UNDERCAPITALIZATION AS A FACTOR IN PIERCING THE CORPORATE VEIL IN CONTRACT CASES: BALANCING RISKS AND INCENTIVES*

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I. INTRODUCTION

Since its inception as an institutional incentive to spur investments using the corporate vehicle, limited liability has become the most significant feature of corporate law.[1] In its barest form, the implication on those who deal with modern corporations has been definite and clear: corporate investors risk no more than what they invest. Those who have supported limited liability during the course of its formation as a norm in corporate law argue that is has a fully rational economic basis and is, therefore, the more efficient rule. Supporters assert that the main social benefit derived from observing this liability regime is the availability of funds for new investments. On the other hand, the rule is criticized for creating yet another incentive – although this time considered to be socially and economically undesirable – the incentive to externalize costs. In response to this criticism, courts have formulated their version of an equally pervading rule to reduce the impact of this social cost by allowing corporate claimants to "pierce the corporate

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1 See Robert C. Downs, *Piercing the Corporate Veil – Do Corporations Provide Personal Liability*, 53 UMKC L. REV. 174, 174 (1985).

veil" in situations where the costs associated with excessive risk taking ostensibly exceed the benefits of limited liability.[2] Under this structure, limited liability and piercing the corporate veil certainly appear to be well-conceived and fair corporate law doctrines.[3]

Although this introduction fittingly presents the close correlation between these two doctrines and reveals the cause behind any unveiling of the protective mantle of limited liability in certain cases, the piercing doctrine remains the least understood issue in corporate law.[4] What may account for this perplexity

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[2] Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93 (1985).

[3] Limited liability and piercing the corporate veil are recognized principles in Philippine corporate law. In the case of Cease, et al. v. Court of Appeals, et al., G.R. No. L-33172, October 18, 1979, 98 SCRA 483, the Court held the "[g]enerally, a corporation is invested by law with a personality separate and distinct from that of the persons composing it as well as from that of any other legal entity to which it may be related. By virtue of this attribute, a corporation may not, generally, be made to answer for acts or liabilities of its stockholders or those of the legal entities to which it may be connected, and vice versa. This separate and distinct personality is, however, merely a fiction created by law for convenience and to promote the ends of justice (Laguna Transportation Company vs. Social Security System, L-14606, April 28, 1960; La Campana Coffee Factory, Inc. vs. Kaisahan ng mga Manggagawa sa La Campana, L-5677, May 25, 1953). For this reason, it may not be used or invoked for ends subversive of the policy and purpose behind its creation (Emiliano Cano Enterprises, Inc. vs. CIR, L-20502, Feb. 26, 1965) or which could not have been intended by law to which it owed its being (McConnel vs. Court of Appeals, L-10510, March 17, 1961, 1 SCRA 722). This is particularly true where the fiction is used to defeat public convenience, justify wrong, protect fraud, defend crime (Yutivo Sons Hardware Company vs. Court of Tax Appeals, L-13203, Jan. 28, 1961, 1 SCRA 160), confuse legitimate legal or judicial issues (R.F. Sungay & Co. vs. Reyes, L-20451, Dec. 28, 1964), perpetrate deception or otherwise circumvent the law (Gregorio Araneta, Inc. vs. Tuason de Paterno, L-2886, Aug. 22, 1952, 49 O.G. 721). This is likewise true where the corporate entity will be pierced or disregarded, and the corporation will be treated merely as an association of persons or, where there are two corporations, they will be merged as one, the one being merely regarded as part or the instrumentality of the other (Koppel [Phil.], Inc. vs. Yatco, 77 Phil. 496; Yutivo Sons Hardware Company vs. Court of Tax Appeals, supra."

[4] Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991). This work is an empirical study on all federal, state and administrative cases which deal with the issue of piercing the corporate veil. The work includes all Westlaw cases up to 1985 concerning the issue. Using the search terms "piercing the corporate veil" and "disregard! the corporate entity", factual data such as whether or not the court pierced the corporate veil, the year of promulgation, the number of shareholders, the nature of the claim (i.e., tort, contract, criminal, statutory, etc.), and the reasons for the court's decision were compiled. This resulted to a universe of 85 reasons gleamed from a previous research and a sampling of the cases in the data set.

is that as an equitable remedy, the piercing exception is applied by the courts "in an extremely discretionary manner in accordance with the individual conscience of judges."[5] This approach which involves the judicial balancing of costs and benefits including other imponderables is difficult to discern and to apply because it avoids formulating verifiable rules of decision.[6] What should have been leading principles are often stated in broad terms that offer little or no guidance.[7] The predictability of the law in this area and consequently, its effectiveness are therefore easily compromised.

In the application of these two opposing doctrines, courts have increasingly insisted that gross undercapitalization is the most important factor.[8] One particular case[9] is even cited as authority for stating the undercapitalization, in and of itself, may result in the imposition of full personal liability on the part of the controlling shareholder for corporate debts. Most courts, however, insist that inadequate capitalization is but one of a number of factors to be considered[10] and

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[5] STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL 1-8 (1995).

[6] Secon v. St. Joseph, 855 F.2d 406, 414 (7th Cir. 1988).

[7] Thompson, *supra* note 3.

[8] William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 859 (1982); *contra* Thompson, *supra* note 2, at 1065-66 (stating that although undercapitalization is a factor frequently cited by commentators as part of a normative standard in piercing cases, undercapitalization was present in only 61 out of 327 contract cases, or 19 per cent, in which the courts pierced the veil).

[9] The case referred to is Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal.Rptr. 641 (1961). In this case, Minton's daughter drowned in the pool which Seminole, a corporation, leased and operated. Cavaney was a director, secretary and treasurer of Seminole. In Minton's suit for damages, the court found that there was no attempt to provide adequate capitalization and that Seminole had no substantial assets. The court held that the capital was "trifling compared with the business to be done and the risks of loss." The evidence also supported an inference that Cavaney actively participated in the conduct of the business. *Id.* at 475. Although the case seems to stand for the principle that equitable owners should be liable when they provide inadequate capitalization and actively participate in the conduct of corporate affairs, it appears reasonable to consider the undercapitalization factor as the sole basis for disregarding the corporate form in this case. This conclusion proceeds from the fact that ownership and management are not separated in a closed corporation and thus, owners may be reasonably expected to actively participate in the management of the business.

[10] Perhaps the most exhaustive list of factors may be found in Laya v. Erin Homes, Inc., 352 S.E.2d 93 (W.Va. 1986). These factors are: "(1) commingling of funds and other assets of the corporation with those of the individual stockholders; (2) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholders); (3) failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors; (4) an

that inevitably, some other factor must be present before the shareholder would be held liable.[11] Notwithstanding this seeming divergence of beliefs in respect of undercapitalization's role and importance in piercing cases, what is essential is the common recognition that it is a principal factor.

Similar to the general concept of limited liability, the undercapitalization factor has an implicit and functional economic structure. From this makeup, some courts have taken an unconventional position by stating that undercapitalization is irrelevant when it comes to piercing the corporate veil in contract-related cases.

The ensuing discussion proposes to examine the irrelevance argument and intends to give an expanded economic presentation of the issue using modern corporate finance principles. First, it looks into the undercapitalization factor as a Law and Economics principle and leads to an analysis of the contract-tort dichotomy. Second, it explains the traditional argument leveled against the

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individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation; (5) failure to maintain corporate minutes or adequate capital records; (6) identical equitable ownership in two entities; (7) identity of the directors and officers of two entities who are responsible for supervision and management (a partnership or sole proprietorship and a corporation owned and managed by the same parties); (8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking; (9) absence of separately held corporate assets; (10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation; (11) sole ownership of all the stock by one individual or members of a single family; (12) use of the same office or business location by the corporation and its individual shareholder(s); (13) employment of the same employees or attorney by the corporation and its shareholder(s); (14) concealment or misrepresentation of the identity of the ownership, management or financial interests in the corporation, and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security); (15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities; (16) use of a corporate entity as a conduit to procure labor, services or merchandise for another person or entity; (17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another; (18) contracting by the corporation with another person with the intent to avoid risk of nonperformance by use of the corporate entity, or the use of a corporation as a subterfuge for illegal transactions; (19) the formation and use of the corporation to assume existing liabilities of another person or entity." *Id.* at 98-99. It may seem unlikely but this list does not purport to be exclusive. For grounds recognized under Philippine corporate law, see footnote 3.

[11] Hackney & Benson, *supra* note 6, at 885-86.

relevance of undercapitalization in contract cases and develops additional ideas to provide further credence to the initial contentions made by earlier works on the subject. The discussion concludes with the finding that undercapitalization is essentially a judge-made, literary generalization created to convey the result of a complex process of balancing and allocating risks between shareholders and creditors in a firm-specific capital structure context.

II. UNDERCAPITALIZATION AS A LEGAL AND ECONOMIC NORM

A. *Limited Liability and Piercing the Corporate Veil: A Quick Guide*

The arguments both for and against the relevance of undercapitalization in contract cases focus substantially on the same principles upon which limited liability and, conversely, piercing the corporate veil are founded.

Two alternative liability regimes are recognized in corporate law.[12] Since their legal conception, limited liability has been preferred to unlimited-personal liability. As may be gleamed from the Introduction, the reason for this bias is apparently limited liability's greater efficiency.

This efficiency can be proved in several ways. First, in the absence of limited liability, shareholders jointly agree the company's debts and effectively act as agents of creditors. This condition expands the scope for monitoring both by shareholders and creditors and therefore increases the agency costs associated with unlimited liability.[13] Second, the efficiency of limited liability is explained further in terms of the large, publicly held corporation.[14] It is known that the

[12] Under the Model Business Corporation Act, § 6.22, "[u]nless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct." Thus, depending on the incorporation statute, the articles of incorporation may expressly provide that shareholders shall be personally liable for corporate debts. Although this language is not particularly found in the Corporation Code of the Philippines, there appears to be no legal impediment to shareholders stipulating in the articles of incorporation that they be held directly liable, in whatever way, for corporate debts.

[13] Tony Orhnial, *Liability Laws and Company Finance*, *in* LIMITED LIABILITY AND THE CORPORATION, 184 (Tony Orhnial ed., 1982).

[14] Easterbrook & Fischel, *supra* note 2, at 93.

distinctive characteristic of publicly held corporations is the separation of ownership and control. This separation enables skilled managers to run businesses even though they do not have the personal wealth to finance the company's investments, and, in turn, gives investors who have wealth but lack management skills the needed opportunities to invest and to earn. However, this separation of investment and management is costly. In this setting, these agency costs include the need of investors to monitor management activity and the efforts of management to convey proper signals to appease investors. But because publicly held corporations have thrived, it is believed that the gains from the "separation and specialization of function" exceed these monitoring and bonding costs. Limited liability is a more efficient rule because it greatly reduces the costs of the separation and specialization of function.[15]

Although limited liability is popularly explained in terms of the large, publicly held firms, it also serves important functions in close corporations. Limited liability facilitates diversification by franchising and by making passive investment feasible in closely held firms. Without the threat of personal ruin, investors can freely put their money in different close companies and basically adopt the same investment strategy of shareholders who own diversified portfolios in large firms. In addition, as with the publicly held firm, the need of creditors and shareholders to monitor shareholder wealth is reduced.[16]

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[15] *Id.* According to Easterbrook and Fischel, limited liability reduces agency costs because: (1) limited liability decreases the need of investors to monitor managers since investors can hold a diversified portfolio without risking their entire personal wealth and which makes passive shareholder behavior a rational strategy; (2) it reduces the costs of monitoring other shareholders since individual shareholder wealth would be irrelevant; (3) because limited liability promotes the free transferability of shares (i.e., it provides a significant measure of certainty in the valuation of securities and supports the existence of organized securities markets), managers are given incentives to act efficiently by keeping share prices high to prevent takeovers; (4) limited liability makes it possible for market prices to impound additional information about the value of the firm; (5) it allows more efficient diversification since investors can own a diversified portfolio without risk of personal liability which in turn allows corporations to raise capital at lower costs; and (6) limited liability facilitates optimal investment decisions since management can choose high variance projects that have positive NPVs without exposing the entire wealth of shareholders.

[16] Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 106 (1991).

Nevertheless, it is claimed that the limited liability regime is severely inefficient because it enables shareholders to effect uncompensated transfers of business risks to creditors, which thus creates incentives for excessive allocations of social resources to risky economic activities.[17] This implies that for shareholders, incorporation with limited liability represents a reallocation of risks from them to creditors.[18] Piercing the corporate veil reduces the extent to which creditors bear these uncompensated costs.[19] The possibility of piercing decreases the incentive created by limited liability to engage in excessively risky activities because of the dangling threat of ultimate personal liability. Once piercing is ordered, actual costs or losses are reallocated proportionately by the courts to the appropriate risk bearers.

B. *Undercapitalization*

As mentioned earlier, undercapitalization is one of the critical factors in disregarding the corporate form which may expose shareholders to full personal liability. The assertion that it should, in fact, be the only factor is logically appealing due largely to the nature of the other grounds. For example, common factors such as the failure to observe corporate formalities (expect, perhaps, financial records) and the exercise of shareholder control and dominance have no apparent causal connection to the claims of either contract or tort creditors.[20]

The inclusion of inadequate capital as one of the factors which may lead to the imposition of shareholder liability has no basis in statutory corporate law. It therefore shares with the piercing doctrine the general characteristic of having neither clear rationale nor predictable standards.[21] As aptly described, it seems to happen "freakishly".[22]

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[17] Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L. J. 117, 126 (1980).

[18] Orhnial, *supra* note 2, at 181.

[19] Easterbrook & Fischel, *supra* note 2, at 110.

[20] Downs, *supra* note 1, at 176-80.

[21] Hackney, *supra* note 10, at 854.

[22] Easterbrook & Fischel, *supra* note 2.

From the legal standpoint, the basic idea behind the undercapitalization factor is that shareholders are engaging in an abuse of the corporate privilege for deliberately incorporating with initial capital they know to be inadequate to meet the expected liabilities of the business.[23] In other words, shareholders should not be entitled to personal immunity if they fail to provide the *quid pro quo* for such immunity, specifically, a reasonably adequate capital at incorporation to which creditors may resort.[24]

As may be drawn from the principles dealing with the efficiency of limited liability, the extent of the firm's capital affects shareholders' risk preferences. Thus, the lower the amount of capital, the greater the incentive to engage in excessively risky activities.[25] It is also generally recognized that owners with limited liability at the start have an incentive to undertake risky projects. Since these "owners" are not responsible for any unsatisfied claims beyond their initial investment, it would be rational for them to make investment decisions that have variable returns. With limited liability, shareholders have fixed caps on possible losses but have unbounded opportunities for realizing very large gains – the higher the risk, the higher the payoff.[26] However, with low capital, possible shareholder losses become even less and the incentive for excessive risk taking increases. To reduce the externalization of these costs, courts have pierced the corporate veil in cases where the incentives to engage in excessive risk taking are highest, that is, precisely in situations where the firm's capital is deemed inadequate compared to the ordinary range for the same type of business.[27]

How are these two sets of principles judicially applied? In determining whether to pierce the corporate veil, the "totality of circumstances" test is used. Since the inquiry is fact-intensive, each case is normally resolved on the basis of its unique set of facts. More specifically, a two-prong test has been developed for contract cases. This test raises two principal issues: first, whether there is a unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist; and second, whether an equitable result would occur if the acts are treated as those of the corporation alone.[28] As earlier shown, numerous factors have been identified in making this

[23] PRESSER, *supra* note 4, at 1-54.
[24] *Laya*, 352 S.E.2d at 100.
[25] Easterbrook & Fischel, *supra* note 2, at 113.
[26] Halpern, Trebilcock & Turnbull, *supra* note 16 at 144.
[27] Easterbrook & Fischel, *supra* note 2, at 117.
[28] Kinney Shoe Corp. v. Polan, 939 F.2d 209, 211 (4th Cir. 1991)

determination.[29] Undercapitalization is one of the highly relevant factors in satisfying the "unity of interest" requirement under the first part of this two-prong test.[30]

Having laid out the general criteria for finding shareholders personally liable for firm debts, another major subject developed in corporate case law on this matter involves the determination of capital inadequacy. Two questions are similarly raised: first, how is capital inadequacy measured; and second, what is the right time to make the measurement. Again, both are triable issues of fact.

Perhaps the most descriptive definition of undercapitalization could be found in the case of *In re Mobile Steel Co.*[31] In this case, the amount of capitalization that was deemed adequate was "what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable capitalization in the light of any special circumstances which existed at the time of incorporation."[32] The standards which this general statement suggested to the court in that bankruptcy case were the following:

> (1) [c]apitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the [firm] in light of the circumstances existing at the time the [firm] was capitalized; [and]
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> (2) [c]apitalization is inadequate if, at the time when [any shareholder] advances are made [to the firm], [it] could not have borrowed a similar amount of money from an informed outside source.[33]

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[29] See *supra* note 9.
[30] Nilsson v. Louisiana Hydrolec, 854 F.2d 1538, 1543 (9th Cir. 1988).
[31] 563 F.2d 692 (1977).
[32] *Id.* at 703.
[33] *Id.*

Courts had also phrased the definition in terms of "what [was] reasonably adequate to the anticipated needs of the business, considering the nature and magnitude of the enterprise and the likely risks to be incurred."[34] The term had also been interpreted to be the amount of beginning capital reasonably adequate for the firm to generate sufficient cash flow to cover "reasonably anticipated costs and expenses of doing business"[35] Moreover, capital inadequacy might be measured by the reasonableness of the "equity cushion" for creditors.[36] One court suggested a practical approach by making a simple comparison with the capitalization of other corporations in the same line of business. The amount of capital would be adequate if the firm's capital fell within the ordinary range for the particular business concerned. Alternatively, the firm's capitalization could be compared with average industry-wide ratios obtained from published sources of credible rating agencies buttressed by expert testimony from financial analysts.[37]

The common thread which link all these definitions is the idea that undercapitalization is a function of the type of business in which the corporation is engaged. The issue can then be stated as whether there has been a failure to adequately capitalize the firm for the reasonable and foreseeable risks of the business.[38] Unfortunately, what these risks are have not been explicitly identified. It appears, however, that all forms of business risks have to be considered because of the myriad issues involved in piercing cases. From the nature of these cases, the more pertinent risks would include financing and default risks, product risk (i.e., risk that the firm's products or services will cause harmful and actionable injuries to third parties), and both market and firm-specific risks. The different formulations for determining the appropriate level of capitalization directly result from the fact-intensive nature of piercing cases in general. But each case depends not only on the particular set of facts surrounding it but also on the predilection of the court assigned to resolve the case. This allows the court to "cherry pick" which risks and what facts are relevant and determinative to reach a fair result. Consequently, even the determination of inadequate capitalization which is interposed as an objective inquiry becomes as unpredictable and random.

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[34] Hackney & Benson, *supra* note 9, at 892-93.

[35] *Id.*

[36] Pierson v. Jones, 625 P.2d 1085, 1087 (1981).

[37] *Laya*, 352 S.E.2d at 101.

[38] Labadie Coal Co. v. Black, 672 F.2d 92, 99 (1982).

The remaining question is the appropriate time for measuring capital adequacy. This issue, however, has no additional value in the end. Instinctively, in making this inquiry, it can be anticipated that attention will be immediately focused upon the original capital at incorporation.[39] To some, it is clear that adequacy of capital must be measured at the "beginning period of corporate existence."[40] Conditioned on the theory that limited personal liability is a state-conferred privilege, the argument goes that shareholders are legally required to adequately capitalize the corporation before they could enjoy the benefits of immunity and protection. But once shareholders have done so, there should be no further obligation to provide for losses beyond their initial investment.[41]

At the other end of this time line is the view that the obligation to provide adequate capital is a continuing one, which starts at incorporation or the inception of the business and stretches during the firm's economic life.[42] Those who take this position may have in mind the situation where a firm starts its business with sufficient capital but later expands the size or changes the nature of the business with the attendant shift or increase in project risks. In this case, the firm may be deemed inadequately capitalized unless fresh capital is infused. The problem with the "continuing obligation" requirement is that no amount of capital may ever be enough in case the company starts to incur legitimate business losses. It would have the effect of indirectly circumventing the whole notion behind limited liability if the owners are nonetheless required to provide additional equity each time the original capital gets depleted or worse, completely wiped out.

It should be obvious that in spite of the courts' own explanation on their decision-making process in piercing cases, no amount of words can accurately account for their unbridled exercise of discretion in these cases or can actually translate their judicial actions into measurable and predictable behavior.

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[39] Downs, *supra* note 1, at 186.

[40] Hackney & Benson, *supra* note 9, at 898.

[41] *In re* Mobile Steel Co., 563 F.2d 692 (1977) Ruling that the evidence failed to support a finding that the corporation was undercapitalized at the time of its inception and at the time certain debentures were issued; *id.*

[42] De Witt Truck Brothers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686 (4th Cir. 1976); see Harvey Gelb, *Piercing the Corporate Veil – The Undercapitalization Factor*, 59 CHI-KENT L. REV. 1, 22 (1982) stating that there must be a continuing requirement for the maintenance of an "adequate level of assets" and not one based solely on the asset situation at the inception of the business.

C. Contract versus Tort

The principles that underlie limited liability and undercapitalization can eventually lead to contrasting results depending on the legal context, specifically, whether these concepts find application invoked in a contract or a tort case. In this regard, Law and Economics scholars have made a traditional distinction between contract and tort cases dealing with limited liability and undercapitalization issues.[43] This formality stems from the idea that a contract claimant voluntarily dealt with the firm and had a greater opportunity to evaluate credit risks. Based on the claimant's evaluation, she could have chosen not to deal with the corporation. Thus, if the firm fails to pay, the contract claimant is presumed to have considered that risk and should not be entitled to pierce the corporate veil. In contrast, a tort claimant does not choose to deal with the firm that causes the injury and incurs the corresponding obligation to pay. Unlike the contract claimant, the tort creditor does not have the benefit of a bargain and is unable to evaluate the risks *ex ante*. It is therefore costly and socially undesirable for the tort claimant to internalize the costs and for the firm to shift the risk.

If this logic holds, piercing should be expected to occur more frequently in tort cases rather than in contract cases.[44] But in fact, the evidence shows otherwise: courts pierce more often in the contract context than in the tort context.[45] And if the undercapitalization factor is introduced, courts pierced the corporate veil in 75% of the tort cases and in 70% of the contract cases.[46] The difference, however, is not statistically significant.[47]

Some courts have recognized the academic distinction. In *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*,[48] Judge Easterbrook aptly states the whole proposition as follows:

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[43] Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*. 78 NW. U. L. REV. 148, 167 (1992); e.g. Easterbrook & Fischel, *supra* note 2, at 112.

[44] Easterbrook & Fischel, *supra* note 2, at 112.

[45] Thompson, *supra* note 3, at 1058-59; *contra* PRESSER, *supra* note 4, at 1-37 to 1-39 suggesting that the idea that courts ought to pierce less frequently in contract cases was gaining ground based on his review of the cases that he studied in preparing his treatise in 1991, particularly with regard to cases decided since 1985 which was the cut-off point for Prof. Thompson's empirical study.

[46] Thompson, *supra* note 3, at 1066.

[47] *Id.* n. 149.

[48] 855 F.2d 406 (7th Cir. 1988).

> Analysis of the scope of these exceptions [to limited liability] sometimes appears dominated by metaphor or epithet rather than by logic. [But] [s]ome points stand out, among them that it is a lot harder to hold investors personally liable in contract disputes than for tort judgments. The reason is simple: contract creditors have entered into a voluntary arrangement with the corporation, which gave them the opportunity to negotiate terms reflecting any enhanced risk to which doing business with an entity enjoying limited liability exposed them. If they wanted guarantees from the investors, they could have negotiated for them. Tort creditors [on the other hand] had no chance to obtain compensation *ex ante* for exposure to increased risk, so to cut off liability might encourage excessively risky behaviour.[49]

In the parent company-subsidiary context, the distinction was explained, thus:

> In a contract case, the creditor has willingly transacted business with the subsidiary. If the creditor wants to be able to hold the parent liable for the subsidiary's debts, it can contract for this. Unless the subsidiary misrepresents its financial condition to the creditor, the creditor should be bound by its decision to deal with the subsidiary; it should not be able to complain later that the subsidiary is unsound. In a tort case, by contrast, the [tort] creditor has not voluntarily chosen to deal with the subsidiary; instead, the creditor relationship is forced upon it. Thus, the question of whether the creditor relied on misrepresentations by the subsidiary is irrelevant. Where a parent establishes a subsidiary, undercapitalizes it, and dominates it to such an extent that the subsidiary is a mere conduit for the parent's business, then the parent should not be able to shift the risk of loss due to the subsidiary's tortuous acts to innocent third parties.[50]

Clearly, these and several other courts understand the rationale behind the contract-tort dichotomy which has been chronicled in case reports for some time. But despite the encouraging appreciation by a growing number of courts, the evidence above shows that the distinction has not been uniformly adopted by judges who have touched on the problem. The statistical insignificance attributed to the frequency of piercing in contract and tort cases where undercapitalization was present indicates the unwillingness, or perhaps the outright refusal, of most

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[49] *Id.* at 413-14.

[50] U.S. v. Jon-T Chemicals, Inc., 768 F.2d 686, 693(1985).

courts to apply a reasonable standard. This point speaks negatively on the absorptive ability of these courts.

III. THE IRRELEVANCE ARGUMENT

A. *Voluntary Credit Transactions and Risk*

As already revealed, the strongest argument against the relevance of undercapitalization is the contractual theory of limited liability. Effectively, this position rejects the conception of limited liability as a state-conferred privilege and instead, promotes the idea that a corporation is a complex web of contractual relations among its many constituencies.[51] Under this theory, state action becomes unnecessary to protect corporate constituencies who are able to agree on the terms of their relations by private contract.

If the firm is incorporated with limited liability, voluntary creditors (i.e., lenders, bondholders, trade creditors, and workers) have accepted a risky position because of the firm's inherent right to default and to seek bankruptcy.[52] In a sense, by way of added consideration at the time of bargaining, voluntary creditors have sold shareholders a put option on the company at a strike price equivalent to the market value of the firm's assets. To have value, shareholders must exercise the put option at the point where the firm's debt exceeds the market value of its assets. Of course, if the option is exercised, it results to a negative payoff for voluntary creditors. Whether the value of the debt will eventually exceed the market value of assets depends on the outcomes of the firm's investment or capital budgeting decisions. Since voluntary creditors have accepted a risky position, they must consider the probabilities of these different outcomes and determine an expected yield at which they would be willing to lend to compensate for the risk. For bondholders, this will be reflected in the promised yield on the issued bond; for workers, the promised wage rate, and for trade creditors or suppliers, the terms at which they extend credit or sell their products to the firm.[53]

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[51] See Ribstein, *supra* note 15, at 82-83; Easterbrook & Fischel, *supra* note 2, at 89.

[52] Halpern, Trebilcock & Turnbull, *supra* note 16, at 128.

[53] *Id.*

To see exactly how this risk assessment works, consider the following example:[54] John plans to invest in a risky joint venture. He organizes MyCo, a personal holding company, for this purpose. It will be apparent in one year whether the business would be successful or not. He wants to invest $1.5 million balance. The lender estimates that there is an 80 per cent probability that the venture will be sufficiently successful to enable repayment of the loan and interest on maturity, and a 20 per cent probability that the venture will fail so badly that MyCo shares will be worthless and default on the loan would surely occur. The lender realizes that the current treasury bill rate (T-bill rate), which is accepted as the risk-free interest rate, is 6 per cent.

If the lender agrees to lend the $1 million, she will adjust the loan interest rate to compensate for the risk. On these assumptions, the lender must then calculate the amount that when multiplied by 80 per cent (the probability that full payment will be made after one year) will equal $1,060,000, or the payoff she would have had if she made the risk-free loan instead (i.e., if she invested in T-bills). That amount is $1,325,000. Thus, the lender will charge MyCo an interest rate of 32.5 per cent on the $1 million loan. The difference between the nominal interest rate and the risk-free rate is the risk premium (or 32.5% - 6% = 26.5%).

This example illustrates the fundamental principle that interest rates on loans represent compensation for both risk and return.[55] It also proves that in the contract setting, the voluntary creditor is expected to have evaluated the risks and to have assumed the principal risk that the corporation may be unable to meet financial obligations.[56] Since no "externality" is created,[57] there is no reason for voluntary creditors to invoke the firm's undercapitalization as measured by the "nature and magnitude of the business." In these cases, voluntary creditors cannot invoke the equity powers of the court. However, when voluntary creditors insist on instituting these cases, courts should not deprive the parties of their choice to allocate the risks among themselves at one's expense. Otherwise, the risk of personal liability changes the financial relationship of the parties without their consent and against their expectations.[58]

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[54] This revised example was taken from Richard A. Posner, *The Rights of Creditors and Affiliated Corporations*, 63 U. CHI. L. REV. 499, 501 (1976).

[55] *Id.*

[56] Labadie Coal Co., 672 F.2d at 100.

[57] Posner, *supra* note 53, at 503.

[58] Downs, *supra* note 1, at 197.

There is the view, however, that this consensual approach applies only to certain types of voluntary creditors, specifically, those who are capable of protecting themselves.[59] It basically states that a creditor should not be allowed to invoke undercapitalization only when, under the circumstances, it would be reasonable for that creditor to conduct an investigation of the corporation prior to entering into the contract.[60] This includes situations involving small credit transactions. These transactions may be too small to warrant either a full investigation into the firm's financial condition or a detailed negotiation regarding risk and return.[61] This amounts to what may be termed as a "sophisticated" creditor requirement since only those creditors who have access to company information (either actual access or bargaining power or relationship to gain access) and are able to use them in making credit decisions, would be barred from invoking undercapitalization to tear the corporate fiction. In the case of small creditors, it is argues that it would be more efficient for the company to disclose any "unusual capitalization" than for the unsophisticated creditor to investigate. Piercing the corporate veil gives companies the incentive to make the disclosure.[62] Guided by the measure of sophistication in securities law, these sophisticated creditors can only be banks, other financial institutions, institutional investors, and individuals who have the personal wealth and professional or educational background to assess and assume the investment risk.

However, this argument falls short because it does not fully consider the use and value of interest rates. The risk aspect impounded in interest rates may include those risks associated with asymmetric information. Creditors should be aware that an adverse selection problem exists each time corporate borrowers seek financing. Borrowers inherently want to give the impression that they are better credit risks to receive more favorable credit terms and to obtain lower costs of financing. Thus, contract creditors who think they are not fully aware of the risks can always adjust their interest rates to reflect the possible lack of information.[63]

Moreover, interest rates are not the only protective measure that contract creditors can resort to lessen their risk exposure. Creditors, for example, can always demand that controlling shareholders personally guarantee any corporate

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[59] *Laya*, 352 S.E.2d at 100; Gelb, *supra* note 41, at 13; Hackney & Brown, *supra* note 9, at 899; *id.*

[60] *Id.*

[61] Easterbrook & Fischel, *supra* note 2, at 113.

[62] *Id.*

[63] Ribstein, *supra* note 15, at 95.

debt. This arrangement effectively transforms the liability regime from one of limited liability to unlimited liability since shareholders become personal guarantors of corporate debt. Alternatively, creditors can insist on security for any loan or credit facility. This makes the debt virtually risk-free if the security is deemed adequate. In fact, it reduces the firm's agency costs because monitoring by the secured creditor will be limited to a specific company asset.[64] Other credit terms aside from interest rates can also be structured to limit risk. Trade creditors, for example, can tighten the credit period or restrict credit sales to certain firms after conducting a simple evaluation. At any rate, the decision to lend is always a product of the creditor's own risk preferences. Ultimately, creditors can opt out and refuse to extend credit if they are completely risk averse. Once a determination has been made, however, the creditor should be bound by her investment decision absent any fraud or misrepresentation on the part of the borrower.

In sum, undercapitalization is irrelevant in contract cases because creditors can freely adopt protective devices before dealing with the firm. Shareholders may be presumed as saying to potential creditors that "our liability is limited unless you bargain for more."[65] And when courts cite undercapitalization and decide to hold the shareholders personally liable, they have acted contrary to the parties' agreement on their specific risk allocations.[66]

B. Value of the Firm and Financial Distress

The undercapitalization factor can be viewed from an analogous perspective. As previously explained, the conventional theory requires shareholders to provide the corporation with adequate capital before they could enjoy the benefits of limited liability. Capital adequacy depends on the nature and magnitude of the foreseeable risks of the business.

Undercapitalization is harmful because there is a greater incentive to engage in excessively risky activities when the firm's capital is below the acceptable range for that particular business. Thus, more risk than usual is shifted from shareholders to creditors resulting to socially undesirable cost

[64] *Id.*

[65] Gelb, *supra* note 41, at 10.

[66] *Id.*

externalization. This induced behavior is an aspect of the moral hazard problem arising from shareholders' residual claims. The risk-shifting problem becomes worse when shareholders and managers have the same interests – a situation found prevalently in close corporation. Shareholders who enjoy limited liability and, at the same time, contribute only minimal capital have greater incentives to engage in overly risky activities since they have hedged their positions against huge losses if things go bad but have placed themselves strategically to receive the highest returns possible if the business does well.

To understand undercapitalization's real influence in contract cases, the incentive to engage in excessive risk taking which is predicted to occur particularly in undercapitalized firms must be examined more closely.

Unless the corporation is in financial distress, risk shifting occurs naturally in any levered firm. If the firm stands at a reasonably levered position, the risks are "equitably" shared between shareholders and creditors. Thus, the courts have no reason to change the result of their bargain. Undercapitalization alone does not provide enough incentives for shareholders to engage in the kind of harmful risk shifting that the courts would want to suppress when disregarding the corporate fiction. In other words, having minimal capital does not by itself lead to excessive and actionable risk taking. Being in financial distress or near bankruptcy does. Although the amount of capital can sway how quickly the firm reaches financial distress, reckless investment decisions with their corresponding risks and shareholder misconduct including deliberate risk shifting are the compelling reasons that cause firms to fail and should prompt the courts to impose personal shareholder liability as a way of reaching a fair result. Generalizing that it is gross undercapitalization is poor judicial policy.

Helpful insights on firm value and capital structure may be used to expound the foregoing ideas.[67] Consider a small company with shareholder-

[67] These principles are deduced from the Modigliani and Miller ("MM") Irrelevance Hypothesis. MM explained debt policy and capital structure using two important propositions. Under the first proposition, financing decisions have no effect on the value of the firm in perfect capital markets. This means that the value of the firm is determined by the left-hand side of the balance sheet by real assets and not by the proportion of debt and equity securities that the firm offers. This proposition holds only under the following conditions: capital markets are frictionless, i.e., there are no transaction costs, individuals and corporations are taxed at the same rate, there are no bankruptcy costs, individuals and lenders can borrow at the risk-free rate, corporate insiders and outsiders have the same information, and managers always maximize shareholder wealth. Under the second proposition, the expected rate of return on the

managers and bondholders where the value of this hypothetical company can be viewed as the sum of the net present values (NPV) of the cash flows generated from the firm's different assets. If the firm is loan-free, all corporate income flow to its shareholders. Being an unlevered or all-equity firm, all business risks are internalized by the shareholders (assuming, of course, that no tort claimants exist). One may inadvertently assume that as the firm begins to borrow, some of the risks are immediately shifted to the new bondholders. However, at moderate levels of corporate borrowing, debt virtually remains to be risk-free since repayment of the company's financial obligations to bondholders is still more or less assured. But even if the chance of default is nil, the expected returns of shareholders increase linearly as more debt is added since they bear most of the firm's financial risk at this stage. In other words, even if there is no default risk, leverage increases the risk of the shares held by stockholders because of increased volatility of rates of return and higher *beta* (i.e., higher sensitivity to market changes).[68] As the firm incurs more and more debt, however, the risk assumed by shareholders continues to rise but starts to taper off as part of that risk is shifted to bondholders who now begin to bear the possibility of default. When the firm reaches financial distress or near bankruptcy, the possibility of excessive or even deliberate risk shifting by shareholder-managers increases. These activities are the ones that could lead to harmful cost externalization.

Such inefficiencies are manifested when the company starts to play "financial games."[69] The most common game is Risk Shifting, or the Overinvestment Problem. Suppose that the same financially distressed company has an outstanding debt of $200 and has two mutually exclusive investment projects, Projects A and B. The respective payoffs to the firm, shareholders and bondholders under both projects are as follows:

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equity (R_E) of a levered firm increases in proportion to the debt-equity ratio (D/E). The rate of increase depends on the spread between the expected rate of return on the firm's assets (R_A) and the expected rate of return on debt (R_D). The formula is represented by the equation: $R_E = R_A + D/E\ (R_A - R_D)$. For a full discussion, see Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*. 48 AM. ECON. REV. 261, 261-97 (1958).

[68] RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE, 411 n.14 (1991).

[69] See *id.* at 440-42.

Table 1: Expected Payoffs to a Financially Distressed Firm[70]

	Project A		Project B	
	Recession	Boom	Recession	Boom
Probability	50%	50%	50%	50%
Payoff from Investment (Increase to Value of Firm)	$200	$400	$100	$450
Expected Value of Firm (probability x recession payoff) + (probability x boom payoff)	$300		$275	
Payment to Bondholders	$200	$200	$100	$200
Payment to Shareholders (payoff from investment – payment to bondholders)	$0	$200	$0	$250
Expected Payoff to Shareholders (probability x recession payoff) + (probability x boom payoff)	$100		$125	

To maximize firm value, shareholder-managers should choose Project A (with an expected increase in firm value of $300), but to maximize shareholder value, they will choose Project B (with an expected payoff of $125). Note that if Project B is chosen, there is 50 per cent probability that the bondholders will only be paid half of their total claims. Whereas if Project A is chosen (as any good manager should), the bondholders will always be fully paid no matter what the outcome.

This example illustrates the point that firms in financial distress have greater incentives to choose high risk projects and to prefer the interests of shareholders over creditors. From the discussion in Part A, creditors who deal with the corporation at this stage assume a risky position. Because creditors know

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[70] This example was lifted from one given by Prof. Jonathan Hubbard, Johnson Graduate School of Management, Cornell University, while teaching the course "Management Finance".

in advance that such risk-shifting may occur, they can demand to be compensated. The increased odds of poor decision making in this situation influence all investors to mark down the market value of the firm. Potential lenders, realizing that games may be played at their expense, will demand better terms. Therefore, the fall in firm value and the increased compensation for risk still come out of the shareholders' pockets.[71] In this sense, shareholders eventually bear all the costs!

Another concern for bondholders would be agency costs. For bondholders, "agency costs only arise when there is some probability of default."[72] These agency costs include opportunity costs caused by the impact of debt on the investment decisions of the firm, monitoring and bonding costs incurred by the bondholders and the shareholder-managers, and possible bankruptcy and reorganization costs.[73] Bases on the interpretation of Table 1, these costs arise because limited liability and undercapitalization engender a potential conflict between the interests of shareholders and bondholders.[74] Bondholders, realizing that these agency costs may also be incurred, take them into account at the time of negotiation and quite expectedly, ask for additional compensation. Again, shareholders eventually take on these costs.

One could see that as far as the allocation of risks is concerned, the level of capital is relevant only in determining the debt-to-equity ration where the effects of financial distress turns deleterious and the speed at which the company reaches "melting point" as it levers up. The amount of capital identifies where shareholders and creditors stand and defines what their risk and return tradeoffs are. At best, the relevance of undercapitalization is incidental or even trivial but surely, it is not the pivotal reason that causes firms to suffer financial distress and which leads to detrimental risk-shifting. In the long run, corporate success rests mostly on the company's capital investment and operating decisions.[75] Yet still, shareholders and creditors have willingly bargained and accepted their risk positions even in this situation.

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[71] *Id.* at 443.

[72] Orhnial, *supra* note 12, at 182.

[73] Id.

[74] *Id.*

[75] Brealey & Myers, *supra* note 67, at 448.

Only when the shareholder-manager engages in willful acts that unnecessarily increase the risk or loss of creditors should the legal system be allowed to intervene. An extreme example would be a shareholder who decides to go to Las Vegas and gamble away the remaining corporate assets in the hope of saving a windfall. If her company has an asset value of $100 and with a debt of $90, she can either do nothing and end up with $10 or she could gamble the $100 if the odds are good enough. Even if there is a 50 per cent probability that the shareholder will win $200, the company (and consequently, the creditors) may still be left with nothing.[76] The company will have no assets and the creditors will not be paid. On the other hand, the shareholder has a good chance of earning as much as $45 and thus, a big incentive to actually take the risk.[77]

Similar to this fraudulent act, shareholders may also hide corporate assets, invest in negative NPV projects, or simply "cash in and run", i.e., sell the assets and steal the money. This raises an important yet often overlooked or downplayed element to the piercing equation: it is necessary that an "element of injustice or fundamental unfairness" be present.[78] In the courts' struggle to correct any possible injustice, they should not, however, attempt to formulate so-called "objective" but loose standards to justify a desired result which can only be upheld in equity. Other grounds already exist at common and statutory law. Remarkably, these same grounds have laid down the foundation for the application of the piercing doctrine: the corporate form will be disregarded whenever it "defeats public convenience, justifies wrong, protects fraud, or defends crime."[79] In addition, the seemingly inexhaustible list of factors used to pierce the corporate veil sufficiently provides the courts with more appropriate grounds to correct shareholder misbehavior.[80] Finally, perhaps the more effective way to curb these

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[76] Computed as follows: [(50% probability x $200 payoff) + (50% probability x $0 payoff)] - $100 (representing the firm's investment in the gambling venture, i.e., the firm's remaining assets) = $0.

[77] Out of the $200 gambling profit, $90 must be paid to the creditors. Thus, [50%($200-$90) + 50%($0)] - $10 (representing the shareholder's actual investment which is the value of her shares, i.e., $100-$90) = $45.

[78] De Witt Truck Brokers, Inc., 540 F.2d at 687.

[79] United States v. Milwaukee Refrigerator Transit Co., 143 F. 247, 255 (1905).

[80] See note 8. Among the more pertinent grounds include: (1) diversion of the corporation's funds or assets to non-corporate uses (to the personal uses of the corporation's shareholders); (2) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another; and (3) contracting by the corporation with another person with the intent to avoid risk of

forms of excessive risk taking is not through the piercing doctrine but through bankruptcy and other creditor protection laws such as those which address fraudulent transfers and conveyances and bulk sales.

What seems to occur frequently is that a court would cite "inadequate capital" as a ground when the substance of the decision would inevitably show reliance on another ground. In *De Witt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*[81] and *Weisser v. Mursam Shoe Corp.*,[82] both courts directed their attention to the undercapitalization issue but actually ruled on the basis of the controlling shareholders' respective promises to personally guarantee the claims against the two corporations.

Is capital adequacy the best measure of the firm's ability to pay the claims against it? The accepted reasoning is that capital serves as an equity cushion for the firm's creditors. Stated differently, adequate capital ensures that the firm is solvent. But is solvency the most appropriate test?

From the creditor's viewpoint, her fundamental concern is the ability of the company to generate safe and sufficient cash flows out of its investments. These cash flows will be realized if the firm makes good investment decisions. For the creditor, it is this ability to add value that is crucial. Thus, when the creditor decides whether to lend or not, the firm's investment decision which is anchored on what projects the firm should invest in and how much it should invest is more critical than its financing decision. These financing decisions often consider how the firm should raise the cash for these investments or how to proportion its debt and equity. This brings out another important principle: the value of the firm is measured by the left-hand side of the balance sheet by real assets.[83]

Recognition of this principle has persuaded some commentators to suggest an alternative test to the current legal standard of measuring the adequacy of capital. They state that reliance on the term "undercapitalization" unduly focuses attention on assets provided to a corporation as capital at the time of inception but excludes consideration of the adequacy of assets at a later time.[84]

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nonperformance by use of the corporate entity; or the use of a corporation as a subterfuge for illegal transactions.

[81] 540 F.2d. 681 (4th Cir. 1976).

[82] 127 F.2d. 344 (2d Cir. 1942).

[83] See note 66.

[84] Gelb, *supra* note 41, at 12-13.

The ideal term should not only reflect that amount in determining if, in a specific case, the level of assets available to creditors is fair. Since the proper focus of the inquiry in piercing cases should be whether the corporation has been provided with a level of assets that meets the type of claim involved, it is proposed that "inadequate capital" be replaced by "inadequate level of assets" which is considered a more accurate term.[85] This analysis is useful to emphasize that the real measure of the firm's value is its assets and consequently, its ability to satisfy its financial obligations. However, regardless of what term or value is adopted, the voluntary assumption of risk by creditors in contract cases prevails and overrides the legal ramifications of the selection made.

It has also been recognized that the concept of undercapitalization has not been rigorously defined and that "absolute measures of capital inadequacy such as the amount of stockholder equity or other figures and ratios drawn from the cold pages of the corporation's balance sheets and financial statements, are of little utility..."[86] By piercing the corporate veil on the ground of gross undercapitalization, courts effectively enforce judicially determined minimum capitalization requirements for different businesses and specific firm. Since courts do so to ostensibly protect creditors, requiring more capital must have the effect of preventing creditors' losses in the future. Nonetheless, this remedy is not particularly effective since the determination is made *ex post* and would not necessarily apply to another case unless both cases are perfectly identical.

This brings out the other problem with judicial minimum capital requirements. The courts may not be the best agency to resolve issues of this nature. In finding the optimal capital structure or debt-to-equity ration for any firm, several factors have to be carefully weighed. Put simply, there are no easy answers. One of the most important considerations is the relative tradeoff between the benefits of tax shields and the costs of financial distress. A large corporate debt means a bigger tax shield since interest payments are a tax-deductible expense for corporations. However, as already shown, a high debt-to-equity ratio increases the costs of financial distress. If the company is in a good taxpaying position, i.e., its corporate income is high, increasing its leverage will have beneficial effects in reducing its tax liabilities; if the company incurs losses, tax shields are useless. At the same time, companies with low income may be forced to take on more debt simply because they are unable to finance their investments internally. Moreover, capital structure also depends on business risk

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[85] *Id.*

[86] *In re* Mobile Steel Co., 563 F.2d at 702.

and asset type. Firms that have more business risk and intangible assets such as trademarks or human capital are likely to suffer seriously from financial distress costs and should therefore borrow less.[87] Conversely, companies that have relatively low risk and possess real assets such as commercial real estate or plant and equipment may carry a heavier debt load.[88]

It is therefore hard to imagine if the courts are fully capable of ruling upon these issues when financial managers themselves realize that no "textbook answers" or "fool-proof formulas" exist. Reviewing the long list of bankruptcies and corporate failures in our economic history, the costs of getting it wrong could be devastating.

IV. CONCLUSION

Undercapitalization is irrelevant in contract cases because voluntary creditors have assumed a risky position. The level of capital is relevant only in finding out how much risk the creditors have to take, how probably shareholders or managers will play financial games at their expense, and, finally, how much compensation they should charge for these costs. Ultimately, the firm's investment decisions will save the day for both shareholders and creditors. Unless the firm is in financial distress and engages in extreme, willful and fraudulent risk-taking, there is no reason why any creeping outside market force embodied by the judicial system should intervene and pierce the corporate veil. In all these cases, contract creditors had the chance to be protected and shareholders had already paid the price.

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[87] BREALEY & MYERS, *supra* note 65, at 446-48.

[88] *Id.*