressly or impliedly by the statute.²²⁸ On the other hand, in England the corporate power to acquire and own the shares of another corporation could arise from provisions inserted in the memorandum by the promoters and their counsel, notwithstanding the omission of such power in the incorporation statute.

If the memorandum of association was silent, it was *ultra vires* for a company to purchase shares of another company.²²⁹ However, if the memorandum of association so provided, *In re Barnard's Banking Company*²³⁰ and *In re Asiatic Banking Corporation*²³¹ held that the power existed and that neither the common law nor the 1862 Act was to the contrary. Both courts found helpful, but inconclusive, references to "corporations" in the definition of "persons" who could become "members" in the 1862 Companies Act.²³² These references encouraged them in their conclusion that intercompany stock ownership was contemplated, or at least not forbidden, under the statutory scheme.

With these cases providing direction, the power to acquire and own shares of another corporation was thereafter conveniently achieved by attention to the drafting of the memorandum of association. By this different route, the English law reached the same result that statutory reform accomplished in the United States several decades later.

*In re European Society Arbitration Accounts*²³³ is almost alone in its perception of the interrelation of intercompany stock ownership and limited liability. In other cases, the power of a company to purchase and own shares of another company was discussed and acknowledged without apparent awareness of the consequence of such a change in creating two levels of limited liability sheltering the parent corporation as well as the the shareholders of the parent.

227. 25 & 26 Vict., ch. 89 (1862).

228. Cf. *People ex rel. Peabody v. Chicago Gas Trust Co.*, 130 Ill. 268, 288 (1889).

229. *In re European Society Arbitration Accounts*, 8 Ch. D. 679, 692 (1878); *Great E. Ry. v. Turner*, 8 L.R.-Ch. 149, 151-52 (1872). See *William Thomas & Co. v. Sully*, [1915] 1 Ch. 325, 329-30 (1914) (generally speaking, companies registered under the 1862 Act cannot acquire shares unless the memorandum of association so authorizes, but such authorization may be implied); *In re Asiatic Banking Corp.*, 4 L.R.-Ch. 252, 262 (1869) (Giffard, J.). Cf. *Joint Stock Discount Co. v. Brown*, 3 L.R.-Eq. 139, 149 (1866); *Maunsell v. Midland Great W. Ry.*, 71 Eng. Rep. 58, 72 (1863); *Salomons v. Laing*, 50 Eng. Rep. 1091, 1096 (1850).

230. 3 L.R.-Ch. 105, 112-13 (1867).

231. 4 L.R.-Ch. 252, 257 (1869).

232. *Barnard's Banking*, 3 L.R.-Ch. at 113; *Asiatic Banking*, 4 L.R.-Ch. at 257.

233. 8 Ch. D. 679 (1878).

In *European Society*, the court held *ultra vires* the purchase by one company of the shares of another.²³⁴ Neither company had received the full subscription price of its shares from the shareholders. The court noted that this failure, in effect, meant that the call liability for payment of the balance of the subscription price of the purchased shares was being piled on top of the call liability of the shareholders of the purchasing company to pay the balance of the subscription price for their shares in the purchasing company.²³⁵ The court pointed out that the purchasing company's memorandum of association provided limited liability for the members; this additional exposure of the purchasing company to calls on the purchased shares undermined the usefulness of the limited liability provision.²³⁶

A similar focus on the impact of the limited liability rule as applied to the related question of the insulation from liability of a parent corporation from its subsidiary's obligations might have yielded a more fruitful analysis than unreflective application of the entity doctrine. Instead, the automatic application of the entity doctrine produced multiple layers of liability for the parent corporation and the parent's shareholders.

B. The Initial Application of Limited Liability to Corporate Groups

There are a handful of early American cases, primarily involving railroads, that consider the legal interrelationship of parent and subsidiary corporations. Whether involving issues of procedure, contract construction, or the imposition of tort or contract liability, each of the cases examined the question solely by reference to entity law, emphasizing the separate legal identity of the related companies. The cases dealing with imposition of tort or contract liability provide no indication of a realization that imposition of such liability presented a different issue than whether one or two entities were involved.

Van Allen v. Assessors,²³⁷ decided in 1865, appears to be the earliest case. In *Van Allen*, the Supreme Court held that because a corporation and its shareholders were separate, it was not unconstitutional for a state to tax a shareholder's stock in a national bank.²³⁸

The leading case, *Pullman's Palace Car Company v. Missouri Pacific Railway*,²³⁹ was decided by the Supreme Court twenty years later in 1885. The Court held that a railroad parent corporation's contractual obligation to haul Pullman cars on all roads that it owned or controlled did not include the roads of its subsidiary.²⁴⁰ The Court emphasized that although the parent controlled the subsidiary, the companies were separate with separate boards of directors and that the affairs of the subsidiary were controlled by the subsidiary's directors.²⁴¹ For courts preoccupied with entity law, this decision involving construction of

234. *Id.* at 704.

235. *Id.* at 705-08.

236. *Id.*

237. 70 U.S. (3 Wall.) 573 (1865).

238. *Id.* at 398.

239. 115 U.S. 587 (1885).

240. *Id.* at 595-96.

241. *Id.* at 596-97.

a contract became authority supporting a conclusion that a parent corporation had no liability for the contracts and torts of its subsidiary.

In another contract construction case,²⁴² a South Carolina court had earlier stressed the separate identity of the related corporations and held that the parent's ownership of the subsidiary's stock did not affect the identity of the subsidiary.²⁴³ Emphasizing the separate identity of parent and subsidiary, still another early case²⁴⁴ had held that a subsidiary is an indispensable party defendant in a suit against its parent where the suit involved the construction of a railroad lease by the subsidiary to the parent.²⁴⁵

When for the first time courts considered the very different issue of the imposition of liability on a parent for the unsatisfied obligations of a subsidiary, these decisions reflecting entity law were influential. The courts proceeded in identical fashion, emphasizing the separate identity of the two corporations without any reference to the resulting creation of double layers of insulation from liability.²⁴⁶ Courts recognized that notwithstanding such a general rule, a parent could be liable if the subsidiary had acted as its agent or if some concealment or misrepresentation gave rise to estoppel,²⁴⁷ or where assets conveyed to a corporation's shareholders constituted a fraudulent transfer.²⁴⁸ There was, however, neither discussion nor apparent realization that a second layer of immunity of the parent from liability was being added to the limited liability already accorded to the parent's shareholders.

Limited liability in Anglo-American law was established firmly at a time when corporations generally lacked the power to acquire and own shares of another corporation. Such power came much later. When corporations received such power and a parent-subsidiary structure for the first time became possible, there was no apparent consideration of the crucial question of whether the doctrine of limited liability should protect a parent corporation from liability for the debts of its subsidiary. When the question of intragroup liability subsequently arose, it was without discussion resolved by reference to the entity concept to which limited liability had become inseparably annexed.

A fundamental principle had been accepted in the corporation law apparently without consideration whether such acceptance was sound. History clearly demonstrates this lack of consideration. This failure does not indicate that the extension of limited liability to parent corporations was either unsound or undesirable. It does emphasize, however, the desirability of a searching reex-

242. *Gibbs v. Greenville & Columbia R.R.*, 20 S.C. 179 (1882).

243. *Id.* at 190.

244. *Jessup v. Illinois Cent. R. Co.*, 36 F. 735 (C.C.N.D. Ill. 1888).

245. *Id.* at 741.

246. *Torts: Atchison, Topeka & Santa Fe R.R. v. Cochran*, 43 Kan. 225, 234-35, 23 P. 151, 154-55 (1890); *Atchison, Topeka & Santa Fe R.R. v. Davis*, 34 Kan. 209, 210, 8 P. 530, 531 (1885); *Cf. Pennsylvania R.R. v. Jones*, 155 U.S. 333, 339-40 (1894).

Contracts: Richmond & I. Constr. Co. v. Richmond, N. I. & B. R.R., 68 F. 105, 107-09 (6th Cir. 1895); *Central Trust Co. v. Bridges*, 57 F. 753, 764-66 (6th Cir. 1893) (Taft, J.); *Exchange Bank v. Macon Constr. Co.*, 97 Ga. 1, 7-8, 25 S.E. 326, 328 (1895). All three of these cases oddly involve the attempted imposition of liability on a railroad subsidiary of the construction contract debt of its parent.

247. *Central Trust Co. v. Bridges*, 57 F. 753, 766 (6th Cir. 1893).

248. *Montgomery Web Co. v. H. Dienelt*, 133 Pa. St. 585, 595-96 (1890).

amination of the rule, even though it has been an accepted part of corporation law for almost a century.

IV. ECONOMIC ANALYSIS

A. *The Economists' Analysis of Limited Liability*

It is useful to review the speculations of economists and legal commentators regarding the economic impact of shareholder liability rules on the functioning of corporations and the capital, product, and stock markets in which they operate.²⁴⁹ As noted in the preceding historical analysis, there are numerous examples of legal systems in which corporations have functioned with some form of shareholder liability. It is unfortunate that with one partial exception,²⁵⁰ the discussions on the economic impact of liability rules are entirely theoretical, without apparent awareness of these departures from limited liability or of the fruitful area for empirical research that they provide. With so many categorical assertions as to the economic consequences of limited liability resting solely on theoretical analysis, a view reflecting empirical data would provide a refreshing and more compelling presentation. The economists' views are, of course, of considerable intellectual interest, but the accuracy of their description of the business world is at least open to question when they ignore the wealth of historical experience.

This questionable accuracy is particularly apparent with respect to the fundamental question of the possible content of a rule other than limited liability. None of the analyses reviews the history to determine which alternatives have in fact been tried. Thus, some analyses assume that the alternative to limited liability is unlimited joint and several liability.²⁵¹ Other analyses assume that the alternative to limited liability is pro rata liability.²⁵² Although there is occasional

249. See K. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* 139-43 (1974); R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 14.04 (3d ed. 1986) [hereinafter cited as R. POSNER, *ECONOMIC ANALYSIS*]; Hicks, *supra* note 54, at 11; Orhnial, *Limited Liability Laws and Corporate Finance*, in *LIMITED LIABILITY AND THE CORPORATION* 179 (T. Orhnial ed. 1982); Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 789, 825-36 (1979) [hereinafter cited as *Clark I*]; Clark, *Duties of the Corporate Debtor To Its Creditors*, 90 HARV. L. REV. 505, 540-53 (1977) [hereinafter cited as *Clark II*]; Easterbrook & Fischel, *supra* note 6; Halpern, Trebilcock & Turnbull, *supra* note 6; Jensen & Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) [hereinafter cited as *Landers I*]; Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976) [hereinafter cited as *Landers II*]; Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262-65 (1967); Meiners, Mofsky & Tollison, *supra* note 6; Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 521-24 (1976) [hereinafter cited as Posner, *Rights of Creditors*].

250. Meiners, Mofsky, and Tollison discuss the unlimited liability rule in Massachusetts until 1830 and the apparent lack of impact on the number of incorporations. Meiners, Mofsky & Tollison, *supra* note 6, at 362.

251. See, e.g., Easterbrook & Fischel, *supra* note 6, at 90; Halpern, Trebilcock & Turnbull, *supra* note 6, at 130, 132, 137, 148 n.51; Hicks, *supra* note 54, at 11; Jensen & Meckling, *supra* note 249, at 331; Orhnial, *supra* note 249, at 180. Halpern, Trebilcock, and Turnbull, recognize that a rule of pro rata liability would be more efficient. Halpern, Trebilcock & Turnbull, *supra* note 6, at 137.

252. See, e.g., Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 788 (1972); Jensen & Meckling, *supra* note 249, at 337.

recognition that both alternatives are theoretical possibilities, no analysis appears to recognize that in different jurisdictions and at different times both alternatives have actually been in effect. For example, as noted previously, joint and several liability prevailed in England until 1855, while pro rata liability prevailed in California until 1931. Further, there is no apparent awareness that pro rata liability may take either of two very different forms, both of which have been law in a number of jurisdictions.

1. *Theoretical Advantages of Limited Liability*

Economists have noted a number of theoretical advantages that are attributable to limited liability. Professors Arrow,²⁵³ Manne,²⁵⁴ and Meiners, Mofsky, and Tollison²⁵⁵ point out that limited liability is a method of shifting risk. To the extent that insurance is available to cover the risk, the significance of limited liability diminishes. Judge Easterbrook and Professor Fischel also note that limited liability is important because it encourages division of labor in the publicly held corporation, and therefore, contributes to the growth of large scale firms and economic activity generally.²⁵⁶ Limited liability and the diversified portfolios such liability perverts, encourage the separation of the functions of investment and management. Many of the advantages of limited liability that have been suggested in the literature reflect this general conclusion advanced by Easterbrook and Fischel.

a. Avoidance of Dangerous Exposure of Absentee Investors to Risk

The widespread distribution of shares of the larger corporation makes the shareholder an investor without the opportunity (and presumably the desire) to participate in the management of the corporation. It leads to the separation of ownership and control under which the imposition on absentee investors of liability for the debts of the corporation exposes investors to risks of the business reflecting a decisionmaking process from which they are far removed and for which they bear no realistic responsibility. Such liability is not only hazardous for investors, but also is incompatible with generally accepted views of fairness.²⁵⁷

Exposure to the risk of liability under such circumstances must be a significant deterrent to investment. The degree of deterrence can be determined only by empirical studies, but it is certainly not unimportant. Theoretically, an increase in the expected rate of return would offset such exposure to risk. However, as has been eloquently noted, the potential dimensions of such risk under consequential damage rules are enormous.²⁵⁸ Some risk averse investors may not be prepared for such enormous risks under any circumstances.²⁵⁹ The return required by other investors would limit the amount of financing that could be accom-

253. K. ARROW, *supra* note 249, at 139-40.

254. Manne, *supra* note 249, at 262.

255. Meiners, Mofsky & Tollison, *supra* note 6, at 362.

256. Easterbrook & Fischel, *supra* note 6, at 93-94.

257. See Hicks, *supra* note 54, at 11.

258. See Diamond, *supra* note 31, at 22-24.

259. Miller suggests that in some cases credit rationing rather than rate increases will occur. See Miller, *Credit Risk and Credit Rationing: Further Comments*, 76 Q.J. ECON. 480, 487 (1962). See also Halpern, Trebilcock & Turnbull, *supra* note 6, at 132.

plished. It would appear that limited liability should contribute in some important degree to the encouragement of capital investment in enterprises in which the investor does not participate in the management.²⁶⁰

b. Increased Development of Very Large Enterprises

As the size of enterprises increases, shareholder liability assumes an even more dramatic significance. Large scale enterprise involves enormous risks that dwarf the financial resources of all but the wealthiest shareholders. Exposure to such enormous risks would discourage investment. In addition, the enormous amounts of capital required necessitates investment by thousands of investors, further increasing the widespread distribution of shares and the remoteness of the relationship of shareholders to managerial participation that would make the absence of limited liability a serious deterrent to investment.²⁶¹

Although this argument obviously is valid to a significant extent, it is perhaps somewhat overstated in view of the tremendous growth of financial intermediaries where an ever increasing amount of capital investment is made by financial institutions rather than by individuals, and where financial institutions, not individuals, constitute the major influence in capital and stock markets. Such institutions with large portfolios are in a much better position than individual investors to diversify against such risks. Further, if the alternative rule was a form of prorata liability, rather than joint and several liability, concerns over the scale of the risk would be reduced substantially.

c. Diversification of Portfolios

Limited liability permits investors to invest with more assurance in enterprises in which they have no managerial participation. Thus, they can significantly increase the number of their investments and thereby achieve more extensive diversification of their portfolios, an advantage that is acknowledged as a more efficient pattern for investment.²⁶² Limited liability also facilitates optimal investment decisions because the availability of diversification encourages risk taking that would be discouraged under unlimited liability.²⁶³

This argument, however, applies only to individual shareholders who do not have substantial wealth. Wealthy people and financial institutions are in a position to diversify, notwithstanding shareholder liability. Because financial institutions now hold about one-half of all shares on the New York Stock Exchange, the significance of this factor is weakened substantially.²⁶⁴

d. Avoidance of Increased Agency Costs

In the absence of limited liability, shareholders exposed to risk beyond their capital investment reportedly would be under pressure to assert control over the

260. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 123-24; Manne, *supra* note 249, at 262-65; Posner, *Rights of Creditors*, *supra* note 249, at 503.

261. See Manne, *supra* note 249, at 262.

262. See Hicks, *supra* note 54, at 16-17; Easterbrook & Fischel, *supra* note 6, at 96.

263. See Easterbrook & Fischel, *supra* note 6, at 96-97.

264. See N.Y. STOCK EXCH., FACT BOOK 55 (1985).

conduct of the business managers. Economists note that, even with limited liability, investors are under pressure to monitor the activities of the managers whose decisions will determine the profitability of the enterprise, and accordingly, the value of their investment.²⁶⁵ These economists assert that separation of ownership and control involves significant agency costs in the form of monitoring and bonding of managers and providing incentive compensation structures to assure a greater congruence between the objectives of shareholder investors and managers.²⁶⁶ In the absence of limited liability, the situation would be even more serious. Management decisionmaking would not only determine the profitability of shareholder investment, but in addition, would expose shareholders to the possibility of substantial liability in excess of their investments. Numerous economists argue, therefore, that the elimination of limited liability would lead to substantially increased agency costs.²⁶⁷

e. Avoidance of the Impairment of Capital Market Efficiency

In the absence of limited liability, an investment decision would involve a judgment of the financial condition of fellow shareholders as well as a judgment of the financial merits of the enterprise. Creditors would pursue wealthier shareholders first,²⁶⁸ and the relative conditions of shareholder wealth would influence the practical imposition of liability on particular shareholders. (Although it is not discussed in the economics literature, any legal rule concerning contribution in the event of some form of shareholder liability would also tend to make the wealth of fellow shareholders a matter of interest.) The cost of acquiring information regarding the wealth of fellow shareholders and the enterprise itself would increase because this information would be essential in determining the selection of new investments and the retention of existing investments. Furthermore, information costs for corporate creditors are less than for corporate investors.²⁶⁹ Raising capital would become less efficient, thus impairing the operation of the capital markets. Limited liability, accordingly, has been termed indispensable for an organized securities market.²⁷⁰

265. See Jensen & Meckling, *supra* note 249, at 308-10.

266. *Id.* at 312-30.

267. *Id.* at 331. See also Manne, *supra* note 249, at 262-63; Orhnial, *supra* note 249, at 181; Easterbrook & Fischel, *supra* note 6, at 92-93; Posner, *Rights of Creditors*, *supra* note 249, at 506-07, 511-12, 515-16.

Meiners, Mofsky, and Tollison do not agree. They contend that there is no incentive to shareholders to monitor the behavior of managers because the stock market and security prices provide all the information investors need for investment decisions. See Meiners, Mofsky & Tollison, *supra* note 6, at 362-63.

268. John Stuart Mill emphasized this point in the English debate over limited liability. B. HUNT, *supra* note 5, at 121-22.

269. See Orhnial, *supra* note 249, at 185-86; Halpern, Trebilcock & Turnbull, *supra* note 6, at 123-24; Manne, *supra* note 249, at 262-63.

Hadden reports that joint and several liability under the 1844 English Act was perceived as having retarded investment by more wealthy investors because of their concern that creditors would proceed first against them. Joint Stock Companies Registration, Incorporation and Regulation Act, 1844, 7 & 8 Vict., ch. 110. T. HADDEN, *supra* note 27, at 21. The Joint Stock Companies Winding Up Act, 1848, introduced much improved collection procedures. 11 & 12 Vict., ch. 45.

270. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 129-30; Easterbrook & Fischel, *supra* note 6, at 92.

Meiners, Mofsky, and Tollison, however, assert that such monitoring would in fact not occur, and that this contention is without validity. Meiners, Mofsky & Tollison, *supra* note 6, at 362-63.

This assertion fails to consider the history of the growth of securities markets in England in shares of joint stock associations with unlimited liability, a development that occurred during the two centuries prior to the introduction of limited liability in 1855. Hunt reports that by the end of the seventeenth century there were flourishing public markets in London and the provinces for the shares of all major English companies.²⁷¹ In turn, this growth in the markets led to the passage of a statute licensing brokers as early as 1697.²⁷² Hadden further states that as early as 1808, the Birmingham Flour and Bread Company had as many as 8,000 shareholders.²⁷³ This assertion also fails to take into account the development of more efficient legal procedures for the enforcement of shareholder liability as discussed above.

f. Avoidance of Increased Collection Costs for Creditors

It has been asserted that limited liability avoids the need for corporate creditors to bring expensive and cumbersome individual collection suits against numerous scattered shareholders of corporations that have defaulted on their obligations.²⁷⁴ This assertion overextends itself. After all, even in the absence of limited liability, the corporation would remain liable for its obligations. The availability of an additional remedy against shareholders with its attendant costs of enforcement would in no way impair or render less efficient the existing remedy against the corporate obligor. This suggestion also fails to consider the much approved procedures for enforcement of shareholder liability that were ultimately developed.²⁷⁵

g. Avoidance of Increased Costs of Contracting Around Liability

By including limited liability in corporation law, the law in effect creates an efficient contract term applicable to all transactions. It eliminates the necessity

271. See B. HUNT, *supra* note 5, at 105-12.

272. 8 & 9 Will. 3, ch. 32 (1697).

273. See T. HADDEN, *supra* note 27, at 13.

274. See *Clark I*, *supra* note 249, at 825; Halpern, Trebilcock & Turnbull, *supra* note 6, at 132.

275. See *supra* text accompanying notes 210-12.

Perhaps a more valid observation would be that where procedural difficulties have not been surmounted, the difficulties of enforcing shareholder liability make the remedy illusory and for that reason not a useful supplement to corporate liability. See *Russell v. Men Dwelling in Devon*, 100 Eng. Rep. 359 (1788), in which Judge Ashhurst stated:

[i]f damages are recoverable against the county [public corporation], at all events they must be levied on one or two individuals, who have no means whatever of reimbursing themselves; for if they were to bring separate actions against each individual of the county for his proportion, it is better that the plaintiff should be without remedy.

Id. at 362-63.

In 1846, a Massachusetts court addressed this problem. In a suit to enforce bank shareholder double liability, the court held that a suit by an individual creditor would not lie. The court required that either all creditors join in a single suit or that one or more creditors file a creditors' bill for the benefit of all creditors against all shareholders. *Crease v. Babcock*, 52 Mass. 557, 560 (1846). Improvements in creditors' bill procedures, and more recently modern class action procedures, have decisively dealt with procedural problems. In England, The Joint Stock Companies Winding Up Act, 1848, significantly improved collection procedures through a court-appointed master to oversee liquidation and the proceedings against shareholders. 11 & 12 Vict. ch. 45. The argument, however, goes to the extent of usefulness of a remedy against the shareholder; it is not an advantage of limited liability.

for shareholders to incur the expense of contracting around the liability.²⁷⁶ Where standard contract clauses are available,²⁷⁷ as in the English insurance industry before the adoption of limited liability in The Companies Act, 1862,²⁷⁸ such costs are trivial. Where, however, standard contract clauses are not available, limited liability in corporation law saves the costs that otherwise would be incurred.²⁷⁹

h. Encouragement of Risk Taking

By accomplishing risk-shifting not created in the market place, limited liability encourages business managers to venture into activities that they would otherwise not undertake.²⁸⁰ Although not all such ventures will be successful, investors can diversify against such a risk and be reasonably sure of an overall positive outcome. Society as a whole would then benefit from the increased production. Professor Arrow suggests that research and development activity provides an excellent example.²⁸¹

According to this view, limited liability is a compensatory alteration to deal with the failure of the market to achieve adequate risk shifting on its own. It has a cost: decreased flexibility and responsiveness to change and innovation. Arrow regards insurance as preferable, but recognizes that it is not always available.²⁸²

2. Theoretical Disadvantages of Limited Liability

As against the numerous theoretical advantages of limited liability that have been suggested, economists generally agree on certain areas of disadvantage as well.

a. Unfairness and Inefficiency For Tort and Other Involuntary Creditors

A shift in focus from voluntary creditors to involuntary creditors, particularly tort creditors, causes much of the efficiency advantages of limited liability to disappear.²⁸³ Tort liability is a cost of the enterprise that limited liability transforms into an externality borne by persons not associated with it. Unlike voluntary

276. See Posner, *Rights of Creditors*, *supra* note 249, at 506, 515.

277. See *supra* text accompanying notes 32-36.

278. 25 & 26 Vict., ch. 89 (1862).

279. Again, Meiners, Mofsky, and Tollison disagree. They contend that there is neither empirical nor theoretical basis for the assertion. See Meiners, Mofsky & Tollison, *supra* note 6, at 363.

280. See K. ARROW, *supra* note 249, at 137-38; Easterbrook & Fischel, *supra* note 6, at 97.

281. K. ARROW, *supra* note 249, at 137-38.

282. *Id.* at 141.

283. See, e.g., R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 372; Clark I, *supra* note 249, at 875; Easterbrook & Fischel, *supra* note 6, at 103, 107, 112; Manne, *supra* note 249, at 263; Meiners, Mofsky & Tollison, *supra* note 6, at 364-67; Posner, *Rights of Creditors*, *supra* note 249, at 506-07.

Halpern, Trebilcock, and Turnbull have more reservations. They assert that limited liability is most efficient, even for tort liability, in the case of large, publicly held corporations because of the supposed impact of a different rule on the securities markets. They agree with other economists on the inefficiency of limited liability for tort claimants in the closely held corporation. Halpern, Trebilcock & Turnbull, *supra* note 6, at 147-48.

creditors, involuntary creditors are unable to contract around the liability rule or adjust for it by requiring higher compensation. The interposition of limited liability reduces the incentive to press for cost-justified risk-reduction precautions; it undermines the deterrent objective of the tort system.²⁸⁴ Further, limited liability creates the risk that the parent will escape liability for injuries from dangerous products simply by creating a subsidiary to produce and distribute them.²⁸⁵

In their criticism of the conventional economic analysis of limited liability, Meiners, Mofsky, and Tollison assert that as a theoretical matter, insurance and price adjustments should eliminate the impact of limited liability on tort claimants.²⁸⁶ Schwartz agrees, but notes that these adjustments will not occur in cases of delayed harm, *i.e.*, where the risk is unknowable at the time.²⁸⁷ On a practical level, however, the unavailability of such insurance, as well as market imperfections and governmental intervention, render such observations quite academic. In addition to the inefficiency consequences noted above, and the resulting possibility that corporate structures may be devised to sidestep product liability and other tort liability, limited liability may also be regarded as fundamentally unfair to tort victims.²⁸⁸

Complexities enter into the classification of voluntary and involuntary creditors. For example, Professors Halpern, Trebilcock and Turnbull point out that tort claimants fall into two classes: individuals in their personal capacities and other businesses.²⁸⁹ They recognize the lack of efficiency and unfairness in confronting individual tort victims with limited liability. At the same time, they note that where the tort injures the interests of employees or other businesses that can anticipate such events and insure against them, limited liability is entirely acceptable. They express concern about the inability to distinguish between these very different situations with respect to a rule of liability.

Voluntary creditors who are victims of misrepresentation (*i.e.*, fraud in the inducement), are traditionally treated differently from other voluntary creditors, and the normal rules with respect to disregarding the entity are not applied. The explanation is obvious. In view of the misrepresentation, the underlying transaction, although in form consensual, is not actually voluntary since a consent obtained by fraudulent means is for legal purposes no consent at all. Similarly, it can be argued that if voluntary creditors are uninformed or for other reasons, no genuine bargaining is involved in the transaction, the creditor should receive the same protection as an involuntary creditor.²⁹⁰

The alternatives to dealing with the problem of involuntary creditors, other than the elimination of limited liability, are not obvious. Easterbrook and Fischel

284. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 145-47.

285. See Heitland, *Survival of Products Liability Claims in Asset Acquisitions*, 34 BUS. LAW. 489, 498 (1979); Kadens, *Practitioner's Guide to Treatment of Seller's Product Liabilities in Asset Acquisitions*, 10 U. TOL. L. REV. 1, 41-42 (1978); Schwartz, *Product Liability, Corporate Structure and Bankruptcy: Toxic Substances and The Remote Risk Relationship*, 14 J. LEG. STUD. 689, 717 (1985).

286. Meiners, Mofsky & Tollison, *supra* note 6, at 364-67.

287. See Schwartz, *supra* note 285, at 714.

288. See Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 65-76 (1980) (undermines compensation and makes a mockery of deterrence).

289. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 145-47.

290. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 380, 382.

suggest solutions such as minimum capital requirements, mandatory insurance, imposition of managerial liability, and governmental regulation.²⁹¹ Clark suggests such measures as minimum net worth requirements, insurance, automatic subordination of claims of sophisticated creditors, or some form of no fault liability system.²⁹² Posner suggests insurance or bonds.²⁹³ Manne adds that unemployment compensation and workmen's compensation should be looked upon as partial solutions.²⁹⁴ All of these solutions have obvious serious limitations.

There is considerable confusion on the question of classification of creditors as voluntary or involuntary. Some classifications rest solely on whether in form the parties have consented to the relationship that gave rise to the obligation. This, however, is only the threshold inquiry. The crucial question is whether in the market, the injured party had the economic strength to bargain on the terms of the transaction pertaining to the credit aspects, including a price adjustment to reflect the financial condition of the other party.²⁹⁵ As a practical matter, if the injured party was not able to bargain on the issue, that party is essentially in the same position as the involuntary creditor.

As an example of an overly theoretical classification, some economists lump trade creditors and financial lenders together as voluntary creditors.²⁹⁶ However, other economists readily recognize that many trade creditors are not in a position to bargain for an adjustment in price to reflect credit considerations.²⁹⁷ An extreme example is the identification of consumers and workers as voluntary creditors.²⁹⁸ Such a classification is unrealistic. Consumers making retail purchases and workers looking for jobs are rarely in a position to take credit considerations into account. Such issues play no real role in determining which product the retail consumer purchases or whether the unemployed worker accepts a job.

Most employees and retail consumers and many trade creditors must properly be viewed as involuntary creditors. Consequently, the group adversely affected by limited liability is much larger than a group comprised only of tort claimants. Therefore, the impact of limited liability on involuntary creditors, decried by virtually all economists, is much more significant than generally acknowledged.

291. See Easterbrook & Fischel, *supra* note 6, at 114-17.

292. See *Clark I*, *supra* note 249, at 825 n.161; *Clark II*, *supra* note 249, at 540-53.

293. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 379-80; Posner, *Rights of Creditors*, *supra* note 249, at 520. Posner, however, decries the usefulness of insurance, emphasizing two factors that most would not find fundamental. He first asserts that corporate managers might neglect to insure adequately. He then observes that the insurance company might become insolvent. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 379-80; Posner, *Rights of Creditors*, *supra* note 249, at 520.

294. See Manne, *supra* note 249, at 263.

295. It has been suggested that under certain circumstances, price adjustment will not occur. A creditor may prefer to ration credit rather than adjust the rate. See Miller *supra* note 259, at 485-87. See also Halpern, Trebilcock & Turnbull, *supra* note 6, at 132 n.40.

296. See Easterbrook & Fischel, *supra* note 6, at 104-07; Manne, *supra* note 249, at 263; Meiners, Mofsky & Tollison, *supra* note 6, at 359-62.

297. See Posner, *Rights of Creditors*, *supra* note 249, at 505.

298. See Easterbrook & Fischel, *supra* note 6, at 104-05 ("Employees, consumers, trade creditors, and lenders are voluntary creditors. The compensation they demand will be a function of the risk they face."). But see Posner, *Rights of Creditors*, *supra* note 249, at 522-23 (distinguishes between financial creditors and nonbusiness creditors).

A crucial question in appraising the general utility of the limited liability rule as a contribution to a more efficient economy is the relative numbers of voluntary and involuntary creditors (properly defined) who are affected. Easterbrook and Fischel state flatly that the magnitude of externality (costs of the enterprise imposed on creditors) has been exaggerated.²⁹⁹ They rely on two factors. First, they point to the size of the voluntary creditor group for whom there is no externality. Second, they note the extent of insurance that transfers the risk and loss to the insurance carrier, which through the cost of the insurance, internalizes the cost.

Two observations are in order. First, as noted previously, the inclusion of consumers, workers, and many trade creditors as voluntary creditors is unacceptable. These groups are simply not in business to bargain for credit and can only be regarded as involuntary creditors.³⁰⁰ In the end, financial lending institutions, large trade creditors, and contract creditors in genuinely bargained for transactions constitute the voluntary creditors for whom limited liability is appropriate theoretically.

Second, as noted, insurance is the theoretically desirable solution advanced by many analysts. The problem is not with its theoretical soundness, but with its lack of availability. As a practical matter, the solution is largely irrelevant because of the unavailability of such insurance and the impracticality of expecting that large masses of retail consumers or employees could, or would, purchase it, even if it were to become available. To a lesser degree, insurance also has some of the disadvantages of needing to contract around liability, a disadvantage emphasized by economists when liability is imposed not on unorganized consumers or workers but upon business organizations.

b. Unfairness and Inefficiency for Labor Claimants

There is widespread recognition of the undesirable consequences of limited liability with respect to labor claimants.³⁰¹ Costs properly attributed to the enterprise are avoided, and those costs are shifted to persons least able to protect themselves. Employees have the most severe informational disabilities, the least ability to diversify, and the least capacity to absorb losses.³⁰² In recognition of these factors, bankruptcy law accords labor claimants a priority for ninety days of wages with a maximum of \$2,000.³⁰³ This priority provides such claimants with priority over most other claims, including government taxes. As reviewed above, New York and Wisconsin still have statutes that impose liability upon

299. See *id.* at 104.

300. Thus Easterbrook and Fischel properly acknowledge that voluntary creditors sometimes lack "sufficient information or incentive to assess risk correctly or to monitor the actions of the debtor." *Id.* at 106. Indeed, many, if not most, persons regarded by these distinguished authors as voluntary creditors, particularly retail consumers, employees, and many trade creditors, lack the economic strength to make credit considerations a part of the bargain.

301. See Macharzina, *supra* note 153, at 66; Halpern, Trebilcock & Turnbull, *supra* note 6, at 149-50; Manne, *supra* note 249, at 263.

302. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 149-50. Easterbrook and Fischel surprisingly look upon employees as voluntary creditors, and therefore, in the class for whom limited liability is appropriate. See Easterbrook & Fischel, *supra* note 6, at 183. No other economists seem to have gone this far.

303. 11 U.S.C. § 507(a)(3) (1982).

shareholders or directors for unpaid labor claims.³⁰⁴ Similar statutory provisions are found in Canada.³⁰⁵ Writing with a European perspective, Goyder and Macharzina suggest that as a consequence of limited liability, workers with their jobs at stake have replaced shareholders as the persons liable for the adverse consequences of corporate decisions.³⁰⁶

c. Encouragement of Excessively Risky Investments

By transferring the risk of liability from shareholders to creditors, limited liability increases the likelihood of excessively risky investments by business enterprises; the calculation of risk calculation has been distorted.³⁰⁷ This is a particularly serious problem.

d. Increased Information and Monitoring Costs

It is asserted frequently that the corporate group, particularly the multinational group, pursues a policy of group profit maximization in which the interests of the individual constituent companies are subordinated to the interests of the group as a whole.³⁰⁸ This group focus is reflected in intragroup allocations of resources for new investment to group activities yielding the highest return for programs of equivalent risk, transfers of funds and personnel, and nonmarket intragroup transfer pricing policies. Relying on this view, Professor Landers notes that under a rule of limited liability these allocations inevitably increase information and monitoring costs.³⁰⁹ Judge Posner disagrees. On theoretical considerations alone, and without reference to the very different forces affecting decisionmaking in the multinational enterprise, Judge Posner rejects the premise that group profit maximization in fact occurs.³¹⁰ Without any reference to available studies of transfer pricing or management structure and decisionmaking in the large or multinational corporation, Judge Posner concludes that in order to provide increased management incentive for divisional managers and accurate information on divisional performance, groups normally will pursue a policy of individual constituent company profit-maximization.³¹¹ Thus, these supposed additional costs do not in fact occur.

This possibility, however, is only one of the factors at work. Numerous other factors ignored by Judge Posner make for skewed transfer pricing to

304. N.Y. BUS. CORP. LAW § 630 (McKinney 1963 & Supp. 1986); WIS. STAT. § 180.40(6) (1981-82).

305. See CAN. BUS. CORP. ACT, R.S.C. 1974-75, ch. 33, § 114; ONT. BUS. CORP. ACT, R.S.C. 1982, ch. 4, § 131 (directors).

306. See G. GOYDER, *THE FUTURE OF PRIVATE ENTERPRISE* 18-19 (1951); Macharzina, *supra* note 153, at 67.

307. See Orhnlial, *supra* note 249, at 186; Easterbrook & Fischel, *supra* note 6, at 104-07; Halpern, Trebilcock & Turnbull, *supra* note 6, at 144-45.

308. See Landers I, *supra* note 249, at 591-92; Landers II, *supra* note 249, at 527, 532.

309. See Landers II, *supra* note 249, at 532-33.

310. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 381-82; Posner, *Rights of Creditors*, *supra* note 249, at 513-14.

311. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 299.

achieve group interests. Factors reported by other economists³¹² include transfer pricing to: take advantage of different tax rates in home and host countries; minimize customs duties; achieve capital repatriation; sidestep currency controls and other host country governmental regulations; alleviate political concerns; and aid in labor negotiations by understating the profitability of local subsidiaries. Skewed transfer pricing in vertically integrated industries is also a competitive strategy to concentrate profits in areas of least competition, thus deterring competition at a later stage. Finally, the skepticism of third world countries as to the possible role of skewed transfer pricing in distorting the reported profitability of local units of foreign-based multinational enterprises is a recognized part of the international scene.³¹³ These factors cannot be brushed aside simply by postulating that group maximization should not be expected to occur by reference to only one of the numerous factors in the calculation. At the very least, it must be concluded that the foregoing factors contribute to the use of transfer pricing to achieve global profit-maximization, subject to some restraint arising from the administrative costs noted by Judge Posner.

e. *Impairment of Market*

Professor Arrow has observed³¹⁴ that limited liability is a departure from the free market and necessarily impairs its performance.³¹⁴ This factor is still another cost to be considered in striking the theoretical balance.

f. *Limited Liability and Misrepresentation*

If third parties have been misled about the identity of the entity with which they are dealing, and have been led to believe that they are dealing with the parent corporation or controlling shareholders, rather than with a financially weaker subsidiary or controlled corporation, the case for limited liability disappears. Similarly, if third parties have been misled about the financial condition of the corporation with which they are dealing, the argument for limited liability loses its force. Where such fraudulent misrepresentation can be shown, economists generally agree that elimination of limited liability is sound.³¹⁵

312. See R. CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMICS ANALYSIS* 244-49 (1982); Lectaw, *Some Evidence on Transfer Pricing by Multinational Corporations*, in *MULTINATIONALS AND TRANSFER PRICING* 223 (A. Rugman & L. Eden eds. 1985); R. MASON, R. MILLER & D. WEIGEL, *THE ECONOMICS OF INTERNATIONAL BUSINESS* 382 (1975); S. ROBACK, K. SIMMONDS & J. ZWICK, *INTERNATIONAL BUSINESS MULTINATIONAL ENTERPRISES* 465-68 (1977 rev. ed.). As countries become more sophisticated in dealing with such strategies, their importance should tend to diminish. In any individual case, the validity of the transfer pricing rests on the outcome of the various vector forces at work. See M. GHERTMAN & M. ALLEN, *AN INTRODUCTION TO THE MULTINATIONAL ENTERPRISES* 86-88 (1984) (empirical studies show variation by industries); OECD COMM. OF FISCAL AFFAIRS, *TRANSFER PRICING AND MULTINATIONAL ENTERPRISES* 71 (1979) ("The practices of MNEs in charging for such [intragroup] services [rendered by group affiliates] differ widely.")

313. See Caulfield, *The Rain Forests*, *New Yorker* 41, 98 (Jan. 14, 1985); *Companies Upset by Tax Credit Plan*, *N.Y. Times*, Jan. 7, 1985, at D5, col. 1.

314. See K. ARROW, *supra* note 249, at 139-43.

315. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 380, 382; Black, Miller & Posner, *An Approach to the Regulation of Bank Holding Companies*, 51 *J. Bus.* 379, 395-96 (1978); Easterbrook & Fischel, *supra* note 6, at 112; Halpern, Trebilcock & Turnbull *supra* note 6, at 149; Posner, *Rights of Creditors*, *supra* note 249, at 514, 520-24.

3. Summary

On balance, several conclusions appear evident on a theoretical level. First, limited liability is not essential for the functioning of the economic order; it could readily function under another system of liability. The extreme significance accorded to limited liability in such tributes as those expressed by Presidents Nicholas Murray Butler and Charles Eliot³¹⁶ is hardly justified. This conclusion clearly emerges from such studies as those of Easterbrook and Fischel; Halpern, Trebilcock, and Turnbull; and Meiners, Mofsky and Tollison.³¹⁷

Second, limited liability on the whole seems to serve a desirable function in creating appropriate incentives for widespread investor participation in the equity ownership of major corporate enterprise. On one hand, the financial institutions (including pension funds) that have come to play such a prominent role in the capital and securities markets could cope with a system other than limited liability through portfolio diversification. Individuals (including individual accounts managed by the trust departments of commercial banks), however, represent a substantial part of the pool of investment funds available for the needs of the capital and securities markets. A useful condition for assuring the availability of this vital segment of investment funds is the preservation of limited liability for individual investors. The pattern of security ownership and the scale of enterprise might be very different in the absence of limited liability.

Meiners, Mofsky, and Tollison question whether the rule as to liability has any significant impact at all, but find no compelling reason to change.³¹⁸ In questioning the absence of impact of the rule,³¹⁹ they rely on the Coase theorem that in the absence of change in transaction and enforcement costs, one legal rule or another produces no important difference in allocative outcome.³²⁰ Its soundness, however, rests on the extent to which liability emerges as a result of bargaining in genuinely negotiated transactions. It also rests on assumptions that are not always realistic with respect to the extent to the availability of complete information to all affected parties and the absence of transaction costs.

316. See *supra* note 5.

317. Easterbrook and Fischel conclude that the rule of limited liability does matter "but probably not much," depending on the existence of well-developed insurance markets. Easterbrook & Fischel, *supra* note 6, at 102. See also Halpern, Trebilcock & Turnbull, *supra* note 6, at 147-48; Meiners, Mofsky & Tollison, *supra* note 6, at 352.

318. See Meiners, Mofsky & Tollison, *supra* note 6, at 352.

319. See *id.* at 359-62.

320. See Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). The Coase theorem generally is accepted by the economists in discussing limited liability. They also agree that a change in the legal rule theoretically affects only the distribution of loss, because in the market the shift in risk is matched by a corresponding shift in interest costs. See Posner, *Rights of Creditors*, *supra*, note 249, at 503-07; Halpern, Trebilcock & Turnbull, *supra* note 6, at 128. Posner and Halpern, Trebilcock, and Turnbull, however, see changes in information, monitoring, and transaction costs that make limited liability more advantageous.

In evaluating the validity of the Coase theorem with respect to the allocation of resources, it is important not to lose sight of the fact that the Coase theorem does not deal with the issue of the proper distribution of losses. Thus, in the corporate group, interposition of limited liability for the parent and upstream subsidiaries enables the group to arrange its corporate structure in a manner that shifts losses arising from enterprise operations from solvent components of the group to the victims of the torts and contract defaults of insolvent subsidiaries.

The discussion does not end even if one concludes that limited liability is generally preferable, or that it is so much part of the existing order that proposals for change are unrealistic. Although limited liability may be regarded as desirable overall, those areas in which limited liability is acknowledged as inadequate must be addressed. The question would then be not the elimination of limited liability, but the imposition of restrictions on its use.

Moving beyond the threshold problem of limited liability for the protection of ultimate investors in the enterprise, separate consideration must be given to the application of limited liability to corporate groups. When limited liability is applied to multi-tiered corporate groups, layer upon layer of insulation from liability can result. The application of limited liability to component companies of corporate groups is a vital question in the law today that has received inadequate consideration.

B. Economic Analysis: Limited Liability and Corporate Groups

In the preceding section, the theoretical economic analysis of the rule of limited liability was reviewed. This review included the presumed impact of rules of limited and unlimited liability on both business enterprises and ultimate investors. Most of the discussion in the literature has focused on the respective positions of the ultimate investors in the enterprise, on the one hand, and the creditors of the enterprise on the other. These discussions typically ignore or give only summary consideration to the special problems presented by the subsidiary companies of a corporate group in which the shareholder is the parent or another component company of the group, not the ultimate investor.³²¹

An examination of the advantages and disadvantages of limited liability, as applied for the protection of constituent corporations of a corporate group, reveals several major differences. First, the imposition of liability on the ultimate investors of the enterprise is not a concern. A rule that imposes liability on the enterprise for the torts or other acts of its constituent corporations does not require a change in the rule of limited liability for ultimate investors.

Second, the corporate group analysis does not involve a universe of thousands and thousands of shareholders of varying degrees of wealth.³²² Instead, the subsidiary in a corporate group typically involves a single shareholder, its parent.³²³ Third, corporate group analysis does not involve thousands and thousands of shareholders, who are widely separated from participation in management or control. Within the corporate group, the parent as sole shareholder is almost invariably engaged in the managerial functions of establishing policy, determining budget, providing administrative support, and participating in the decisionmaking of the subsidiary corporation. The degree of involvement varies from group to group. Fourth, the business of the parent is often integrated economically with the business of the subsidiary; indeed, in many cases, the two will be conducting interrelated fragments of a single unitary business.

321. Notable exceptions include Easterbrook & Fischel, *supra* note 6, at 110-11; Posner, *Rights of Creditors* *supra* note 249, at 509-16.

322. Fifty corporations listed on the New York Stock Exchange on December 31, 1984 had 160,000 shareholders or more. N.Y. Stock Exch., FACT BOOK 39 (1985).

323. For a discussion of the problem presented by a partially owned subsidiary, see *infra* text accompanying note 338.

In view of these fundamental changes in the nature of the shareholder and its relation to the subsidiary corporation, it should be immediately apparent that many of the presumed theoretical advantages of limited liability simply become irrelevant in the case of the corporate group. In the following discussion, the advantages of limited liability generally are reexamined to determine their relevance to the "incredibly complex"³²⁴ special world of corporate groups.

(1) The parent corporation is not an absentee owner, therefore, avoidance of exposure to risk of absentee investors is not a relevant factor. (2) Because the parent corporation is the sole shareholder, the necessity of limited liability to encourage the widespread distribution of shares, a requirement for very large enterprises, is also irrelevant. The parent facing the risk of liability for the debts of its subsidiaries is in a position to diversify its portfolio and spread the risk. Economists recognize that a similar ability to diversify on the part of financial institutions who are ultimate investors would make the imposition of limited liability significantly less important than in the case of individual investors lacking the ability to diversify.³²⁵ This factor would be as applicable to corporate groups as to financial institutions.

(3) Avoidance of increased agency costs is another factor to be considered. In the corporate group, the parent corporation is usually engaged to some degree in management of the subsidiary. The subsidiary typically is managed as part of the same enterprise with varying degrees of decentralization. Under such circumstances, the need to establish congruence of the interests of the manager and the owner-investor, with its attendant presumed agency and monitoring costs simply do not arise. The associated problem of senior management monitoring the acts of subordinate managers does not change where part of the enterprise is operated as a subsidiary rather than as an unincorporated branch or division. Thus, this consideration is also largely irrelevant.

(4) Concerns for the avoidance of increased information costs are irrelevant because full information about the subsidiary's operations is always available to the parent corporation. (5) In the case of the wholly owned subsidiary, there is no market for the subsidiary's shares, and therefore, concern with the impairment of the efficiency of the capital markets is an irrelevant consideration. In the case of the partially owned subsidiary, however, there may well be a market in which the publicly held shares are traded. In that limited case, this advantage is still relevant.

(6) Avoidance of creditors' enforcement costs is not a relevant consideration because creditors will be able to proceed directly against the parent. Therefore, the alleged spectre of litigation against innumerable shareholders to enforce shareholder liability would not arise. (7) Avoidance of the cost of contracting around liability unlike so many of the other factors continues to be applicable. (8) The encouragement of risk taking is perhaps the most significant factor in the case of corporate groups. It is particularly important in the case of conglomerate enterprises that are considering investment in areas unrelated to the existing businesses of the group.³²⁶ In the integrated group where the additional investment

324. See Hadden, *supra* note 1, at 274.

325. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 298.

326. See Posner, *Rights of Creditors*, *supra* note 249, at 512.

represents a horizontal or vertical extension of activities already being undertaken, the factor is less significant. Professor Hadden notes that "it is arguable that [without limited liability] some worthwhile but risky ventures which might be undertaken by large groups would not be undertaken at all."³²⁷ He reports that this factor has deterred legislators in Germany and the European Economic Community from imposing absolute liability on holding companies for the debts of their subsidiaries in the existing German law³²⁸ and under the Proposed Ninth Directive of the European Economic Community.³²⁹

Professors Halpern, Trebilcock, and Turnbull conclude that unlimited liability would seem the most efficient for subsidiary companies and other tightly held companies.³³⁰ Professors Easterbrook and Fischel conclude that recognition of the foregoing factors helps explain why, in the opinion of some scholars,³³¹ courts are more willing to "pierce the veil" in cases of parent/subsidiary corporations than in cases of individual controlling shareholders.³³² They suggest that a rationale for limited liability, in the case of parent and affiliate corporations, is to avoid giving unaffiliated firms a competitive advantage. Unfortunately, they point to taxicabs for their example, where they erroneously imply that limited liability is the rule for intragroup tort liability in taxicabs because groups would otherwise be at a disadvantage in competing with "true" single-cab firms.³³³ This analysis is not an uncommon misreading of the taxicab cases. In fact, intragroup tort liability on an enterprise basis has been widely imposed on taxicab groups conducting an integrated taxi fleet operation.³³⁴ At the same time, the ultimate investors in the group frequently have been shielded from liability,³³⁵ which no doubt has led to the confusion.³³⁶ Consequently, this explanation of competitive disadvantage is questionable.

327. Hadden, *supra* note 1, at 281.

328. German Stock Corporation Act (Konzernrecht), Law of Sept. 6, 1965, Aktiengesetz BGB III 4121-1 (1965). See P. BLUMBERG *supra* note 4, at 642-50.

329. Proposal for a Ninth Directive Based on Article 54(3)(g) of the EEC Treaty on Groups, C.E.E. Doc. No. XV 593/75-E; Doc. No. XI 215/77-E. See P. BLUMBERG, *supra* note 4, at 789-94.

330. See Halpern, Trebilcock & Turnbull, *supra* note 6, at 148, 150.

331. See, e.g., Hackney & Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 872-73 (1982); Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 992 (1971).

The author has not yet concluded his comprehensive study of the voluminous case material available. As of the completion of this Article, he was not fully convinced that this has occurred.

332. See Easterbrook & Fischel, *supra* note 6, at 110-11.

333. *Id.* at 111.

334. E.g., *Mangan v. Terminal Transp. Sys.*, 157 Misc. 627, 284 N.Y.S. 183 (Sup. Ct.), *aff'd per curiam*, 247 A.D. 853, 286 N.Y.S. 666 (App. Div. 1936), *motion for leave to appeal denied*, 272 N.Y. 676 (1937); *Robinson v. Chase Maintenance Corp.*, 20 Misc. 2d 90, 190 N.Y.S.2d 773 (Sup. Ct. 1959). See Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

335. *Walkovszky v. Carlton*, 18 N.Y.2d 414, 419, 223 N.E.2d 6, 9 (1966); *Robinson v. Chase Maintenance Corp.*, 20 Misc. 2d 90, 92-93, 190 N.Y.S.2d 773, 775-76 (Sup. Ct. 1959).

336. Several New York cases illustrate the distinction. In *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6 (1966) the Court of Appeals refused to impose liability on an individual controlling shareholder for the obligations of an undercapitalized controlled corporation whose only assets consisted of two used taxicabs and the statutory minimum of \$10,000 of insurance. The decision did not involve imposition of liability on the other controlled corporations of the group which functioned as part of an integrated fleet allegedly "'operated . . . as a single entity, unit and enterprise' with regard to financing, supplies, repairs, employees, and garaging." *Id.* at 416, 223 N.E. 2d at 7. The Court of Appeals left little doubt that the other controlled corporations in the fleet would be liable,

Judge Posner argues that the consolidation or pooling of the assets and liabilities of affiliated companies that would result from the elimination of limited liability would not reduce the risk of creditors overall.³³⁷ Presumably this argument assumes that the added liabilities of the affiliate would offset the added assets. This situation is unlikely. The classic case in this area is that of the solvent parent and the insolvent subsidiary. Imposition of liability on the parent in these cases would benefit creditors of the enterprise at the expense of the shareholders' equity in the parent. Thus, the position of creditors would be enhanced.

A final word on the significance of partially owned subsidiaries is in order. As recognized, the existence of minority shareholders may reintroduce some of the advantages of limited liability that would be irrelevant in the case of a sole shareholder. This situation, however, occurs only in a minority of cases. A study by Curhan, Davidson, and Suri of 189 major United States multinational companies with 11,198 subsidiaries found that 8,059 or about seventy-two percent were wholly owned.³³⁸

In summary, most, but not all, of the suggested arguments for limited liability simply do not apply to corporate groups, or at least are not always fully applicable. The extension of layers of limited liability to the tiers of subsidiaries within corporate groups lacks most of the theoretical justification that has been advanced in defense of the rule. Accordingly, reconsideration of the rule is in order, particularly since application of limited liability to corporate groups appears to have been accidental.

C. *Economic Analysis and Modified Forms of Shareholder Liability*

Dramatic examples of a corporate society functioning under a system other than limited liability include California from 1849 to 1931, England until 1855,³³⁹

stating:

[I]t is one thing to assert that a corporation is a fragment of a larger corporate combine which actually conducts the business It is quite another to claim that the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends In the first, only a larger *corporate* entity would be held financially responsible . . . while, in the other, the stockholder would be personally liable.

Id. at 418, 223 N.E.2d at 8-9 (citations omitted) (emphasis in original).

Robinson v. Chase Maintenance Corp., 20 Misc.2d 90, 190 N.Y.S.2d 773 (Sup. Ct. 1959) upheld a complaint against the component corporations of a group operating a taxicab fleet and dismissed it against the controlling individual shareholders.

Halpern, Trebilcock and Turnbull have had similar difficulties with the outcome in *Walkovszky*. *Halpern, Trebilcock & Turnbull*, *supra* note 6, at 119.

337. See R. POSNER, *ECONOMIC ANALYSIS*, *supra* note 249, at 382.

338. See J. CURHAN, W. DAVIDSON & R. SURI, *TRACING THE MULTATIONALS* 143 (1977): Parent Ownership (1975) Wholly owned (95%-100%) 8,059 Majority-owned (51%-94%), 1,025; Co-owned, 725; Minority-owned (5%-49%), 1,036; Unknown 353; Total, 11,198.

339. Strictly speaking, the English experience involved joint stock associations, not corporations. Since joint stock associations rather than corporations were the typical English vehicle for the conduct of business enterprise and subsequently received limited liability under The Companies Act, 1855 and other statutes, they may be regarded as fully comparable for present purposes.

Massachusetts until 1830, and Rhode Island until 1847.³⁴⁰ In addition, modifications of limited liability such as double (or even triple) shareholder liability for corporations generally were common during most of the nineteenth century.³⁴¹ Double liability provisions for national and state bank shareholders survived until the 1930s.³⁴² Thus, limited liability in its purest form is a relatively modern phenomenon in the United States.

The jurisdictions that adopted legal rules imposing some form of liability on shareholders for corporate obligations followed a number of different models. Most jurisdictions, as in Massachusetts until 1830, Rhode Island until 1847, and England until 1855 imposed joint and several liability. Other jurisdictions followed the widespread rule in the United States through most of the nineteenth century that imposed double or triple liability, measured by the original capital investment. Still others, notably California, and for a short period Georgia, adopted pro rata liability.

Any review of limited liability for the protection of ultimate investors should include discussion of these historical developments. They are, of course, of lesser significance in the discussion of the validity of the interposition of multiple layers of limitation of liability within corporate groups.

1. *Pro Rata Liability*

In the discussion by economists, most have assumed that the only alternative to limited liability was joint and several liability, apparently unaware of California's eighty years of experience with pro rata liability. Thus, the utility of pro rata liability as an alternative to limited liability has not been examined adequately by commentators.

As noted previously,³⁴³ there are at least two forms of pro rata liability, both of which were used in California. Under one early California statute applicable only to mining corporations, shareholders were primarily and directly liable for company obligations to any creditor, subject to a maximum representing the shareholder's proportional ownership of the stock of the corporation applied against the total debts outstanding.³⁴⁴ The same form of pro rata liability was

340. For a detailed discussion of these examples, see *supra* text accompanying notes 8-49, 84-148, and 160-73. In theory, such liability was tempered by the shareholder's right to contribution from fellow shareholders. See J. ANGELL & S. AMES, *supra* note 98, §§ 227-29; Joint Stock Companies Registration, Incorporation and Regulation Act, 1844, 7 & 8 Vict., ch. 110. There are no references in the literature that throw light on the effectiveness of enforcement of liability against shareholders or the practical usefulness of the right of contribution.

341. See J. HURST, *supra* note 79, at 27. See also *supra* text accompanying notes 174-92.

342. See Vincens, *supra* note 183.

343. The California experience with limited liability is discussed *supra* at notes 160-73.

344. Act of Apr. 14, 1853, ch. 65, § 16, 1853 Cal. Stat. 87, 90 as amended by Act of Apr. 27, 1863, ch. 460, § 1, 1863 Cal. Stat. 736-37. Under this statute pro rata did not mean that the liability to each creditor was restricted to the shareholder's proportion of the particular debt in issue. In theory, at least, this greatly increased the effectiveness of the creditor's remedy. However, in view of a litigant's difficulty in determining the total amount of the corporate debts (a necessary step in the determination of the shareholder's maximum liability), it is not surprising that California ultimately utilized the alternative model. Some jurisdictions refused to permit an action for benefit of a single creditor. *Crease v. Babcock*, 52 Mass. 557, 560 (1846).

utilized in a number of early statutes.³⁴⁵ Under another early California statute applicable to corporations generally that served as a model for subsequent California statutes until 1931, shareholders were primarily and directly liable to creditors for their proportional share of each creditor's claim.³⁴⁶

Accordingly, theoretical examination of the advantages and disadvantages of both models of pro rata liability deserve an important place in any academic discussion of limited liability or alternative systems of shareholder liability for corporate obligations. Although most theoretical analyses fail to do so, some commentators discuss pro rata liability briefly, adopting the latter type of pro rata liability as their model.³⁴⁷

Halpern, Trebilcock, and Turnbull suggest that under a system of pro rata liability, shareholders would not be "as interested in monitoring the wealth composition" of fellow shareholders.³⁴⁸ There would be a greater incentive on the part of shareholders to ensure that the company did not undertake projects that would increase risk. In brief, they conclude that in a number of ways, pro rata liability would avoid some of the theorized costs arising in both limited liability and unlimited liability systems. The increased, although still limited, risk would be reflected by an increase in the return demanded by investors and a lower equilibrium price for corporate securities.³⁴⁹

In a brief discussion of pro rata liability, Manne stresses two factors. He points to the fact that some shareholders have received shares for promotional activities or for other noncash consideration, and thus would be unwilling or unable to shoulder a burden for corporate debts.³⁵⁰ This illustration is not representative. Further, it may describe some smaller or newly financed enterprises, but is hardly helpful in reviewing alternative systems of liability for corporations of significant size, including corporate groups.

Manne also points to the alleged practical difficulties of collecting "fractional" liabilities from large numbers of shareholders.³⁵¹ This problem is significant, although in view of the procedural reforms as discussed above, is not as serious as Professor Manne suggests.³⁵² In corporate groups, the problems in

345. *Hatch v. Burroughs*, 11 F. Cas. 795, 796 (C.C.S.D. Ga. 1870) (No. 6203); *Branch v. Baker*, 53 Ga. 502, 512-13 (1874); *Lane v. Harris*, 16 Ga. 217, 227 (1854) (legislative bank charters). See 1 C. BEACH, *supra* note 168, § 154, at 280 (1891).

346. Act of Apr. 22, 1850, ch. 128, § 32, 1850, Cal. Stat. 347, 350, as amended by Act of Apr. 27, 1863, ch. 518, 551, 1863 Cal. Stat. 766. See *supra* text accompanying notes 160-73.

347. See Manne, *supra* note 249, at 262; Halpern, Trebilcock & Turnbull, *supra* note 6, at 137-38. Orhnial recognizes that under unlimited liability, there would be "economic inducements" to develop cost minimizing arrangements such as "agreed limitation of [shareholder] liability to pre-determined sums." Orhnial, *supra* note 249, at 187. Pro rata liability and double or triple liability appear to provide the limitations that he has in mind.

348. Halpern, Trebilcock & Turnbull, *supra* note 6, at 137-38.

349. *Id.*

350. Manne, *supra* note 249, at 262.

351. *Id.*

352. The New York Stock Exchange estimates that total institutional holdings would represent one-half of the stock listed on the Exchange. N.Y. STOCK EXCH., FACT BOOK 55 (1985). Further, even where individual shareholders are concerned, the mature stage of the old creditors' bill provided an efficient remedy against all shareholders residing in the state of incorporation, and reduced the problems of proof in other jurisdictions to minor proportions. See generally Abbot, *supra* note 210. See also *Crease v. Babcock*, 52 Mass. 557, 560 (1846). Modern class action practice further facilitates the prosecution of such actions.

prosecuting actions against a large number of individual shareholders, even to the extent not cured by improved procedural remedies, simply do not arise. In most cases, the parent (or other group affiliate) is the only shareholder. Even where there are minority shareholders, a single action against the parent (or other affiliated shareholder) represents an efficient and substantial solution to the collection problem.

Since empirical studies of the California experience are apparently not available, a conclusion as to how well the California system actually functioned cannot be drawn. However, the California system, as well as earlier, more sweeping systems of unlimited shareholder liability in New England and England, survived for a significant period. A further conclusion is that the economic life of the area functioned reasonably well despite the very different legal rule. Whether the economy would have functioned better under a system of limited liability remains at issue. At any rate, whatever the virtues of the pro rata liability system, it did not ultimately survive in a world operating under limited liability.

2. Double or Triple Shareholder Liability

Double or triple shareholder liability is another model of imposition of liability upon shareholders in addition to their original investment. As has been noted, for decades double liability was a normal feature of the general corporation laws of most states as well as the rule for all national banks and most state banks.³⁵³ Nevertheless, it failed to survive the Great Depression. In the case of banks, double liability was superseded by deposit insurance which was viewed as a more effective means of providing protection for this important class of bank creditors. In the case of corporations generally, the usefulness of double liability in protecting creditors was apparently outweighed by the additional burden imposed on shareholders who had already lost their entire investment.

3. Summary

Whatever the lessons of history with respect to the relative usefulness of pro rata or double liability as variant ceilings on shareholder liability, this issue is of minor importance. The critical question remains whether limited liability should be applied to the components of corporate groups, regardless of the application of the rule to ultimate investors. That issue is entirely separate from the question of whether any change in the rule for limited liability for ultimate investors or consideration of some variant system such as pro rata liability or double liability may deserve attention.

V. APPLICABILITY OF LIMITED LIABILITY TO COMPONENTS OF CORPORATE GROUPS

Once corporate power was extended to include acquisition and ownership of the shares of another corporation, the creation of parent and subsidiary corporations and the development of business enterprises, frequently fragmented

353. See *supra* text accompanying notes 174-95.

into a number of affiliated corporations for the overall convenience of a corporate group, became possible. At the same time, the judicial system extended limited liability to parent corporations in their roles as shareholders of their subsidiaries without any apparent consideration of the advantages and disadvantages of this fundamental decision. If a subsidiary corporation constitutes only one of a number of components of a corporate group collectively conducting a fragmented unitary business, the very basis for the establishment of limited liability as a matter of general legal policy³⁵⁴ disappears.³⁵⁵

VI. CONCLUSION

In the preceding sections, the historical, economic, and legal authorities dealing with limited liability in general and with corporate groups in particular have been reviewed. At different times in Anglo-American history and in different areas, limited liability was rejected as the legal rule. Nevertheless, the economic system in the jurisdictions in question functioned reasonably effectively. In fact, it is still not clear whether a legal rule imposing some form of shareholder liability made any significant difference in the nature or dimensions of economic activity. On the other hand, intuitively, it is difficult not to suppose that it would discourage investment by individuals.

Further, the economic advantages asserted in support of limited liability, advantages that supposedly increase the efficiency of the economic system, are not accepted universally even among the economists. More importantly, such conclusions, even if valid generally, are largely irrelevant when the special case of intragroup liability is considered.³⁵⁶ Finally, limited liability was accepted as a legal principle at a time when corporations generally lacked the power to acquire and own the shares of other corporations and thereby function as parent corporations. When such power was finally recognized, the extension of limited liability from protection of ultimate investors to protection of parent corporations followed almost automatically, without any apparent consideration of the soundness or the desirability of the extension of the principle to create successive layers of protection against liability within the corporate group.

Both as an academic and a political matter, the application of limited liability to corporate groups has never undergone the scrutiny and debate that such a fundamental extension of the doctrine deserves. With the increasing

354. Extension of limited liability to reflect a deliberate bargain between the parties presents a very different problem; irrespective of the general liability rule under corporation law, limited liability could, of course, survive as a matter of contract law.

355. If a subsidiary is not a fragmented part of an integrated business and represents a separate business within a conglomerate group, intragroup liability may present a different issue. Issues requiring examination in such an inquiry include the extent of decentralization of decisionmaking; the extent of group financial, administrative, and personnel support and interrelationship; the extent of public identification of the separate business of the subsidiary as an activity of the group; the extent of continued participation of former management in the direction of the subsidiary (in those cases where the subsidiary had been acquired after having been previously operated under independent ownership); and the extent to which the subsidiary significantly represents an investment diversification, rather than an extension or expansion of the business or businesses in which the group is currently engaged.

356. Although conglomerate groups may present a stronger case for the application of limited liability, further analysis is still required in the individual case.

predominance of large corporate groups on the world economic scene and the increasing emergence of an interdependent world economic order, such a reexamination is not only desirable, but inevitable.

Torts and employee obligations present the most urgent areas for reconsideration. These questions are urgent within each country. They are equally urgent within the world community as a result of the increasing importance of the multinational enterprise. With world attention focused on recent environmental catastrophes involving local subsidiaries of foreign multinational enterprises (such as the Bhopal and Channel oil spill disasters) and with increasing labor concern on multinational problems of plant relocation and work transfer, the liability of the parent and upstream subsidiaries for the obligations of their local subsidiaries is a problem of increasing seriousness throughout the world. The legal rule inevitably will be on the world agenda for consideration.

