Accounting, Economics, and Law
A Convivium

Volume 1, *Issue* 1 | 2011 | *Article* 12

Avoid Automatic Piercing: A Comment on Blumberg and Strasser

Nicholas L. Georgakopoulos, *Indiana University School of Law - Indianapolis*

Recommended Citation:
Georgakopoulos, Nicholas L. (2011) "Avoid Automatic Piercing: A Comment on Blumberg and Strasser," *Accounting, Economics, and Law*: Vol. 1: Iss. 1, Article 12.

DOI: 10.2202/2152-2820.1002

Avoid Automatic Piercing: A Comment on Blumberg and Strasser

Nicholas L. Georgakopoulos

Abstract

This comment argues against piercing by default, a regime that the arguments of the main piece do not justify. Piercing of subsidiaries' veil in contract law is justified but under exceptional circumstances and presumed piercing would not cover all of them. Legislatures, courts, and agencies have moved to validate rather than undermine limited liability. Moreover, automatic piercing would erode the socially desirable incentive for business creation that limited liability provides, reduce or eliminate the markets for venture capital, buyouts and corporate control, and preclude the flexible financing that limited liability makes possible.

KEYWORDS: corporate law and economics, enterprise groups

JEL Classification Codes: K22, K40

Acknowledgements: Nicholas L. Georgakopoulos is Harold R. Woodard Professor of Law at the Indiana University School of Law - Indianapolis. He wishes to thank the anonymous referee, and Professors Biondi, Blumberg, and Strasser for helpful comments. Please send your comments to ngeorgak@iupui.edu.

TABLE OF CONTENTS

1. Introduction

The article of the renowned Professors Blumberg and Strasser, who are also dear co-authors of mine,[1] can be read as extending a readily acceptable statement, that the law of piercing the corporate veil should adapt to the legal environment of its application. The consequence of this adaptability would be easier piercing in those legal areas where it is merited but no change in others. There the current regime would apply, which views piercing as an extraordinary remedy.

Allow me, however, to play devil's advocate perhaps and argue against an excessive reading of their thesis. Professors Blumberg and Strasser's piercing thesis could also be read to argue that in most legal areas the corporate veil should be ignored, because the corporate veil is already easily ignored in some aspects of securities regulation, labor law, tax law and civil procedure. This version of the article's thesis is extreme. It is in conflict with a long and well justified jurisprudential tradition that veil piercing is an extraordinary remedy that courts undertake on exceptional circumstances to redress abuses of the corporate form. By definition, a corporate parent's desire to take advantage of the limited liability that the corporate form offers is not abusive by itself. Otherwise, there would be no limited liability for subsidiaries. Since one could also read Professors Blumberg and Strasser's article to argue that subsidiaries should have no limited liability, this comment will address that in Part 3. Part 2 will argue assuming that subsidiaries' limited liability is accepted. In other words, Part 2 asks, assuming that limited liability for subsidiaries can be desirable in at least some circumstances, do the arguments lead to the conclusion that parent corporations should be liable for subsidiaries' deficits as a default rule? Part 3 will argue that the limited liability of subsidiaries is desirable on the merits.

2. No Piercing by Default

The proper interpretation of the fact that the legislature has chosen to ignore the corporate veil in some areas of law is that in the remaining areas, the veil should not be ignored. In the rest of the legal system, piercing the corporate veil should continue to be an extraordinary measure. I offer four arguments. Contract law should not be seen as a legal field where the courts have adopted enterprise principles. The legislative action is produced by unique considerations of each legal field. The Supreme Court has reaffirmed the exceptional nature of veil

[1] See Blumberg, Strasser, Georgakopoulos and Gouvin, BLUMBERG ON CORPORATE GROUPS (2004).

DOI: 10.2202/2152-2820.1002

piercing. Finally, similar legislative moves in other legal fields have not let to a reversal of the corresponding overarching legal principles.

2.1 Inapposite Contract Law

Having myself argued in favor of veil piercing in contract, I could hardly disagree with the authors (and the evidence). [2] Courts pierce the veil relatively often in contract disputes. Nevertheless, piercing remains exceptional. Whereas courts occasionally apply enterprise principles in contract law, one should not form the impression of a presumption in favor of veil piercing. Special arguments apply in cases where the abuse of the corporate form or its control frustrates the purposes of contract law. Courts only pierce the corporate veil when exceptional circumstances occur.

One of the paradigmatic opinions where piercing is justified, illustrates the wrong that necessitates the piercing as well as the insufficiency of the solution proposed by Professors Blumberg and Strasser. The wrong is subversion of the operation of contract law. The insufficiency is that piercing by default would not lead to piercing in this case.

Contract law can be subverted when a controlling entity can induce another to breach a contract without either entity truly suffering the full financial consequences of the breach. While it happens in cases of insolvent subsidiaries, that does not argue for piercing by default. First, solvent subsidiaries do have the incentives not to breach. They do suffer the financial consequences of breaching their contracts. Moreover, the same circumstances can exist outside the parent-subsidiary context. Therefore, courts must not lose vigilance about identifying piercing circumstances, as they might if a default rule provides for piercing.

To illustrate subversion of contract law outside the parent-subsidiary context, consider an example positing several farmers, an intermediary buyer (a grain elevator named Warren) and a large corporate user of grain called Cargill.[3] Suppose that the farmers choose to reduce the risk they bear by entering into "forward" grain contracts with grain buyers for some fraction of each farmer's expected crop of grain.

After the forward contract, if grain prices rise, the contract benefits the buyer. If prices drop, it benefits the selling farmer. The enforcement mechanism of contract law, breach damages, induces the parties to abide by their agreement. If either would breach, the other would make the covering market transaction and contract law would give the covering party a claim for the financial consequences

---

[2] Nicholas L. Georgakopoulos, *Contract-Centered Veil-Piercing*, 13 STANF. J. OF LAW BUSINESS AND FINANCE 121 (2007).

[3] The example is based on the facts of *A. Gay Jensen Farms v. Gargill*, 309 N.W.2d 285 (Minn., 1981).

of the breach. If, for example, grain prices fell and the buyer refused to perform, the farmers would sell at the lower prices and have a claim for their deficiency (compared to the contract price) against the buyer.

Granted, the incentive scheme of contract law can fail. This happens when the breaching party is insolvent. The obligation that the breach would create is ineffective because the breaching party bears no financial consequence.

Imagine that Cargill happens to lend to Warren and subsequently Warren's financial circumstances aggravate. Warren becomes insolvent at a time when the price changes of the grain on outstanding grain purchases make Warren's contracts worth performing (rather than breaching and buying the grain on the open market). Grain prices have risen. Cargill can see that performance by Warren will also lead to subsequent performance of Warren's contacts to sell grain to Cargill. Whereas an ordinary lender would let the indebted grain elevator fail and collect a fractional amount of the claim in bankruptcy, Cargill experiences an extra gain from continuing to finance Warren. If Cargill were to push Warren into bankruptcy, then not only would Cargill's loans receive a few cents on the dollar (fractionally paid in bankruptcy) but Cargill would also have to buy grain in the higher prices of the open market. So Cargill does not prosecute its claim.

Cargill finances the grain buyer during a few seasons. During those seasons the price of grain changes in a way beneficial to Cargill. It rises before each harvest. Then a season comes when grain price drops instead of rising. This time Cargill realizes that instead of the above double harm from letting the grain elevator fail, it will only recognize one (unavoidable, now) harm and have one benefit. Cargill's loan will not be repaid (as it never would) but Cargill will benefit from buying grain in the open market. Accordingly, Cargill refuses further credit, Warren fails and breaches its contracts with the farmers. As Warren and Cargill are unrelated entities, the ordinary outcome would be that the breach claims of the farmers and the loan claim of Cargill would be fractionally paid in bankruptcy with a few cents on the dollar.

The farmers invoke lender liability, a theory akin to veil piercing, and seek to impose liability on Cargill for Warren's breach. Despite fairly weak indications of control of Warren by Cargill, the court finds that Cargill has made Warren into its agent, akin to piercing the veil separating Cargill from Warren. Cargill is liable for its agent's breach of the contracts with the farmers.

Cargill had managed to put itself in a position where it had subverted contract law. Cargill had managed to use Warren as a contracting puppet that Cargill could sacrifice with no financial consequence. Cargill had changed the nature of the contracts with the farmers. Contract law would operate only to Cargill's benefit if the farmers breached. When it became advantageous to breach, Cargill would not suffer. The example illustrates the importance of piercing in contract. Without piercing, puppeteers can subvert contract law. More importantly, it illustrates that piercing is not enough, since the same phenomenon can arise in settings that do not involve parents and subsidiaries, as it did in the example.

The example also illustrates the insufficiency of piercing by default. Even if the legal system had espoused the thesis of Blumberg and Strasser for piercing by default, that would not lead to liability of Cargill because it is not Warren's parent. Rather, adoption of piercing by default could reduce the vigilance of the courts to identify subversions of contract law's incentives and make the courts more reluctant to apply doctrines equivalent to piercing, such as lender liability, substantive consolidation, equitable receivership, or marshalling.

2.2 Legislature has Acted in Extraordinary Areas

The legislature's choice to reverse the presumption against veil piercing in some legal fields is justified by considerations unique to those fields. It would be wrong to infer from this legislative choice, a legislative predisposition or support for the corporate veil to be readily pierced in other areas of law. The expansive reach or securities regulation can be justified by the extraordinary importance of protecting the integrity of the capital markets, to which the Supreme Court also subscribed, for example, in its opinion in *Basic*.[4] In labor law, the easy piercing of the corporate veil can easily be justified by a legislative desire to grant extraordinary protection to unionized labor. In tax law, the application of enterprise principles may be justified by an extraordinary concern over tax revenues coupled with the relative ease for the taxpaying parent of avoiding tax consequences otherwise.

The ease with which enterprise principles have been applied in those fields (and have recently been expanded, for example with the Sarbanes-Oxley Act which expands the concept of enterprise principles in securities regulation) argues that the legislature can readily do the same in other areas. Rather than urge the courts to adopt enterprise principles in every legal field, the explicit adoption of enterprise principles in those areas suggests that other areas of law have not produced concerns that would lead to the adoption of enterprise principles and automatic veil piercing. Rather, the specificity of the exceptions should be seen to weigh in favor of the status quo that veil piercing is exceptional.

2.3 The Courts Side with Extraordinary Piercing

One can easily argue that precedent of the Supreme Court is misguided and should be reversed. However, absent a reversal, such precedent suggests that

[4] Basic v. Levinson, 485 U.S. 224 (1987).

arguments to deviate from it are imbued with an additional futility. The idea that the corporate veil should be readily ignored in some legal areas suffers that futility.

The Supreme Court underscored the exceptional nature of veil piercing in *Bestfoods*.[5] The court opined on environmental law, a subject that the majority of the circuit courts had interpreted the corresponding statute as setting a regime where the corporate veil would be readily pierced.[6] The contrary holding of the Supreme Court dramatically undermines the idea that the corporate veil should be readily pierced.

2.4 Legislature Promotes Limited Liability

The legislature has chosen to reverse longstanding common law principles such as buyer beware in some parts of consumer protection and of securities regulation. This has not led to a wholesale departure from the principle of buyer beware in other areas of law, such as real estate, commercial, or intellectual property contracts. The exceptional nature of veil piercing is similarly part of the fabric of the legal system. The deviation from that presumption in some areas of law does not indicate that a general reversal is desirable.

Legislative action has been in the opposite direction. Legislatures have adopted en masse the new vehicle for limited liability, the Limited Liability Company. If legislatures felt that limited liability were harmful, they could either resist and not enact an LLC statute or deviate from limited liability by providing for easy piercing by statutory language.

One could argue that the legislative adoption of LLC statutes does not signify acceptance of limited liability. For such an argument to hold, however, one would have to show that the legislatures were unaware of their ability to legislatively ease piercing or that they were forced to accept a form of limited liability for LLCs that they found disagreeable. No such argument can be made.

3. Merits of Not Piercing Subsidiaries

The arguments in favor of limited liability are league (see, e.g., Easterbrook & Fischel 1996, Presser 1992). Here, only three less frequent ones are discussed. Business creation is crucial for economic growth but it depends on lack of automatic piercing. Automatic piercing would change the way business is organized, undermining economic integration, venture financing and the market

---

[5] U.S. v. Bestfoods, 524 U.S. 51, 53 (1998).

[6] *See, generally,* George J. Weiner, Lara Bernstein Mathews, *Parent Corporation and Individual Liability Under Cercla After* Bestfoods, 13 NATURAL RESOURCES AND ENVIRONMENT 456 (1999).

DOI: 10.2202/2152-2820.1002

for control. Automatic piercing would end a regime that allows flexibility of independence and impose enormous burdens on the financing of business.

3.1 The Social Desirability of Risk Reduction

That legislatures consistently keep providing vehicles with limited liability is no accident. Business entails risks and neither individuals nor institutions easily accept to shoulder new risk. Entrepreneurs and parent corporations who engage in new business ventures place new ventures in business entities with limited liability so as to avoid exposing their other assets to each venture's risk.

Society is effectively diversified, having a stake in every business, but neither individual entrepreneurs nor parent companies are diversified with regard to entrepreneurial risk. Thus, we should fully expect that society wants to encourage entrepreneurs and parent corporations to take the risk of new ventures that they would be unwilling to take. Providing them with limited liability is a small inducement to provide the very valuable service of starting businesses.

3.2 Distortions from Automatic Piercing

Automatic piercing would radically alter the ownership structure, the financing and control of business. The joint ownership of synergistic businesses reduces the cost of integrated enterprises. Financing of new ventures depends on the availability of venture capital. The efficient operation of businesses depends on the threat of an acquisition from private equity of buyout firms. All those depend on the continued respect of the limited liability of subsidiaries.

If veil piercing were automatic then parent corporations who have placed synergistic businesses in subsidiaries would face an additional cost, the danger that they will be liable for the subsidiary's deficit. Thus, automatic piercing would be an obstacle against the integration of businesses or an incentive for divestitures.

Automatic piercing would be disastrous for businesses that routinely buy and sell large stakes in other businesses, such as venture capital, private equity and takeover firms. Limited liability ensures that such owners can buy and sell businesses without each harming the rest of their portfolio. Automatic piercing would render the entire portfolio hostage to the failure of a single business.

3.3 Automatic Piercing is an Inflexible Change

One of the themes that pervade business law is flexibility. Flexibility allows the infinite creativity of contracts and business arrangements that can be customized to circumstances. The existing regime of limited liability for subsidiaries is actually flexible. Automatic piercing is not.

Limited liability is waivable through guarantees whereas automatic piercing would be an unavoidable consequence. The result is that businesses now have the flexibility of changing the degree of their limited liability as circumstances change while automatic piercing would eliminate that flexibility. In the current regime of limited liability, parties desiring additional security can obtain it in the form of guarantees by related entities. It is important to notice that parties that seek security do not have a direct interest to prevent their counterparties from starting businesses or acquiring subsidiaries. In a world of automatic piercing, however, parties that seek additional security would need to protect themselves against the taking of new risks such as the starting of new businesses or the acquisition of subsidiaries, because those would expose the parent to unlimited liability. Thus, not only is the current regime more customizable but also any customization induced by a regime of automatic piercing would tend to be socially undesirable for it would tend to stifle business creation.

Conclusion

The excellent paper of Professors Blumberg and Strasser should not be read too broadly. They correctly argue the law does and should stand willing to pierce the corporate veil in many areas of law with sensitivity to the circumstances of each area of the law. It would be excessive and socially undesirable, however, to accept an argument that veil piercing should be automatic for subsidiaries.

Limited liability has been defended several times. Easterbrook and Fishel (1996) offer numerous arguments in favor of the limited liability of large corporations that were not pursued here. Those arguments are founded on the instrumental role of limited liability for diversification, monitoring, and the market for control. They all apply to subsidiaries. Presser (1992) defends limited liability as an integral component of the political economy of the entrepreneurial, free market society. While some have argued for *pro rata* liability (as has Professor Blumberg, 1986, as well as, e.g., Hansmann & Kraakman, 1991) the arguments of the present comment also argue against *pro rata* liability. Venture capital, leveraged buyout and private equity funds could be wiped out from the catastrophic failure of a single company in their portfolio in a regime of *pro rata* liability.

The strength of the desirability of limited liability and exceptional piercing obviates the need to even refer to the weaker arguments against piercing by default. Unlimited liability of a parent for subsidiary obligations would frustrate many regulated industries, where clarity of the assets and the obligations of

DOI: 10.2202/2152-2820.1002

entities in a corporate pyramid is essential. Also, lenders rely on their debtors' financial statements but in a world of automatic piercing lenders would need to perform due diligence on every subsidiary continuously. Moreover, the implementation of automatic piercing would force the legal system to establish the exact amount of control that leads to piecing, something that the Supreme Court has avoided, for example, by overruling the adoption of the sale of business doctrine by practically all circuits in the case of *Landreth Timber* rather than expose courts to having to wrestle with what fraction of ownership constitutes control.[7]

Judicial Cases

A. Gay Jensen Farms v. Gargill, 309 N.W.2d 285 (Minn., 1981)

Basic, Inc., v. Levinson, 485 U.S. 224 (1987)

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985)

References

Blumberg, Phillip I., 1986: *Limited Liability and Corporate Groups*, J. CORP. LAW 11:573, 576.

Blumberg, Phillip I., Kurt A. Strasser, Nicholas L. Georgakopoulos and Eric J. Gouvin, 2004: BLUMBERG ON CORPORATE GROUPS, Aspen.

Easterbrook, Frank H., and Daniel R. Fischel, 1996: THE ECONOMIC STRUCTURE OF CORPORATE LAW, Harvard University Press.

Georgakopoulos, Nicholas L., 2007: *Contract-Centered Veil-Piercing*, STANF. J. OF LAW BUSINESS AND FINANCE 13:121.

Georgakopoulos, Nicholas L., 2005: *Principles and Methods of Law & Economics*, Cambridge University Press.

Hansmann, Henry, & Reinier Kraakman, 1991: *Toward Unlimited Shareholder Liability for Corporate Torts*, YALE L.J. 100:1879.

Presser, Stephen B., 1992: *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, NW. U. L. REV. 87:148.

[7] *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

United States v. Bestfoods, 524 U.S. 51, 53 (1998).

Weiner, George J., Lara Bernstein Mathews, 1999: *Parent Corporation and Individual Liability Under Cercla After* Bestfoods, in NATURAL RESOURCES AND ENVIRONMENT 13:456.