

# Contract-Centered Veil Piercing

Nicholas L. Georgakopoulos\*

*The application of the doctrine of piercing the corporate veil to contract disputes has been attacked as undesirable. This article shows that applying piercing to contracts is desirable. Contract-centered veil-piercing functions akin to a penalty-default clause that encourages the efficient production of information, avoids wasteful precaution, and promotes the use of the corporate form for entrepreneurship.*

---

\* Harold R. Woodard Professor of Law, Indiana University School of Law - Indianapolis. For their helpful comments, I wish to thank Professors Ron Davis, Janis Sarra, Steven Schwarcz, George Triantis, Antony Page, Jay Weiser, the audiences at the Indiana University Law School - Indianapolis Speaker Series, the annual meetings of the Canadian, Midwestern, and American Law and Economics Associations as well as the members of the Law and Economics Seminar of the University of British Columbia Law School. I particularly owe warm thanks to my research assistant, Mark Conner. I urge you to send your comments to me at [ngeorgak@iupui.edu](mailto:ngeorgak@iupui.edu).

### Introduction

A private helicopter takes off. Two men in dark suits are its only passengers. One is a U.S. senator, the other his trusted assistant. They talk amiably as the senator enjoys the view of the tranquil, sun-drenched Potomac under them. Suddenly, the assistant is transformed into a blue-feathered woman, an evil mutant who proceeds to attack and kidnap the senator. This scene from the X-Men feature film<sup>1</sup> (see figure 1) illustrates the importance of errors about identity. Had the senator known the true identity of his companion, he would have avoided the risk of an insecure meeting.

*Subsidiaries* can expose *outsiders*,<sup>2</sup> with whom they enter into contracts, to errors similar to that of the senator. The senator inferred that his assistant's incentives not to

<sup>1</sup> X-MEN (20th Century Fox 2000).

<sup>2</sup> To avoid verbose text, this article uses the terms *outsider* and *subsidiary* [corporation] to refer to the two contracting parties, although both may be subsidiaries or the subsidiary may be owned by one or more individuals (whereas the customary understanding of the term implies ownership by a parent corporation). *Outsider* is the party who seeks to obtain performance from the *subsidiary* under their contract, fails, and pursues piercing of the corporate veil that would impose liability on the controllers of the subsidiary.

In addition, this article will also use expansive versions of the terms *parent* and *affiliate*. The term *parent* refers to the entity that controls the subsidiary. This is usually a shareholder but may be, for example, a lender in cases of lender liability. See also *infra* text accompanying note 53. The term *parent* includes controlling shareholders that are individuals (whereas the customary usage implies a corporation). Also, the term *parent* refers to the ultimate parent, i.e., the controlling entity that may be separated by several layers of subsidiaries from the subsidiary that is a party to the contract (in this case the analysis becomes equivalent through piercing of their several veils to reach the ultimate parent). The term *affiliates* refers to all other corporations under common control with the subsidiary, i.e., all that are controlled by the same parent. The analysis applies equally to many variations of corporate structures and control but these broad definitions allow the text to proceed using the simple setting of an *outsider* contracting with a *subsidiary* controlled by a "parent" that may also control other "affiliates."



Figure 1: Four Frames from X-Men.

attack him were sufficient but those incentives did not apply to the actual passenger because of the senator's error about the passenger's identity. Likewise, outsiders think that subsidiaries' incentives are sufficient to perform their contracts. Yet, those incentives may not apply because the subsidiaries (a) may be *subjugated*,<sup>3</sup> having become puppets in the hands of dominating puppeteers, who have no regard for their interests, or (b) have no assets, and nothing to lose from breaching, whereas the outsiders thought they were contracting with their apparently solvent parents.

The doctrine of veil piercing (also shortened here to "piercing") extends the outsider's claim so that it encompasses the controller, the puppeteer, or the asset-rich parent.<sup>4</sup> Piercing overcomes errors about independence and size or solvency; piercing, thus, restores the incentives of contract law. *But for* piercing, outsiders would have little protection.<sup>5</sup> Contrary to recent claims,<sup>6</sup> piercing in contract disputes is desirable.<sup>7</sup>

Part II demonstrates the schism in legal attitudes about piercing by contrasting the academy's preference for piercing in tort rather than contract, with the courts' preference for piercing in contract rather than tort. Part II searches for the function of contract-centered piercing by asking how outsiders would react to its absence. Part III shows that the primary function of piercing is that of a penalty default clause.<sup>8</sup> The parent avoids the threat of future piercing by informing

---

<sup>3</sup> The terms *subjugate* and *subjugation* will be used to denote the conduct of a *parent* (a controller, *see supra* note 2) that induces the subsidiary to suffer harm in order to bestow a benefit to the parent. In other words, subjugation means that the parent sacrifices the subsidiary's interests for the parent's own benefit. This distinguishes subjugation from the exercise of control in good faith, where the subsidiary's actions are driven by its own interests. If a parent or affiliate sees benefit from the subsidiary's breach (or other conduct), then the exercise of control in good faith means that the parent or affiliate must induce that breach (or conduct) by negotiating at arm's length with the subsidiary and the outsider.

<sup>4</sup> For a definition of the term *parent*, *see supra* note 2.

<sup>5</sup> Outsiders are not protected by the contract law doctrines of mistake and change of circumstances, nor can they raise a deceit or misrepresentation claim. *See infra* text accompanying notes 27-36.

<sup>6</sup> *See generally* Steven M. Bainbridge, *Abolishing Veil Piercing*, 26 IOWA J. CORP. L. 479 (2001) (advocating the abolition of veil-piercing on the basis that deceit and other doctrines are sufficient substitutes).

<sup>7</sup> *See infra* text accompanying notes 38-54.

<sup>8</sup> While most default clauses in contract law are the product of their assumed use in a majority of contracts, penalty default clauses have consequences that one or both parties seek to avoid. Thus, penalty default clauses induce drafting, disclosure, or conduct that avoids them. *See generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). For a general discussion of default

outsiders about the subsidiary's assets and control structure. Part IV concludes.

### I. The Schism about Piercing

The jurisprudential attitudes about veil piercing are in tension. The academy's attitudes toward veil piercing are strongly in favor of piercing in tort but not in contract. In contrast, the courts disfavor piercing in tort and favor piercing in contract.

#### A. The Academy's Bias for Piercing in Tort

The source of the academy's biases about piercing may be confidence in the role of deterrence. Tort law might receive explanations besides deterrence, such as compensation and, more rarely, retribution.<sup>9</sup> Yet, those uniquely fail to justify tort law. Compensation can come from insurance and retribution from criminal or administrative sanctions.<sup>10</sup> Unique nuance dresses tort law if it is viewed as an incentive for balancing care and risk.<sup>11</sup> Some very high levels of care become unjustified because the accidents they prevent are exceedingly unlikely and small. Tort liability, therefore, is an incentive. It leads to the desirable balancing of risk and care.

Against this understanding of tort law, the academic view of the importance

---

rules, see Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. J. 389 (1993).

<sup>9</sup> See, e.g., Richard W. Wright, *Justice and Reasonable Care in Negligence Law*, 47 AM. J. JURIS. 143 *passim* (2002) (tort law is a mixture of compensation, retribution, and regulation); David G. Owen, *Deterrence and Desert in Tort: A Comment*, 73 CAL. L. REV. 665 (1985) (tort law serves several functions, including compensation and punishment).

<sup>10</sup> See, e.g., Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference Shaping Policy*, 1990 DUKE L.J. 1 *passim* (1990) (tort law by itself is insufficient to regulate all socially negative activities; the existence of criminal law shows this); Richard B. Stewart, *Crisis in Tort Law? The Institutional Perspective*, 54 U. CHI. L. REV. 184 *passim* (1987) (some conducts are better served by regulation than tort because the cause of harm is too difficult to discover and the risk of injury is too small to deter).

<sup>11</sup> The voluminous literature on the effect of negligence law on deterrence starts with the statement of the "Hand formula" in the classic case of *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (where Judge Learned Hand stated the famous formula that established the negligence standard so as to induce cost-effective care and not encourage wasteful care). The foundations of the voluminous academic literature on negligence are the now classic works by Guido Calabresi, *Optimal Deterrence and Accidents*, 84 YALE L.J. 656 (1975); Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972); Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980).

of the protection of contract law is small.<sup>12</sup> Contracting parties are governed by freedom of contract and the principle of "buyer beware."<sup>13</sup> Parties are free to negotiate for the protections they need. If contract law easily added terms to contracts, this would reduce the importance of actual clauses and their negotiation. Producing clauses is a costly endeavor. In the shadow of interventionist contract law, it is also an endeavor that the courts might ignore. The drawback of an interventionist contract system is enormous because it discourages parties from trying to customize relations, reach ideal contracts, and even from devising innovative clauses.<sup>14</sup>

At first blush, the protection that veil-piercing law affords to contracting parties appears identical to that enjoyed by parties that obtain guarantees.<sup>15</sup> An outside party that obtains a guarantee by the controller against the non-performance of the subsidiary, seems in the position of having pierced the veil and being able to impose liability on the parent. The apparent availability of a consensual substitute, the guarantee, combines with the academy's view of contract law as an enforcer of actual bargains. Since contract law should not alter bargains and parties can bargain for protection identical to veil piercing, therefore piercing in contract seems as a distortion of contracts. The argument for the abolition of piercing follows naturally,<sup>16</sup> but the original premise is false because guarantees do not protect against subsequent subjugation and are inapposite in cases of errors about size or solvency

---

<sup>12</sup> See, e.g., Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 516-24 (1976); Bainbridge, *supra* note 6.

<sup>13</sup> The distinction between the regime of buyer beware that applies in ordinary transactions and the deviation from it established by securities regulation is discussed in Nicholas Georgakopoulos, *Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671 (1994); see also, e.g., Florrie Young Roberts, *Disclosure Duties in Real Estate Sales and Attempts to Reallocate the Risk*, 34 CONN. L. REV. 1 (2001) ("buyer beware" has long governed contracts, placing the burden on the buyer to discover any negative attributes of the bargaining item).

<sup>14</sup> Paradigmatic of the concern that any infringement of freedom of contract will cause unwanted distortions is the position that invalidating contracts or clauses on the basis of unconscionability to protect the side with weak bargaining position, such as the poor, actually hurts the poor by limiting their ability to enter into contracts. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 117 (6th ed. 2003).

<sup>15</sup> Guarantees by a parent corporation offer no protection to outsiders against the acquisition and subjugation of the parent. Effective protection also requires change-of-control clauses, which change the texture of the protection and make the consensual substitute different from piercing. See also *infra* text accompanying note 44.

<sup>16</sup> See, e.g., Bainbridge, *supra* note 6.

which create the appearance that a guarantee is not needed.<sup>17</sup>

Therefore, the academy's approach to veil piercing doctrine sees only, or greater, importance in its application to tort disputes rather than to contract disputes. The analysis of this article shows that this approach does not appreciate the importance of errors and information for the shape of the contract and the protection that the parties obtain.

Compared to the academy's preference for piercing in tort, it is interesting to note that practice has moved in the opposite direction. Rather than reduce the means for using limited liability, limited liability is promoted by legislatures, the regulatory environment and the transactional practice. Legislatures help entrepreneurs use entities with limited liability. The regulatory environment secures limited liability. Transactional practice creates in profusion entities with limited liability.

The most pervasive innovation in transactional lawyering of the last thirty years is the appearance of LLCs. Limited Liability Companies have been created in every state.<sup>18</sup> Many state statutes can be read as attempting to insulate LLCs from piercing.<sup>19</sup> The emergence or even dominance of LLCs demonstrates how

<sup>17</sup> See *supra* note 15.

<sup>18</sup> For the sake of abbreviation, the following list cites only the first section of each state's statutes, omitting the year and the designation of the reporter as Annotated: ALASKA STAT. § 10.50.010; ALA. CODE § 10-12-1; ARK. CODE § 4-32-101; ARIZ. REV. STAT. § 29-601; CAL. CORP. CODE § 17000; COLO. REV. STAT. 7-80-101; CONN. GEN. STAT. § 34-100; D.C. CODE § 29-1001; DEL. CODE tit. 6, § 18-101; FLA. STAT. ch. 608.401; GA. CODE ANN. § 14-11-100; HAW. REV. STAT. § 428-101; IOWA CODE § 490A.100; IDAHO CODE § 53-601; 805 ILL. COMP. STAT. 180/1-1; IND. CODE § 23-18-1-1; KY. REV. STAT. ANN. § 275.001; KAN. CORP. CODE ANN. § 17-7662; LA. REV. STAT. ANN. § 12:1301; ME. REV. STAT. ANN. tit. 31, § 601; MD. CODE, CORPS. & ASS'NS § 4A-101; MASS. LAWS ch. 156C, § 1; MICH. COMP. LAWS § 450.4101; MINN. STAT. § 322B.01; MISS. CODE ANN. § 79-29-101; MO. ANN. STAT. § 347.010; MONT. CODE ANN. § 35-8-101; NEB. REV. STAT. ANN. § 21-1601; 2004 NEV. STAT. 86.010; N.Y. LTD. LIAB. CO. LAW § 101; N.H. REV. STAT. ANN. § 304-C:1; N.J. STAT. § 42:2B-1; N.M. STAT. § 53-19-1 – 53-19-74; N.C. GEN. STAT. § 57C-1-01; N.D. CENT. CODE § 10-32-01; OHIO REV. CODE ANN. § 1705.01; OKLA. STAT. ANN. tit. 18, § 2000; OR. REV. STAT. § 63.001; 15 PA. CONS. STAT. § 8901; R.I. GEN. LAWS § 7-16-1; S.C. CODE ANN. § 33-44-101; S.D. CODIFIED LAWS § 47-34A-101; TENN. CODE ANN. § 48-201-101; TEX. REV. CIV. STAT. ANN. art. 1528n; UTAH CODE § 48-2c-101; VT. STAT. tit. 11, § 3001; 13 V.I. CODE ANN. § 1101; VA. CODE ANN. § 13.1-1000; WASH. REV. CODE ANN. § 25.15.005; W. VA. CODE ANN. § 31B-1-101; WIS. STAT. ANN. § 183.0102; WYO. STAT. ANN. § 17-15-101.

<sup>19</sup> See, e.g., FLA. STAT. ch. 608.4227(1) (2004):

Except as provided in this chapter, the members, managers, and managing members of a limited liability company are not liable, solely by reason of being a member or serving as a manager or managing member, under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.

Nevertheless, courts apply the doctrine of veil piercing to LLCs. See, e.g., XL Vision,

legislatures and the IRS promote, rather than hinder, the use of limited liability. The proliferation of structured financing is also intimately related to the use of limited liability entities.<sup>20</sup>

## **B. The Courts' Bias for Piercing in Contract**

While the academy sees negative value in piercing in contract, courts and litigants demonstrate a bias in favor of piercing in contract disputes compared to tort disputes. In part, this bias is evidenced in the research of Professor Robert Thompson, which shows an abundance of piercing in both contract and tort disputes.<sup>21</sup>

A closer study of the data reveals additional detail from this abundance. The data allow a comparison between the overall ratio of opinions about contract disputes to tort disputes, to the ratio of opinions about piercing in contract disputes to tort disputes. If no unique biases applied to piercing opinions, then one would expect that ratio to be constant. This would mean that whatever fraction of tort opinions contract opinions are, opinions about piercing in contract would be the same fraction of opinions about piercing in tort. For example, suppose that all tort opinions were 10,000 and all contract opinions were 5,000, meaning contract opinions are half the tort opinions. This ratio is the result of multiple dynamics. If the same dynamics applied when the issue of piercing arose, then the same ratio would apply in the smaller set of piercing opinions. Suppose that the actual count revealed that the piercing opinions in contract disputes were five hundred and piercing opinions in tort disputes were about one thousand. Such a count would be unable to refute the hypothesis that litigants and courts have the same attitudes about piercing in contract as in tort. This is the "null hypothesis" for the statistical analysis that follows, the baseline for comparison.

The process used for counting contract and tort opinions and veil piercing opinions was that used by Thompson. Searches were performed on the databases of

---

LLC. v. Hollowan, 856 So.2d 1063 (Fla. Dist. Ct. App. 2003); Kaycee Land & Livestock v. Flahive, 46 P.3d 323 (Wyo. 2002) (piercing the veil of the LLC was an available equitable remedy); Bastan v. RJM & Assocs, 2001 Conn. Super. LEXIS 1605 (Conn. Super. Ct. June 4, 2001).

<sup>20</sup> For an analysis of problems akin to piercing in structured financings, see Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 BUS. LAW. 109-145 (2004).

<sup>21</sup> Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

Westlaw that collect all the opinions of state courts (named "allstates") and of federal courts (named "allfeds"). Contract and tort disputes are identified by West "key" numbers.<sup>22</sup> Following Thompson, opinions about veil piercing were identified by an additional text search.<sup>23</sup> The searches were repeated for each year from 1947 to 2003. The searches were repeated for opinions on either tort or contract. By inference, this also produced the count of opinions on both contract and tort.<sup>24</sup>

The actual counts are reproduced in Table 1. The rows correspond to opinions on contract disputes, on tort disputes, and opinions including both contract and tort disputes. The fourth row sums each column and the last two rows contain the ratio of the sums and the result of the statistical test. The column labeled "without reference to piercing" holds the count of opinions that do not mention piercing. The column labeled "referring to piercing" holds the count of opinions that do refer to piercing. The last column, labeled "predicted" holds the predicted count, i.e., the number of opinions that would mention piercing if they followed the allocation of the opinions that do not mention piercing. Because the number of piercing opinions is about half of one percent of the rest, as seen from the ratio of the sums, the predicted number is about half of one percent of each category of opinions in the first column. A statistical test can calculate the probability that the observed allocation of piercing opinions can arise if the underlying generating dynamics or

---

<sup>22</sup> Following Thompson, *supra* note 21., the key number 95 identifies contract disputes and the key numbers 48av, 48avi, 272 and 379 identify tort disputes. In a slight deviation from the methodology of Thompson, this excludes the key number for fraud, which West categorizes as tort but encompasses both contract and tort disputes.

<sup>23</sup> As in Thompson, opinions that refer to piercing are identified by searching for the terms "pierc! the corporate veil" or "disregard the corporate entity." The exclamation point is a wildcard, that finds any ending, including pierce, pierced, and piercing.

<sup>24</sup> The number of contract opinions includes some opinions on both contract and tort. Similarly, tort opinions include some on both. Summing those two and subtracting the number of opinions on either contract or tort gives the number of opinions that include both contract and tort. For example, if the contract opinions were five, three of which include tort, and the number of tort opinions is four, the number of opinions on either contract or tort are six. Summing the five contract opinions and the four tort opinions and subtracting the number of opinions about either gives three, the number of opinions about both ( $3=5+4-6$ ).

The count of contract opinions gives the sum of (i) only contract opinions and (ii) of opinions on both contract and tort, call that  $c + b$ . The count of torts gives (i) torts only and (ii) both,  $t + b$ . The count for either contract or tort, gives  $c + t + b$ . Note that the sum of the counts for contracts and that for torts counts twice the opinions on both and can be transformed from  $(c + b) + (t + b)$  to  $c + t + 2b$ . Subtracting from that, the number of the search for either,  $c + t + b$ , leaves  $b$  ( $b = c + t + 2b - c - t - b$ ).



mechanism was the same. The name of this statistical test is the chi-test.<sup>25</sup> The result is a probability of less than one in a million or 0.00001%. Statisticians can say that this evidence rejects the null hypothesis with 99.9999% confidence. In lay terms, it is extremely improbable that so many piercing opinions are about contract disputes if piercing opinions are produced by the same dynamics as overall contract and tort opinions. Piercing is invoked more in opinions about contract dispute than it is in opinions about tort.

**Table 1: Number of opinions: contract, tort and piercing**

	Without reference to piercing	Referring to piercing	Predicted
<b>Contract</b>	61,040	475	290.53
<b>Contract and tort</b>	4,375	68	20.98
<b>Tort</b>	109,901	285	520.40
<b>Sum</b>	175,316	828	
<b>Ratio of all piercing to all without piercing</b>	0.47%		
<b>Chi-test p-value</b>	0.0000...%		

That these searches do not identify piercing outcomes is not a concern for several reasons. First, the analysis does not make any assumptions about the strategies of contract and tort litigants. Unless litigants pursuing contract or tort claims act differently when they also pursue piercing, the conclusions are valid. Suppose that litigants with contract claims bring claims of less merit than tort claimants. The result would be that the number of contract disputes is disproportionately large compared to the number of tort disputes. If the same attitudes carry over to piercing, then we would still expect to see the greater number of contract claims involving piercing. This test, however, is about the ratio of contract to tort claims rather than about the true comparison of the number of contract and tort claims. As long as contract disputes involving piercing are brought with the same excess, the ratio will not change. However, since the ratio changes in

---

<sup>25</sup> See, e.g., DAVID FREEDMAN ET AL., *STATISTICS* 525 *et seq.* (3d ed. 1998).

favor of contract piercing, the conclusion is that courts and litigants do not pursue piercing in torts as much as in contract.

Moreover, Professor Thompson does count the victories in contract and tort disputes that involve piercing. The bias does not indicate weaker contract claims but the opposite, weaker tort claims and greater chance of piercing in contract disputes.<sup>26</sup> Finally, the conventional wisdom about the practices of lawyering also tends to suggest that contract lawyers do not tend to bring weak claims.

In sum, a schism between theory and practice exists in the area of veil piercing. The theoretical analysis of the academy justifies piercing in tort claims but not in contract disputes. The practice is one that promotes the insulation of entrepreneurs with limited liability against tort while it favors piercing in contract. To bridge the gap, we must find the role of piercing in contract disputes. The role of piercing can be seen by a counterfactual comparison with how parties would behave in a world with no piercing.

## II. A World Without Piercing

If piercing provides some protection, without it the parties would seek substitute protection. Returning to the scene of the opening paragraph, if the senator were aware that a mutant could impersonate his assistant, then the senator would take precautions to ensure the identity of his assistant. Outsiders dealing with corporations receive some protection from the law of veil piercing. Its assessment requires that we ask how outsiders would protect themselves if veil piercing were unavailable. The errors that piercing addresses in the context of contract disputes are errors about the subsidiary's size and errors about the subsidiary's subjugation. Before discussing outsiders' alternative protection, it is important to see that conventional contract law does not provide significant protection against such errors.

### A. Exposure under Contract Law, Common and Civil

The protection of contract law is inadequate under the doctrines of common law as well as civil law. The common law doctrine of mistake and the doctrine of frustration of purpose produce the same outcome.<sup>27</sup> Essentially, the contract is

---

<sup>26</sup> Thompson, *supra* note 19, at 1058.

<sup>27</sup> See, e.g., *Raffles v. Wichelhaus*, 2 H. & C. 906, 159 Eng. Rep. 375 (1864) (invalidating the contract where parties referred to different ships, both named "Peerless"); *Krell v. Henry*, [1903] 2 K.B. 740 (C.A.) (refusing to enforce a lease for a room with a view to

invalidated and the outsider cannot obtain expectation damages.

Suppose that outsiders entered a contract thinking that they were contracting with a properly capitalized subsidiary or thinking that they were contracting with an independent entity. Later, the outsiders found out that their counterparty was an undercapitalized subsidiary or a subsidiary that sacrificed its own self-interest for that of its parent. Would the outsiders be able to gain from attacking the contract under the mistake doctrine?

The mistake doctrine compares the actual will of the contracting sides and considers a contract formed only if their intentions did match. Significant discrepancies prevent the formation of a contract, even if the text that the parties used seemed to indicate agreement. Applied in the context of piercing, if an outsider were to persuade a court that the error was significant, the contract would be invalidated and no longer bind the subsidiary. Clearly, outsiders do not gain from attacking the contract under the mistake doctrine.

The civil law doctrine of error (*erreur*,<sup>28</sup> *irrtum*,<sup>29</sup> πλάνη<sup>30</sup>) produces voidability in favor of the erring party. In the setting of veil piercing, the erring party is the outsider. Invoking voidability, however, again invalidates the contract and precludes the outsider from obtaining breach damages, the benefit of the bargain.

The outsider is also not protected by the contract law doctrine of frustration of purpose.<sup>31</sup> The outsider may argue that the purpose of the contract was to bind an independent entity. When it turns out that the contract is ineffective because it is with a now insolvent subsidiary or a subjugated one, the outsider could argue frustration of purpose but that would not be beneficial. First, the change of circumstances does not regard the main obligation in the contract, which makes the argument unlikely to succeed. Moreover, even if the outsider were to show frustration of purpose, the result would not benefit the outsider because again the contract would no longer bind the subsidiary.

---

coronation procession when the procession was indefinitely postponed). See generally, E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 506-11, § 7.9, 720-729, § 9.7 (2d ed., 1990) (discussing the mistake doctrine, § 7.9, and the doctrine of frustration of purpose, § 9.7).

<sup>28</sup> *Erreur* is the French term that produces voidability, for example, according to § 1110 and § 1117 of the French civil code and §§ 23-24 and 31 of the Swiss code of obligations.

<sup>29</sup> *Irrtum* is the German term that produces voidability, for example, according to § 119 of the German civil code (BGB).

<sup>30</sup> πλάνη is the Greek term that produces voidability, for example, according to articles 140-142 and 154 of the Greek civil code (AK).

<sup>31</sup> See *supra* note 27.

Some civil law jurisdictions have adopted an interpretive approach that considers parties having written a clause in the contract that conditions it on surrounding circumstances remaining substantially unchanged. This is known by its Latin name *clausula rebus sic stantibus*, which roughly translates as "clause of things remaining as they stand."<sup>32</sup> An outsider might invoke it by arguing that a change of control or the event of subjugation is a significant change of circumstances that triggers the implied clause. This, too, produces the outcome of invalidating the contract and does not give the outsider expectation damages for breach. The analysis is the same as with frustration of purpose under common law.

Thus, contract law doctrine, whether in common law or in civil law, limits the outsider at most to the return of his performance and does not allow the outsider to obtain performance from the subsidiary. If the subsidiary does not have the assets to return the outsider's performance, then the outsider cannot even obtain that. Contract law doctrine does not help when the problem is error about the subsidiary's size or subjugation.

Some argue that outsiders are sufficiently protected by the jurisprudence of fraudulent misrepresentation.<sup>33</sup> However, the standards for misrepresentation are very different than those for piercing. Control is irrelevant for misrepresentation.<sup>34</sup> Misrepresentation requires actual false statements with the appropriate state of mind (knowledge of falsity and intent to deceive)<sup>35</sup> rather than the production of a false impression about independence and solvency. By contrast, piercing can occur without any fraud or false statement.<sup>36</sup>

---

<sup>32</sup> See, e.g., STEFAN SCHMIEDLIN, *FRUSTRATION OF CONTRACT AND CLAUSULA REBUS SIC STANTIBUS* (1985).

<sup>33</sup> See *Torco Oil Co. v. Innovative Thermal Co.*, 763 F. Supp. 1445, 1451 (N.D. Ill. 1991) (J. Posner) ("Since fraud is independently actionable, one may question the need for a doctrine of piercing the corporate veil in contract cases."); see also Bainbridge, *supra* note 6, at 516.

<sup>34</sup> Indeed, the maker of a false statement can be liable if it was repeated by its recipient, without regard to the independence of the person who repeated it. RESTATEMENT (SECOND) OF TORTS § 533 (1997) ("The maker of a fraudulent misrepresentation is subject to liability . . . if the misrepresentation . . . is made to a third person and the maker . . . has reason to expect that its terms will be repeated . . .").

<sup>35</sup> See *id.* at § 526 ("A misrepresentation is fraudulent if the maker . . . knows that he does not have the basis for [it]."); *id.* at § 531 ("[The maker] is subject to liability to the persons . . . whom he intends or has reason to expect to act . . .").

<sup>36</sup> Even when courts use the term "fraud" in piercing, that is often satisfied by the general unfairness or the fact that the outsider has not received the benefit of the bargain. *Freeman v. Complex Computing Co.*, 979 F. Supp. 257, 260 (S.D.N.Y. 1997) (finding that

When outsiders contract with subsidiaries with little capital while they have the innocent impression of contracting with large parents, then the piercing that imposes liability on the parents also gives the outsiders the benefit of their bargain. After the piercing, the outsiders can collect from the parties that have the size that matches the outsiders' impression. Since the safeguards and terms of contracts depend on the creditworthiness of the sides, the result of piercing is that, when it places liability on the parents, it places responsibility on the parties that have the creditworthiness on which outsiders relied.

The question becomes how outsiders would compensate for the absence of piercing and obtain comparable protection against errors about identity or solvency. As this mistake exists before the contract is formed or the transaction is executed, the alternative protection that outsiders would pursue is pre-transaction protection.

The second defect that piercing cures is not necessarily related to an error. Contract law rests on the effectiveness of the remedies it provides as incentives for the performance of contracts. However, when a controller subjugates an entity to the point of making it sacrifice its own interests to promote those of its controller, then the remedies of contract law against the subjugated entity are pointless. The subjugation of an entity may occur after the contract. It may be the result of an acquisition, a workout, or other change in circumstances. As this defect may appear after the execution of a contract, the alternative protection that outsiders would pursue would be post-transaction protection.

## **B. Pre-Transaction Protection**

Outsiders that cannot have the benefit of piercing have alternatives. They can protect against the possibility that their impression of their counterparty's size is false by additional precaution. This precaution, however, results in waste because information that is immediately available to the corporation is more difficultly obtained by the handicapped outsider.

### **1. Precaution**

Outsiders may compensate for the possibility of errors in various ways. Since the relevant error is the confusion of a subsidiary for its parent, the financial information about the parent is useless and, to the extent it induces outsiders not to

---

Glazier committed fraud because his actions left the plaintiff "as a general creditor of an essentially defunct corporation with virtually no assets.").

seek stricter terms in their contracts, it increases their harm. The protection of outsiders requires information about the difference between the subsidiary and its parent or siblings. Yet, that information is not available to outsiders.<sup>37</sup>

Moreover, the agents and officers of the parent can also represent the subsidiary and be its officers. While the formal aspect of contract and agency law seems to avoid uncertainty about the identity of the counterparty,<sup>38</sup> the reality may pave the way to mistakes.

The undesirability of precautionary research lies in its waste. The information that the outsider obtains at significant cost is already known to the subsidiary. Moreover, the waste is repeated, since in all contracts of a subsidiary, all outside parties will pursue the same information.

## 2. Discounting the Gain from Contracts

The difficulty and the cost of precaution may lead outsiders to other ways of protection against the risk of error. Perhaps outsiders may reduce transactions with corporations, generally. In economic terms, this reaction could be explained as a discounting by the outsider of the value of the transaction. The discounting corresponds to the increase of the outsider's risk (i.e., the reduced protection) that is the result of inability to pierce the veil. Compared to the reaction of expending more effort to ascertain the identity of the counterparty, it may appear that avoiding transactions is not as costly. The proper assessment, however, is not only that it is likely more costly for the individual, but also that it is almost surely more costly for society.

For the individual, discounting the benefit of trades with corporations (for the lack of piercing<sup>39</sup>) is the alternative to expending effort or money in establishing their identity and assets. The choice, however, influences the risk that outsiders bear. Obtaining information does not only avoid the need to discount but it also reduces

---

<sup>37</sup> Even if the parent has stock that is traded publicly and, therefore, is subject to the disclosure obligations of the securities laws, the financial information in those disclosures is "consolidated." The parent and all its subsidiaries appear as a single entity without providing readers an easy understanding of a subsidiary's finances.

<sup>38</sup> The doctrine of agency law also seeks to prevent the misleading effect of common agents. See *RESTATEMENT (THIRD) OF AGENCY* § 6.05.

<sup>39</sup> Needless to say, individuals may have reasons other than the absence of piercing for discounting benefits from trades with subsidiaries. As the focus of this analysis is on piercing, the surrounding circumstances that are not influenced by piercing must be assumed to stay constant.

risk. The proper comparison of the reduced risk of piercing is with the reduced risk of having exercised precaution and obtained information about a subsidiary's identity and size.<sup>40</sup>

For society, the harm is lost gains from trade. The decision of individuals to discount their own benefits means that some contracts become unappealing. However, when contracts fail to occur, the social calculus includes both sides' loss.

---

<sup>40</sup> The effect is visible in an example that tracks contracts and potential contracts in both settings, where some effort reduces error and where outsiders accept the higher error and discount their benefits. Suppose that piercing never occurs and that in 40% of contracts of a specific type the outsiders make innocent errors where, without the error, they would not enter in the contract in this form. Instead, outsiders would require clauses that would protect them. Assume the protection would have been to require payment within one week instead of three. If the outsiders observed size accurately, out of every hundred contracts, in forty they would require payment within a week and in the remaining sixty within three weeks. Because outsiders cannot make that distinction, in every contract they require payment in two weeks. Still, forty contracts are erroneously lenient and sixty erroneously strict.

Out of the forty erroneously lenient contracts, suppose that in one quarter, i.e., in ten, nonperformance occurs because of the additional week afforded to the subsidiaries for payment. Supposing the outsider loses \$100 in each such case, the aggregate loss due to the error is \$1,000.

The discounting would seek to spread that loss over the hundred contracts. Spreading the loss of \$1,000 over a hundred suggests ten per contract ( $10=1,000/100$ ). Outsiders would discount their benefits by \$10 if they are neutral toward risk and somewhat more if they are averse to it. The risk does not change despite the fact that the adjustment means that some fraction of outsiders will not enter into contracts. The adjustment will depend on elasticity of demand. Suppose it is such that 10% fewer contracts occur. All numbers drop by 10%. Instead of 100 contracts, only 90 occur, instead of 40 being erroneously lenient, only 36 are (while 54 instead of 60 are strict). Instead of 10 failures, only 9 occur, and they cost outsiders \$900 instead of \$1,000. The risk for outsiders does not drop. The loss of \$900 from 90 contracts still corresponds to \$10 per contract ( $10=900/90$ ).

By comparison, suppose that an amount of effort by outsiders allows them to observe a piece of imperfect information about the subsidiaries' size. Subsidiaries' size is large or small, with sixty being large and forty small. This information allows outsiders to draw a correct inference about the subsidiaries' size in 80% of the cases. Accordingly, they give three-week payment terms to 80% of the sixty large subsidiaries but also to 20% of the small ones. Thus 48 large ones and 8 small ones get three-week terms. Twelve large and 32 small get one-week terms. The example has erroneous lenience as the only source of loss. A quarter of the subsidiaries under erroneously lenient terms fail when those are two-week payment. Somewhat more than a quarter should be expected to fail now that the erroneously lenient treatment is three weeks. However, only eight in a hundred are subject to falsely lenient treatment. If the failure rate stayed at a quarter, two would fail and cause harm of \$200 to outsiders. Even if three fail, they cause harm of \$300 and the loss of the outsiders per contract is about \$3. A comparison with the alternative of losing \$10 per contract, suggests that outsiders save about \$7 per contract and should be willing to expend about \$7 to obtain this type of information.

### 3. Incorporation Pointlessness?

Also important is a distortion caused by the lack of piercing. If piercing never occurs, then outsiders bear the error from the false perception of a subsidiary's identity and assets. Rather than investigate or discount their benefits, outsiders can prefer contracts with individuals instead of corporations. Errors about individuals' identity and assets are much less likely. This type of protection, however, reduces the gains from deploying the corporate form. While the corporate form and limited liability aim to enable the taking of entrepreneurial risks, lack of piercing may lead to avoidance of corporate contracts and reduced marketability of their products or services. At its extreme, this reaction to lack of piercing renders useless the option of incorporating.

In sum, the pre-transaction reactions to the repeal of veil piercing appear undesirable. Outsiders must protect themselves against innocent errors. To the extent that outsiders expend more effort investigating, the result is undesirable because they bear a cost to produce information that the counterparty could provide, and that may have been produced in previous transactions. To the extent outsiders discount their gains, they bear additional risk. To the extent that trades do not occur, society suffers lost contracts and loses the joint gains from trade. These effects of pre-transaction protection correspond to those of transaction costs because the absence of piercing functions as a transaction cost, a burden to the outside party of every contract with a corporation. If outsiders react by resisting contracts with corporations, this reduces the gains from having corporations, the associated promotion of entrepreneurship and diversification.

### C. Post-Transaction Protection

While veil piercing protects parties from errors at the time of the contract, it also protects against *subjugation*.<sup>41</sup> If a parent subjugates a subsidiary, then the subsidiary sacrifices its own interests to promote those of the parent, ignoring the incentives to perform its own contracts and avoid breach penalties. Unlike errors, subjugation may arise after the formation of the contract. When trying to assess the role of piercing law by hypothesizing its absence, in a world without piercing, outsiders would seek protection that would be effective against subjugation after the formation of the contract.

This setting is different from errors about identity and assets, that were

---

<sup>41</sup> For a definition of *subjugation*, see *supra* note 3.



discussed above. The difference is clarified by precluding errors by hypothesis. At the time of the contract, the outsider knows the assets of the subsidiary and that it is controlled by the parent. Outsiders with this information can protect themselves against future subjugation in two ways, by guarantees and by change-of-control clauses.<sup>42</sup>

Guarantees make the guarantor secondarily liable for a primary obligor's obligation. In the setting of the subsidiary's contract with an outsider, the guarantee is for the outsider's benefit. The subsidiary is the primary obligor and its parent is the guarantor. If the parent sells the subsidiary, the guarantee remains in effect. An outsider might elect to release a parent who is selling a subsidiary but, presumably, the outsider would require an equivalent guarantee by its acquirer. Thus, the guarantee of the parent can be expected to lead often to guarantees by subsequent acquirers.

A guarantee eliminates the parent's temptation to subjugate the subsidiary because it makes the parent liable for its obligations. Outsiders are protected because the damages for breach that would fall on the subsidiary, if it did not perform, will fall on the parent. The parent, therefore, does not benefit by having the subsidiary breach this contract to promote the parent's interests.<sup>43</sup>

---

<sup>42</sup> The astute reader may propose security interests as one more form of protection. Strictly speaking, this is correct. Subsidiaries that pledge their assets to secure their liabilities to outsiders do limit their controllers. For example, their controller cannot induce the sale of those assets for full value (a sale that may have been followed by business practices that would undermine the subsidiary's ability to perform or pay damages). However, security interests also have drawbacks. The subsidiary's pledge-worthy property is likely already pledged to secure financing. Even if such property is available, encumbering it precludes future financing, making it too limiting for the business. Furthermore, security interests are problematic in that they do not protect against bad management and deterioration of the subsidiary's financial condition. This is particularly true when the asset securing the obligation is depreciating or is a group of assets with a value that depends on managerial decisions, such as machinery. Even less is the protection given by the pledge of a security interest in the subsidiary's stock. The controller can eliminate its value by poor management and the outsider may not be allowed to exercise control during a bankruptcy process. *See, e.g., In re Fairmont Communications Corp.*, 155 B.R. 64 (Bankr. S.D.N.Y. 1993) (court rejected plan of creditors to establish committee to sell debtor's assets on which creditors could sit, vote on, and veto, sales); *In re Bicoastal Corp.*, No. 89-8198-8P1, 1989 Bankr. LEXIS 2046 (Bankr. M.D. Fla. 1989) (court rejected petition of creditor to enforce loan agreement with debtor which would have allowed debtor to elect board members and control activities of debtor until loan repaid). *Cf. In re Marvel Entertainment Group*, 209 B.R. 832 (D. Del. 1997) (court allowed the exercise of voting rights to elect new board because they were exercised by non-creditors who happened to be creditors of the parent company).

<sup>43</sup> The controller's interest must also be less than the cost of subsidiary's breach. If

Outsiders can also protect themselves against future subjugation of the subsidiary by including change-of-control clauses in their contract. Change-of-control clauses are typically phrased so as to consider a change in the ownership of the subsidiary or its parent as a basis for accelerating all its future obligations under the contract. When such clauses are used in loans to the subsidiary, this means that the subsidiary's entire obligation becomes due. This is devastating financially. From the perspective of the outsiders, however, this ensures that the acquirer will not disregard the subsidiary's contract obligations. Since the subsidiary's obligations become due, if the acquirer wants to obtain the outsiders' consent for restoring the timing of the original contract, then the acquirer must make the outsiders completely comfortable with the new ownership.

Finally, guarantees and change-of-control clauses are not substitutes. Without guarantees, outsiders are not protected against subjugation by the current parent. Without change-of-control clauses, outsiders are not protected against acquirers of the current parent. Outsiders who contract with subsidiaries of a publicly controlled parent, even if they obtain guarantees by the parent, are not protected against a subsequent acquisition of the parent and subjugation of both the parent and the subsidiary by the acquirer.

In sum, guarantees and change-of-control clauses, combined, offer solid protection against subjugation of the subsidiary by either its current parent, a buyer of the subsidiary, or a buyer of its parent. An important issue is whether they would be part of most contracts, in which case the argument could be made that guarantees and change-of-control clauses should be (customary) default terms, which would obviate veil-piercing. Clearly, the courts do not treat them as default terms. The paradigmatic case is *Metropolitan Life v. RJR Nabisco*.<sup>44</sup> The dispute sprung from the acquisition of RJR Nabisco in a leveraged buyout. The deal's size, its nature, and the personalities involved were such that it was the subject of a successful book that also

---

the controller's gain is greater than the breach obligation, then even controllers who gave guarantees would have their subsidiaries breach even if they were not subjugated. The subsidiary would require compensation by the controller and would pay its breach obligation, meaning that the outsider would not be harmed. This is analogous to efficient breach. See *Thyssen, Inc. v. S.S. Fortune Star*, 777 F.2d 57, 63 (2d Cir. 1985) (breaches of contracts that are wealth-enhancing even after compensating injured party for its expectation interest in the contract are efficient and should be encouraged); see also *XCO Int'l, Inc. v. Pac. Sci. Co.*, 369 F.3d 998, 1001 (7th Cir. 2004).

<sup>44</sup> 716 F. Supp. 1504 (S.D.N.Y. 1989).

became a cable movie, *Barbarians at the Gate*.<sup>45</sup> The issue before the courts was much more pedestrian. Metropolitan Life held over half a billion dollars of RJR Nabisco obligations, which used to be considered very safe. The planned acquisition called for its merger with the acquiring corporation, which would borrow enormous amounts to pay for RJR's stock. This change of control, the merger, meant that a single corporation, the merged entity, would owe RJR's obligations, so that the claims from the financing of the acquisition would swamp the old claims, such as that of Metropolitan. The risk that the post-acquisition RJR would fail and not repay its obligations was much greater than that of the old RJR. This meant buyers—the market—discounted the value of such claims, like Metropolitan's claim.

Metropolitan would have been protected by a change-of-control clause. The clause would have been triggered by the buyout and the merger. The principal amount of its claim would have become due. Although after the RJR buyout, change-of-control clauses would become frequent, Metropolitan did not have one. It sought protection in court.

Metropolitan's argument was based on contract interpretation, good faith and fair dealing. The court rejected it. If the court had accepted it, then contract interpretation would protect against harm from changes of control. Injecting such protection would likely be excessive. The new RJR might not fail yet Metropolitan would receive full payment. The new RJR could also fail under circumstances that the old RJR would also have failed, and granting Metropolitan additional protection would have improved its position.

Change-of-control clauses and guarantees neither are, nor should be, part of default contracts. They entail real costs for their promissors. However, lenders or obligees who do not obtain them seem to have little alternative protection. Subsidiaries and independent corporations alike may be dominated. The main alternative seems to be again individuals. In a jurisdiction without piercing, the danger of future subjugation of subsidiaries could lead outsiders to prefer to deal with individuals.

In sum, this survey of protection for outsiders before and after a contract with a subsidiary finds few substitutes and they tend to be undesirable. Present errors can be avoided with research, but that is repetitive and wasteful, since the information could be provided by the subsidiary at little cost. Future domination can

---

<sup>45</sup> BRYAN BURROUGH & JOHN HEYLAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990); *BARBARIANS AT THE GATE* (Glenn Jordan 1993).

be avoided with guarantees and change-of-control clauses, but their cost likely exceeds that of piercing. Both defects can be addressed by a bias in favor of dealing with individuals that erodes the jurisdiction's gain from limited liability and the corporate form.

### III. The Function of Piercing

From the estimation of outsiders' reaction to the absence of veil-piercing, it is possible to derive its function. Veil piercing mitigates the distrust toward the corporate form, prevents wasteful searches for information and deters the seeking of clauses that would impede restructurings.

#### A. Pre-Transaction: Penalty Default

An example shows how piercing functions akin to a penalty default or *in terrorem* clause. Suppose that some confusion exists about the distinction between a parent and a subsidiary. The subsidiary is in the process of negotiating a long-term contract with an outsider. Although the outsider has not asked for a guarantee, the parent already has determined that it will not grant such a guarantee. The parent seeks to reduce the chance that the outsider may later be able to pierce the subsidiary's veil and impose liability on the parent.

Compare the effect of the parent's passivity to that of sending a letter signed by parent's counsel that informs the outsider that the parent will assist the subsidiary to perform but shall not guarantee the subsidiary's obligation. Passivity has no influence on the outsider's possible error. The letter, by contrast, informs the outsider of the difference between the parent and the subsidiary. The outsider will not be able to allege a mistake about the subsidiary's identity or its separation from the parent. Indeed, the courts routinely refuse to pierce in these circumstances.<sup>46</sup>

The fear of veil-piercing induces the production of the information that precludes outsider confusion between parent and subsidiary. This function is similar to that of penalty defaults. The possibility of future liability induces the parent to provide information, and that prevents the undesirable result.

The fear of piercing induces the parent to inform the outsider about the subsidiary's assets and control. As a result, during the negotiation of the contract,

---

<sup>46</sup> See PHILLIP I. BLUMBERG ET AL., BLUMBERG ON CORPORATE GROUPS § 69.04[B] nn.33-56 (2d ed. 2005) ("Cases Refusing to Pierce the Veil Where No Misrepresentation or Confusion Has Been Shown," citing over 90 cases).

piercing functions akin to a penalty default clause.<sup>47</sup> It prevents the wasteful investigation by the outsider. The information is provided to the party that needs it and faces a large cost of getting it.

**B. Post-Transaction: Counter Anti-Commons?**

Change-of-control clauses give outsiders the power to block some acquisitions and restructurings that create new holding corporations. While outsiders can use this power as intended — to prevent acquisitions and restructurings that increase the risk of their claims — outsiders may also exceed the intended scope of their power and block acquisitions and restructurings that do not increase the risk of their claims. As change-of-control clauses cannot differentiate and prevent their excessive use, their proliferation has the effect of hampering acquisitions and restructurings. In effect, the proliferation of change-of-control clauses would create a collective action problem akin to the prisoner's dilemma or to what has been called an anti-commons problem. Whereas collectively the firm and all its stakeholders would have chosen to allow some beneficial acquisitions and restructurings, the selfish interests of the holder of a change-of-control clause may be to threaten to block the transaction in order to extract some gain. Thus, the likely desirable policy is to limit the incentives on outsiders to obtain change-of-control clauses. The law of veil piercing influences the intensity of the need that outsiders feel for change-of-control clauses. If veil piercing is easy, outsiders can impose liability on a new parent by piercing the veil. This reduces the new parent's incentives to abuse control. In turn, outsiders become less concerned about changes of control and, therefore, are less desirous of change-of-control clauses.

Outsiders have a reduced need for the clauses because the ease of piercing the veil makes them partly redundant. To the extent that outsiders could use the change-of-control provision to assess the probability that the acquirer would abuse control and, in response, to negotiate appropriate protection, easy piercing is a substitute.

Since veil piercing law is thus linked to the frequency of change-of-control clauses, the legal system must choose its piercing policy in conjunction with the policy about the frequency of change-of-control clauses. In most types of contract clauses, the policy analysis does not interfere with their frequency. The conventional wisdom used to be that clauses that impose costs on third parties should be deterred

---

<sup>47</sup> See *supra* note 8.

but the current analysis follows the insight of Coase that outsiders will become involved in the bargain if they can do so with no cost (and no other impediments or distortions). Accordingly, if the policy choice about veil piercing in reaction to subverting control is motivated by the policies surrounding change-of-control clauses, the analysis must address some impediments faced by third parties, the impediments that distort or prevent their influence on such agreements. However, change-of-control clauses do not significantly harm third parties. They may even confer a benefit on other outsiders who do not have such clauses by reducing the probability of a disadvantageous change of control.

The analysis of change-of-control clauses must also take into account other legal protection against disadvantageous changes of control that outsiders may have. Alternative protections of outsiders would reduce the importance of change-of-control clauses. As a matter of policy, to the extent protection of outsiders is desirable, its availability means a reduced need for piercing. Also, if outsiders have alternative protection, they will pursue change-of-control clauses less often. Thus, adequate alternative remedies mitigate the potential harm of outsiders by changes of control on veil-piercing policy.

Outsiders get protection against the dangers of subjugation under several legal doctrines. Every doctrine has some complexity. The nature of the protection that each offers to outsiders is different.

Outsiders can avoid excessive payments to shareholders under the law of fraudulent transfers as well as under corporate law that also imposes liability on directors. If an acquirer obtains control of a solvent subsidiary, outsiders having contracts with the subsidiary may reasonably fear that the acquirer may cause the subsidiary to distribute its assets to the acquirer. If this transfer leaves the subsidiary unable to fulfill its obligations to the outsider, this would mean that it is in insolvency, either in the sense that its assets do not cover its debts (known as "balance sheet insolvency") or in the sense that it is unable to meet its obligations as they become due (known as "equity insolvency"). Either type of insolvency renders fraudulent a transfer for less than reasonably equivalent value. Dividends to shareholders are not exchanges for any value. Repurchases of the corporation's stock perform the same function and, since the repurchased shares are cancelled, also do not involve a true exchange. Accordingly, such dividends and repurchases are

fraudulent and the outsiders can void them.<sup>48</sup> State corporation statutes contain analogous prohibitions against excessive distributions to shareholders. They offer an additional remedy, compared to fraudulent transfer law, because they also impose liability on the directors of the corporation. The statutes use various standards to determine inappropriate dividends. They are mostly consistent with fraudulent transfer law. The principal exception is known as “nimble dividends” and allows the distribution of the current year’s profits even if the corporation is insolvent.<sup>49</sup>

Outsiders also have some protection from corporate law doctrine against sales to looters. When a corporation’s board of directors approves a sale to a buyer and the board should have known that the buyer would usurp corporate assets to the detriment of the creditors, then the creditors have been allowed to turn against the board.<sup>50</sup> For outsiders, this protection augments slightly that against fraudulent or improper dividends. If a looting buyer leaves the corporation unable to perform its obligations, outsiders would be able to invoke the impropriety of the transfers that exhausted the corporation’s assets. Attacking those transfers as fraudulent and improper gives outsiders claims against the looters and the board installed by the looters. Those are likely to be mostly the same individuals and likely judgement-proof. The outsiders’ claim against the pre-sale directors makes sales to looters less likely.

When the corporation becomes insolvent, the directors’ fiduciary duty to shareholders shifts to creditors, including the outsiders as claimants pursuant to their contract.<sup>51</sup> This shift of fiduciary duties prevents opportunistic decisions that would hurt creditors. When a corporation that is near insolvency is faced with a risky decision, the benefits from the favorable resolution of the risk accrue to its shareholders, but the loss from bad luck burdens its creditors. The result is that the directors, whom the shareholders elect, would take risks that a solvent corporation would not, exposing creditors and outsiders to losses. The shift of fiduciary

---

<sup>48</sup>The transfers that render the corporation unable to meet its obligations as they become due violate §4(a)(2)(II) and are fraudulent as to both existing and future creditors. The transfers that render the corporation insolvent in the balance sheet sense violate §5(a) and are fraudulent only opposite existing creditors.

<sup>49</sup> See, e.g., DEL. CODE ANN. tit. 8, § 170(a) (2007) (“or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.”).

<sup>50</sup> See ROBERT C. CLARK, CORPORATE LAW § 11.4.1 (1986) (“Sales to Looters”).

<sup>51</sup> See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. 1991).

obligations protects outsiders by ensuring that directors make their decision after including its possible effect to the outsiders and other creditors. This protects outsiders against the disregard of the corporation's ability to fulfill its obligation to them rather than against the intentional incapacitation of the corporation; the law of fraudulent transfer protects against the latter harm.

Outsiders may also benefit indirectly from the precedent of *Perlman v. Feldman*,<sup>52</sup> which deters a controlling shareholder's sale at a premium, if the premium captures the value of the controlled corporation's extraordinary market position. The corporation's extraordinary market position was the national moratorium against raising steel prices during the Korean War and the associated shortage of steel. Rather than raise the prices for its steel, the steel producing corporation in *Feldman* obtained payments for its steel long in advance of delivery. The buyer, who paid the unusually large premium for the controlling block of stock, was a manufacturer of steel products. Consider the position of outsiders with contracts to buy steel. The buyer, thirsty for more steel, was likely seeking abundant steel that would allow an expanded production of strongly demanded steel products. This explains the unusually large premium and its impropriety. The premium was being paid for steel, rather than control of the corporation, but the steel was a corporate asset from which minority shareholders could not be excluded. Return to the outsiders with outstanding advance purchases of steel. If the buyer cancelled some of these contracts, the outsiders' remedy may well pale compared to the gain that the buyer would enjoy from expanded production. More than a remote analogy exists with a subjugation that would justify piercing the veil. To the extent that corporate law deters such sales, it prevents one more type of opportunistic action that might harm outsiders.

That several measures protect against subjugation of a corporation by an acquirer weakens the argument that veil-piercing is motivated by the concerns surrounding changes of control. Subjugation, however, of a corporation by its parent can occur without a transaction selling control. The erstwhile controllers may shed their attitudes granting it the independence to pursue its self-interest. The succession of generations changes the individuals behind control. Those may also change through reorganizations in bankruptcy and from the mere deterioration of the corporation's finances. Because no consensual change of control occurs, outsiders

---

<sup>52</sup> 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955).



lose the protections they enjoy in consensual changes of control. The importance of veil piercing in those settings is much greater than when a negotiated change of control triggers alternative remedies. Veil piercing is more appropriate pursuant to non-consensual changes of control than to consensual changes of control.

### C. Refinements

The clear distinctions of this academic analysis are a rarity in practice. Errors about identity entangle with errors about subjugation. Controllers may not be parents and clear abuse of the corporate form may be acceptable because substitutes are preferable to the fear of liability by entrepreneurs.

Consider the following two hypotheticals. They illustrate the confusion that the outcomes of veil piercing can cause.

*Jenson Hypothetical:* An outsider, Jenson, negotiates with a subsidiary that appears to be independent. Jenson is unaware that his counterparty is dominated. The controlling parent is in the same business as the dominated subsidiary and uses its product as an input. The subsidiary does not perform the contract with Jenson. Should Jenson expect to be successful in imposing the breach liability on the parent?

The *Jenson* hypothetical fits perfectly the analysis of this article. Jenson seems to have been victimized by dealing with a puppet, a straw-person. The incentives of contract law fail because the puppeteer subordinated the interests of the puppet to his own. Jenson's contract offered no assurance of performance. Since Jenson did not know this, Jenson could neither negotiate for protection nor compensate by adjusting other terms. The liability for breaching Jenson's contract must fall on the parent.

The actual case on which the *Jenson* hypothetical is based used lender liability rather than piercing because the controller was not a shareholder but a lender. Nevertheless, the underlying policy is identical and the court used the analogous doctrine of lender liability to produce the same result. The controller bore the liability to plaintiffs like Jenson.<sup>53</sup>

*Freeman Hypothetical:* An outsider, Freeman, enters into an employment contract with a corporation by negotiating with its parent. Unlike Jenson, Freeman knows that the parent dominates the corporation. Also unlike Jenson, Freeman has the sophistication to recognize the difference. Freeman alleges breach of contract by the corporation. Should he expect to be successful in imposing the breach liability on the parent?

---

<sup>53</sup> A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981).

The pattern of the *Freeman* hypothetical does not fit neatly in the analysis of this article. Insofar as Freeman's argument rests on domination, it appears indistinct from the *Jenson* hypothetical. If the parent subjugated the subsidiary and rendered it insolvent, then the breach damages do not induce performance. However, Freeman's sophistication and knowledge relates to the nature of piercing as a penalty default. At the time that Freeman negotiated the contract, he knew of the domination and had the sophistication to address it. Yet, he did not extract a guarantee from the parent. Therefore, Freeman assumed the risks associated with the parent's domination. He may have adjusted other terms to compensate for that risk (although that is not mentioned in the opinion). If the court allowed Freeman to pierce the veil, he would be protected for a risk that he assumed. Indeed, the court on these facts did not pierce the veil.<sup>54</sup>

The *Freeman* hypothetical has an additional difference from that of *Jenson*. *Jenson's* case involved a non-consensual change of control. In the *Freeman* hypothetical, however, the parent did not change. If Freeman did not have the sophistication to negotiate for contractual protection against changes of control or the circumstances did not allow it, then the result might change. Under the circumstances, however, Freeman's sophistication suggests that he could have negotiated against changes of control but chose to bear its risk.

#### IV. Conclusion

This Article showed that piercing has a valid role in contractual disputes because it functions akin to a penalty default clause, inducing the disclosure of control and identity of subsidiaries by parents who seek to reduce the danger of subsequent piercing. Nevertheless, the normative impact of this analysis allows the distinction between lack of subsidiary independence at the time of the transaction and subsequent subjugation of a corporation. The consensual means — change-of-control clauses — by which outsiders obtain protection against subsequent subjugation impose a burden on restructurings and corporate transactions. Moreover, substitute creditor protection may exist in cases of overt sales of control but not in cases of covert assumption of control. Thus, the analysis reveals that piercing is a valuable component of corporate law and informs its application.

---

<sup>54</sup> *Freeman v. Complex Computing Co.*, 119 F.3d 1044 (2d Cir. 1997).

Disclosure of a subsidiary's size or subjugation at the time of the transaction should prevent piercing. Subsequent siphoning of assets or subjugation should lead to piercing. A different piercing standard seems justified in cases of subjugation after the transaction, with the standard for piercing being easiest to meet in the case of a change of control that does not involve an acquisition.