

Should Shareholders Be Personally Liable for the Torts of Their Corporations?†

John Walkovszky was struck by a taxi owned by the Seon Cab Corporation. As a result of the accident he suffered a double fracture of the pelvis and a possible skull fracture; he may be partially disabled for life. To pay his claim for half a million dollars compensation, Seon could put forward as assets only two mortgaged taxi cabs and \$10,000 of insurance. The corporation's meagre assets contrasted strikingly with the wealth of its dominant shareholder: he allegedly owned ten other two-cab corporations. Walkovszky asked the New York Court of Appeals to "pierce the corporate veil" and hold Seon's owner personally liable, but the court dismissed his plea for failure to state a cause of action.¹

Corporations owned by affluent shareholders, yet too impoverished to meet their tort liabilities, are the inevitable product of present-day

† President Nicholas Murray Butler of Columbia said in 1911: "[I]n my judgment the limited liability corporation is the greatest single discovery of modern man. . . . Even steam and electricity are far less important . . . and they would be reduced to comparative impotence without it." 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF CORPORATIONS* § 21 (1917). President Eliot of Harvard regarded limited liability as "by far the most effective legal invention for business purposes made in the nineteenth century . . ." Cook, "Watered Stock"—Commissions—"Blue Sky Laws"—Stock Without Par Value, 19 MICH. L. REV. 583 n.4 (1921). This note questions this long-assumed desirability of limited liability insofar as corporate torts are concerned.

Since the contract creditor voluntarily selects those to whom he lends, and does so with knowledge of whom he may hold to account for his loan, there is no apparent reason why limited contract liability is inequitable. If the contract creditor wants to hold corporate shareholders liable for a debt, he may contract with them accordingly. If he fails to do so, there is little justification for giving him the benefit of a bargain he did not make.

As a statutory grant to incorporated businesses, however, limited contractual liability may in practice be of questionable benefit to the close corporation. If an enterprise has earnings and assets sufficient to warrant a loan on its own credit, a lender would probably consent to limited liability whether or not the enterprise was incorporated. Conversely, a lender is likely to require the owners to assume personal responsibility for a loan to any kind of enterprise without such earnings and assets. O'Neal thus observes that "in practice, incorporation often does not provide limited liability for the participants, because banks and other prospective creditors may require them to assume personal liability for the corporation's obligations as a condition to furnishing needed resources to the corporation." 1 H. O'NEAL, *CLOSE CORPORATIONS* 40 n.11 (1958).

1. Telephone interview with Laurence Lauer, Attorney for Walkovszky, February 27, 1967. See also *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966). Several years before Walkovszky's accident, John Mull was crushed between his own automobile and a taxi operated by Colt Co., Inc. Because of the injuries he sustained, Mull underwent more than twenty surgical operations and was hospitalized over two hundred days, incurring \$30,000 in medical bills. His left leg was badly shattered and his right ultimately amputated. To cover Mull's claim for compensation, Colt could put forward as assets only two used taxi cabs and \$5,000 of insurance. The shareholders of Colt reputedly owned over one hundred corporations, each possessing two taxi cabs. *Mull v. Colt Co.*, 31 F.R.D. 154, 156-57 (S.D.N.Y. 1962).

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incorporation laws. Modern statutes invite financial irresponsibility by granting immunity from tort liability to the shareholders of all incorporated businesses.² Even where shareholders have incorporated for the clear purpose of escaping tort liabilities,³ claims against the firm must be satisfied solely from corporate assets.⁴ The logical result is the two-cab corporation, designed to be painlessly sacrificed at the first major accident.⁵

Taxi owners are not the only entrepreneurs who incorporate to limit their tort liabilities. Shareholders of real estate,⁶ entertainment,⁷ shipping,⁸ and manufacturing⁹ enterprises, for example, have successfully used limited liability to escape personal responsibility for the torts of their corporations. As a consequence, plaintiff law firms in metropolitan areas will often have two to three cases a year in which their client's recovery is thwarted by the corporate fiction.¹⁰

2. Seon Co. was organized under the N.Y. BUS CORP. LAW, Section 628(a) of which provides that:

A holder of or subscriber for shares of a corporation shall be under no obligation to the corporation for payment for such shares other than the obligation to pay the unpaid portion of his subscription which in no event shall be less than the amount of the consideration for which such shares could be issued lawfully.

Section 630 qualifies this limitation of liability by making the ten largest shareholders of certain closely held concerns personally responsible for various wage claims.

Unlike New York, Delaware makes limited liability optional with shareholders rather than mandatory. DEL. CODE tit. 8, § 102(a)(7). Cf. ARIZ. REV. STAT. § 10-122(9) which precludes limited liability unless affirmatively provided in the corporate charter.

3. Elenkrieg v. Siebrecht, 238 N.Y. 254, 262, 144 N.E. 519, 521 (1924), states the judicial permissiveness with respect to the motive for incorporation:

Many a man incorporates his business or his property and is the dominant and controlling feature of the corporation. He may do so for the very purpose of escaping personal liability, and he may do so as a cover if in fact the corporation really exists

Some courts have even gone so far as to hold that no inquiry may be made as to whether a business was "incorporated in good faith, or whether incorporation was a mere form and an evasive device on the defendant's part to escape an individual responsibility for the conduct of the business." Werner v. Hearst, 177 N.Y. 63, 67, 69 N.E. 221, 221-22 (1903).

4. "[I]t is fundamental that a corporation has a separate and distinct existence apart from its stockholders . . . and in the absence of fraud, the liability of the corporation is not the liability of the shareholders. . . ." McMillan Welding & Mach. Works v. General Towing Co., 247 F. Supp. 402, 405 (E.D. La. 1965). This immunity extends to tort as well as contract claims. Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, 155 N.E. 58 (1926), *reargument denied*, 244 N.Y. 602, 155 N.E. 914 (1927).

5. In Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962), the court fails to determine whether the fragmentation of a single business into separate corporate entities will justify shareholder liability. That issue was recently answered negatively in Walkovszky v. Carlton, 18 N.Y.2d 414, 419, 223 N.E.2d 6, 9, 276 N.Y.S.2d 585, 589 (1966) the court observing that had the taxicab fleet been owned by a single corporation, it would be readily apparent that the plaintiff would face formidable barriers in attempting to establish personal liability on the part of the corporation's stockholders. The fact that the fleet ownership has been deliberately split up among many corporations does not ease the plaintiff's burden in that respect.

6. Elenkrieg v. Siebrecht, 238 N.Y. 254, 144 N.E. 519 (1924).

7. Banks v. Jones, 239 Ark. 396, 390 S.W.2d 108 (1965).

8. *In re Sheridan*, 226 F. Supp. 136 (S.D.N.Y. 1964).

9. Petrovich v. Felco Chem. Corp., 194 Misc. 111, 86 N.Y.S.2d 327 (Sup. Ct. 1949).

10. The problem is especially acute for real estate owned by "slum landlords," taxi and

The Inadequacy of Judicial Controls

Courts have evolved a variety of techniques to hold shareholders personally responsible for the debts of their corporations.¹¹ Sometimes, judges have "pierced the corporate veil" on the theory that shareholders have used the corporation as a "mere instrumentality," "alter ego," or "agent."¹² In these cases, shareholders are precluded from invoking the corporate fiction to shield themselves from personal liability when they commingle corporate assets with their own, or when they mislead another as to their personal responsibility for the debts of their business.¹³ Since contract creditors who have relied on the corporation's appropriated assets or who have been deceived by the apparent lack of a corporate entity have a clear grievance, the use of the "alter ego" rule to hold the owners makes eminent good sense in this context. But on such

trucking fleets. Telephone interviews with members of the bar in Boston, Chicago, Cleveland, Los Angeles, Miami, New York, and Phoenix, December 13 & 15, 1966.

For taxicab operations within New York City, the problem has reached almost scandalous proportions.

It is common knowledge that owners of large fleets of taxicabs, for the purpose of limiting the amount of a possible recovery with respect to any accident, have developed a method of continuing to operate those large fleets of many hundreds and perhaps a thousand taxicabs, and yet maintaining the ownership of such taxicabs in the fleet in the names of many corporations [N]o more than three or perhaps four taxicabs are registered in the name of any one corporation. . . .

Boyle v. Judy Cab Corp., 24 Misc. 2d 746, 747, 203 N.Y.S.2d 309, 310-11 (Sup. Ct. 1960). One New York Justice thus concludes:

(1) that the public is inadequately protected with respect to compensation for personal injuries . . . ; (2) that the true owners of most of the large fleets of taxicabs are using a corporate device to defraud the public; and (3) the State and the city are unwitting accomplices of a legalized racket to avoid liability for payment for the negligent maiming and killing by taxicabs.

Teller v. Clear Service Co., 9 Misc. 2d 495, 503, 173 N.Y.S.2d 183, 190 (Sup. Ct. 1958).

11. These techniques are sufficiently ambiguous that courts in the same jurisdiction will reach inconsistent results. Compare *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962), with *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966), both decided under New York law. See also cases cited *infra* note 18.

12. "When one corporation controls another, and uses it as the means, agency and instrumentality by which the former carries out and performs its business, it is liable for the torts of the latter." *Mangan v. Terminal Transp. Sys.*, 157 Misc. 627, 631, 284 N.Y.S. 183, 188 (Sup. Ct. 1935), *aff'd*, 247 App. Div. 853, 286 N.Y.S. 666 (3d Dep't 1936). Such language has inspired one commentator to conclude that what these theories "come down to, once shorn of verbiage about control, instrumentality, agency and corporate entity, is that liability is imposed to reach an equitable result." E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 191 (1936). Unfortunately, the conclusion better describes hopes than reality.

13. The figurative terminology "alter ego" . . . is generally used [to hold the] equitable owners of a corporation . . . liable when they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will (see *Riddle v. Leuschner*, 51 Cal. 2d 574, 577-81, 335 P.2d 107 [1959]; *Thomson v. L. C. Roney & Co.*, 112 Cal. App. 2d 420, 429, 246 P.2d 1017 [2d Dist. 1952]); [and] when they hold themselves out as being personally liable for the debts of the corporation. (*Stark v. Colter*, 20 Cal. 2d 839, 847, 129 P.2d 390 [1942]).

Minton v. Cavaney, 56 Cal. 2d 576, 579, 364 P.2d 473, 475 (1961). See also N. LATTIN, CORPORATIONS 66-67 (1959).

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a rationale, the "piercing" doctrine cannot protect *tort* creditors; they have neither relied nor been deceived.

Some courts believe that shareholders who are careless in following the rites of incorporation law sacrifice their statutory immunity.¹⁴ But holding that a tort victim's recovery depends on whether shareholders have observed the statutory formalities before the accident makes compensation turn on circumstances purely fortuitous to the tort claim. Furthermore, shareholders can avoid liability simply by being careful, which is to say, simply by retaining adequate counsel. In all probability, corporate owners are especially cautious where their primary purpose in creating the corporation is to avoid personal liability. Even where shareholders have been sloppy, the judgment creditor faces formidable practical obstacles to recovery. The rule imposing liability for neglect of formalities calls for proof of facts which counsel may be unable to obtain under state discovery procedures; even with the federal rules, they may involve such time and expense in the gathering that a plaintiff may be compelled to settle.¹⁵

Some commentators have said that courts will "pierce the veil" when shareholders have supplied their corporation with inadequate capital.¹⁶ But undercapitalization has never been more than one of several factors

14. Thus *Walkovszky v. Carlton*, 18 N.Y.2d 414, 420, 223 N.E.2d 6, 10, 276 N.Y.S.2d 585, 590 (1966), concludes that if shareholders use their corporation as a mere instrumentality or alter ego, "such a 'perversion of the privileges to do business in a corporate form' . . . would justify imposing personal liability on the individual stockholders." Presumably the state thereby encourages business arrangements which conform to the much discussed "corporate norm."

15. Telephone interview with Laurence Lauer, counsel for John Mull and John Walkovszky, on December 13, 1966. Mull's experience illustrates the delay which can attend a corporate entity case. Mull was injured in 1958, yet it was not until 1962 that the suit had advanced to the point where the court could determine that his pleadings stated a cause of action for which relief could be granted. Already financially pressed and faced with the prospect of further delays and costs, Mull settled for \$100,000, although his claim was worth \$250,000 in the opinion of counsel and judge. Telephone interview with attorney for John Mull on February 22, 1967.

16. Ballantine asserts:

It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risk of loss, this is a ground for denying [limited liability].

BALLANTINE, CORPORATIONS 303 (rev. ed. 1946). The authorities Ballantine cites, however, clearly illustrate that he has overextended his assertion. The two cases presented for direct support (*id.* at 303, n.56) involve not shareholder liability, but the entirely different doctrine of equitable subordination, in which shareholder claims against their corporation are subordinated to the claims of other creditors. *Pepper v. Litton*, 308 U.S. 295, 310 (1939); *Hanson v. Bradley*, 298 Mass. 371, 379-81, 10 N.E.2d 259, 263-64 (1937). Other cases cited under the topic *Inadequate Capital* (BALLANTINE, *supra*, at n.55) involve corporate "dummies" established with no capital, or do not refer to undercapitalization at all. *Dixie Coal Mining & Mfg. Co. v. Williams*, 221 Ala. 331, 128 So. 799 (1930); *Christian & Craft Grocery Co. v. Fruitdale Lumber Co.*, 121 Ala. 340, 25 So. 566 (1898); *Mosher v. Salt River Water Users' Ass'n*, 39 Ariz. 567, 8 P.2d 1077 (1932).

courts have considered in deciding whether to pierce the corporate veil.¹⁷ In any event, the "undercapitalization" doctrine is no solution for tort cases. When courts determine the sufficiency of capitalization, they look only to the *proportion* of assets constituting shareholder equity;¹⁸ they refuse to judge the adequacy of *total* corporate assets. Indeed many state corporation statutes expressly allow a corporation to do business with nominal assets.¹⁹ Thus the "undercapitalization" doctrine does nothing about the corporation which has neither borrowed funds nor equity to meet potential tort claims.²⁰

17. It seems that there are, in fact, no authorities which justify a disregard of a corporation's separate existence solely because of its undercapitalization (as opposed to no capitalization) when its controlling stockholder has at least regarded the formalities of its existence. See *Fisser v. International Bank*, 282 F.2d 231, 240 (2d Cir. 1960). A plaintiff's attempt so to use the doctrine is thus usually summarily dismissed by a statement such as "the corporate form may not be disregarded merely because the assets of the corporation together with the . . . insurance coverage . . . are insufficient to assure . . . the recovery sought." *Walkovszky v. Carlton*, 18 N.Y.2d 414, 419, 223 N.E.2d 6, 9, 276 N.Y.S.2d 585, 589 (1967).

"An obvious inadequacy of capital, measured by the nature and magnitude of the Corporate undertaking, has frequently been an important factor" influencing a court to deny limited liability on other grounds, however. *Anderson v. Abbot*, 321 U.S. 349, 362 (1944). "The legal implication of capital inadequacy seldom finds explicit recognition in decisions, the results of which are masked behind such terms as 'instrumentality,' 'agency,' or 'alter ego,' presumably because of the difficulty of articulating a satisfactory basis for introducing capital inadequacy as a liability determinant." Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1382 (1938). See also Douglas & Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 YALE L.J. 193, 203-04 (1929).

18. See *Luckenbach S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir. 1920), where the court notes that a subsidiary, organized with \$10,000 of capital, leased from its parent corporation steamships worth several million dollars. See also *Herman v. Mobile Homes Corp.*, 317 Mich. 233, 26 N.W.2d 757 (1947), where two subsidiaries, one organized with \$5,000 and the other with nothing for capital, undertook duties involving the use of over \$1,000,000 in materials supplied by the parent. For a case ignoring the issue of adequacy of capitalization with respect to assets available for creditor claims, see *Moe v. Harris*, 142 Minn. 442, 172 N.W. 494 (1919), in which owners of a corporation with no capital were nonetheless insulated from liability.

19. In California and Delaware, for example, three or more persons may organize a corporation, without meeting any minimum capital requirement. CAL. GEN. CORP. LAW § 300; DEL. CODE tit. 8, § 101. Incorporation was intentionally made this easy by legislators who desired to lure industry to their states and profit from the issuance of corporate charters. See *Liggett v. Lee*, 288 U.S. 517, 557-64 (1933) (dissenting opinion of Brandeis, J.). The attainment of that goal would be impeded were courts to impose capital requirements without legislative authority.

20. In addition, courts concerned with the adequacy of funding arrangements for tort liability would be more interested in insurance than in capital requirements. For instance, if each year an industry had ten firms, any one of which could be faced with a \$100,000 tort claim, under the undercapitalization theory each would have to hold \$100,000 in reserves, even though in any given year only one firm would actually incur the tort liability. For the nine firms which committed no tort, the reserves would be wasted if their businesses had no use for additional investment. The logical reply is that the ten firms should pool their risks so that (assuming all firms face the same accident risk) every year each firm would hold in reserve only ten thousand dollars, which would be turned over to the one firm that actually incurred the tort liability. This risk pooling, however, which is presently achieved by insurance, has never been required by a court applying an undercapitalization theory. This is understandable since the theory has traditionally been concerned with how much debt a corporation may contract for, which is not a problem

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Despite the "piercing" doctrines, then, shareholders are still virtually immune from the claims of tort victims so long as they treat their corporate entity with proper respect. To be sure, where the corporation's assets are sufficient to cover its obligations, shareholder immunity harms no one. But when debts to tort creditors exceed assets, limited liability throws the losses resulting from accidents or defective products upon tort victims. Present law permits such loss shifting even for the close corporation²¹ whose shareholders, as corporate officers, are personally responsible not only for the operational policies giving rise to the tort, but also for the failure to accumulate sufficient assets or insurance to satisfy the tort judgment. The limitation of risk curtails the personal interest such shareholders would have in insuring or accumulating reserves against tort liabilities, and in operating their business as safely as possible.²² As a consequence, limited liability thwarts the objectives of modern tort law—compensation for the injured, deterrence of future accidents, and punishment of the personally culpable.²³

In one contemporary view, losses arising from corporate acts are as much a part of the cost of doing business as is workmen's compensation;²⁴ corporations should therefore compensate for injuries connected with their operations, regardless of "fault" and "negligence" notions. But whether a corporation is held strictly liable for its activities, or is accountable only for its negligence, shareholder immunity conflicts with the premises of tort liability. Business enterprises liable to their victims under either approach escape responsibility by recourse to the corporate fiction.

soluble by insurance principles; moreover, "courts will not, without a legislative mandate, compel a business to carry insurance. See *Teller v. Clear Service Co.*, 9 Misc. 2d 495, 173 N.Y.S.2d 183 (Sup. Ct. 1958).

21. Indeed, even for one-man corporations. Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473, 477 (1953).

22. The amount of insurance an enterprise carries is a function of the risks it faces and the assets it has subject to those risks. Accordingly, as limited liability restricts the assets available to satisfy tort claims, the amount of insurance an enterprise maintains will also be reduced.

At times limited tort liability even exerts a perverse influence, inducing shareholders purposely to cut their costs by thinly capitalizing their corporation and carrying only minimal insurance. In *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962), for example, defendants created over 100 corporations, each with two taxicabs and meager insurance. "While part of the motivation for this proliferation of corporations is undoubtedly inspired by tax avoidance considerations, it is equally certain that the more compelling motive is the desire to evade paying the full amount of recoveries for personal injuries resulting from the negligent operation of these taxicabs." *Id.* at 159.

23. Compare W. PROSSER, THE LAW OF TORTS § 4 (3d ed. 1964) with 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 26.5, at 1372-74 (2d ed. 1956).

24. The multiplicity of views with respect to "enterprise liability" is discussed in Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 499-517 (1961), and Morris, *Enterprise Liability and the Actuarial Process—The Insignificance of Foresight*, 70 YALE L.J. 554 (1961).

One justification for limited liability is that it encourages industry.²⁵ By shifting part of the tort risk to the victims, incorporated enterprises avoid the expense of fully funding their liabilities. But this means that the tort victims of infant industries subsidize the owners. If society at large benefits by the development of new businesses, then society, not particular victims, should provide the subsidy.²⁶

Personal Liability for Shareholders of the Close Corporation

The "piercing" doctrines developed by the courts have not yet become generally applicable, and because of the limited situations in which they can come into play, they probably never will. Two solutions are possible. A statutory requirement that shareholders assume personal responsibility for corporate torts would ensure the "piercing" doctrines the universal application they need to protect tort victims. Any failure to provide corporate resources sufficient to meet tort liabilities should suffice to justify piercing the veil. Since shareholders can insure their enterprise against tort liability, or accumulate reserves to meet it, they can easily protect themselves from personal liability if they want to.²⁷

Alternatively, compulsory insurance for small corporations would protect tort victims without intimidating investors. After outlining a proposal for shareholder liability in close corporations, we shall compare the two approaches.

Why Not All Corporations?

The conclusion that shareholders should not enjoy limited tort liability applies generally to all enterprises. But in practical terms, the need to hold the owner of the close corporation is particularly great. The close corporation is seldom substantially owned by passive investors

25. *E.g.*, "The object and intention of the legislature in authorizing the association of individuals for manufacturing purposes, was, in effect, to facilitate the formation of partnerships, without the risks ordinarily attending them, and encourage internal manufacturers." *Slee v. Bloom*, 19 Johns. 456, 473 (N.Y. 1822).

26. Of course, a few marginal companies may not earn enough to bear the added expense of accumulating reserves or procuring insurance against tort liabilities. But if an enterprise earns too little to cover these costs, it does not produce a net social benefit irrespective of the personal profits of the corporation's owners. Such an enterprise should contract its business to a point where it is profitable, or cease operations altogether; it would do so if forced to pay the true cost of its operations. See Morris, *Enterprise Liability and the Actuarial Process—The Insignificance of Foresight*, 70 YALE L.J. 554, 556 (1961).

27. Garrett & Garrett, *Choosing the Form of Business Enterprise*, 1954 U. ILL. L.F. 359, 368. Liability insurance was unknown until practically the end of the last century. C. CROBAUGH & A. REDDING, *CASUALTY INSURANCE* 395 (1928). It may be questioned whether legislatures would have adopted limited tort liability in the first place had insurance been as generally available in the early nineteenth century as it is today.

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(although occasionally some of its shareholders, like limited partners, may take no active part in the conduct of the business).²⁸ The charters of many close corporations enable each shareholder-owner to elect certain directors and preclude corporate action unless all or nearly all directors concur.²⁹ In this respect, the shareholder of the close corporation functions no differently from the partnership member, who enjoys no personal immunity from the obligations of his business.³⁰

In the publicly held corporation, on the other hand, shareholders are too numerous and dispersed to take part in managerial decisions.³¹ Even if they could participate, they are usually neither inclined nor competent to do so. Like lenders of capital, these shareholders pay their money and await their dividends,³² without substantial power to shape corporate policies.³³ Since these "passive owners" lack the personal responsibility that close corporation shareholders have for corporate operations, and since they are unable to affect corporate funding policies, the equities justifying personal liability are correspondingly less substantial. And the practical problems would be immense. Even if tort claimants could recover from a manageable number of shareholder defendants, shareholders paying the tort victims' judgments would then have to sue the non-defendant owners for their proportionate obliga-

28. "In the . . . close corporation . . . often the same persons are both managers and shareholders, with no clear differentiation separating one capacity from the other." Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1376 (1956). See also O'Neal, *Foreword to A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U.L. REV. 700 (1958).

29. See *State ex rel. Ross v. Anderson*, 31 Ind. App. 34, 67 N.E. 207 (1903); *Katcher v. Ohsman*, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953); *Benintendi v. Kenton Hotel, Inc.* 294 N.Y. 112, 60 N.E.2d 829 (1945); Note, 28 COLUM. L. REV. 366 (1928). See also Hoffman, *Distribution of Control in Organizing Close Corporate Enterprise* (1964 P.L.I. Materials).

30. Close corporations are thus frequently described as "Chartered Partnerships." See, e.g., *Ripin v. United States Woven Label Co.*, 205 N.Y. 442, 447, 93 N.E. 855, 857 (1912).

31. Industrial giants of course have a multitude of shareholders. American Telephone and Telegraph Company has 2,840,500 stockholders, MOODY'S PUBLIC UTILITY MANUAL 94 (August 1966); General Motors, 1,313,038 (common), MOODY'S INDUSTRIAL MANUAL 2959 (June 1966); and Standard Oil of New Jersey, 727,825, *id.* at 2669. But there are 2,400 companies listed on the various stock exchanges which typically have numerous investing shareholders. 29 SEC ANN. REP. 39 (1963). For example, to be listed on the New York Exchange, a company must have 600,000 publicly held shares and at least 1,500 shareholders who hold 100 or more shares each. On the American Stock Exchange, each company must have 750 public shareholders who hold a total of 200,000 or more shares. Gilroy, *Responsibilities of Public Corporations* 7 (1964 P.L.I. materials).

32. "[The business corporation] enables skilled entrepreneurs to enlist large masses of capital which they employ to the advantage of the absentee owners." Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1375 (1956). Thus "the position of ownership has changed from that of an active to that of a passive agent" in the public corporation. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 66 (1932).

33. "Finally, in the corporate system, the 'owner' of industrial wealth is left with a mere symbol of ownership while the power, the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control." A. BERLE & G. MEANS, *supra* note 32, at 68.

tions. The thought of collecting *pro rata* shares from, say, the nearly three million holders in AT&T suggests grist for the lawyers, but little else of social value.³⁴

A system of personal liability for public corporation shareholders would also make it more difficult for corporations to offer their shares to the public. The ordinary investor would not want to place his entire personal fortune at the risk of strangers.³⁵

Finally, since publicly held concerns tend to have greater assets, it is less likely that limited tort liability will result in a shift of losses to the tort victim.³⁶

A Statute for the Close Corporation

If these factors³⁷ justify retaining limited liability for shareholders in public but not close corporations, then any statute repealing limited liability must distinguish between the two.³⁸ The closely held concern

34. For a discussion of the legal confusion concerning contribution among parties who share a joint liability, see 1 F. HARPER & F. JAMES, TORTS § 10.2 (1956).

35. Empirical data is difficult to gather on this point, but the history of the New England corporation leads Dodd to conclude that "It is probably true that the wide distribution of corporate shares among large numbers of small holders which has come to be a characteristic feature of most of the larger industrial enterprises of the present day could not have come about if share-ownership still involved personal liability for corporate debts." Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351, 1378 (1948). Conversely, Dodd believes that limited liability did not substantially influence the development of business when it was carried on primarily by the close concern. In fact, Dodd believes New England could have delayed the introduction of limited liability for fifty years without significantly retarding business; for it wasn't until a half century after New England generally introduced limited liability that business organizations grew to the scale where limited liability was useful. *Id.* at 1378-79.

36. Publicly held corporations listed on the New York Stock Exchange must have \$5,000,000 in net assets available to common stock, and an average net income after taxes of over \$400,000 for the past three years or their "delisting" will be considered. NYSE COMPANY MANUAL at A291-96, 2 CCH 1967 FED. SEC. L. REP. ¶ 23,177. It seems reasonable to assume that publicly held corporations not listed on the exchange also are likely to have substantial assets in comparison to the average closely held concern. There will, of course, always be exceptions. In contrast to the public issue corporation, "most close corporations are small businesses with relatively few assets." *Symposium—The Close Corporation*, 52 NW. U.L. REV. 345, 346-47 (1957). For the number of corporations in various asset size classes, see *infra* note 50.

37. These factors underlie the substantial difference in the legal positions of close and publicly held concerns. For a description of the different treatment accorded the two entities, see O'Neal, *Development in the Regulation of the Close Corporation*, in 8 CORR. PRACTICE COMMENTATOR 267 (1966).

38. Israel's once remarked "that no satisfactory all-purpose definition of a close corporation appears ever to have been worked out." Israel, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948). The definitional problem is sufficiently great that the New York Joint Legislative Committee to Study Revision of the Corporation Laws, the committee that drafted the present New York Business Corporation Law, concluded that no definition clearly delineates between close and public-issue corporations and therefore declined to draft a separate close corporation statute. Hoffman, *New Horizons for the Close Corporation in New York under Its New Business Corporation Law*, 28 BROOKLYN L. REV. 1-2 (1961). This Note, of course, does not attempt to draft an all purpose definition.

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has traditionally been defined as "a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."³⁹ Unfortunately, such a definition is too general to alert shareholders that they own stock in an enterprise not affording them the traditional immunity.

To warn shareholders of their potential liabilities, the statute abrogating personal immunity should define the close corporation as "any incorporated enterprise whose common stock is held by or for not more than twenty-five persons." Twenty-five shareholders constitute a group both small enough to come up with a plan for protecting themselves against personal liability, and large enough to ensure that close corporation owners do not escape the new liability at the outset of the definition. Under this definition, an entrepreneur might attempt to evade close-corporation status by bestowing insignificant stock interests on each of twenty-five friends. To avoid this result, the statute should include as shareholders only those with "substantial" stock holdings, amounting to 1 per cent of the total stock or \$10,000 book value.⁴⁰

If shareholders are to protect themselves against personal liability, they must know whether their enterprise is likely to become a close corporation in the future. That would be impossible to determine if the corporate status can fluctuate daily as investors buy and sell shares. To prevent such fluctuations, corporate status should be determined

39. *Brooks v. Willcuts*, 78 F.2d 270, 273 (8th Cir. 1935). In 1963, Florida enacted a special statute to govern close corporations, and defined the term to mean corporations "for profit whose shares of stock are not generally traded in the markets maintained by securities dealers or brokers." FLA. STAT. ANN. § 608.0100(2) (Supp. 1966).

Subchapter S (§§ 1371-77) of the INT. REV. CODE OF 1954 is intended to "make it possible for small corporations which are essentially partnerships to enjoy the advantages of the corporate form of organization without being made subject to possible tax disadvantages of the corporation." Senate Report, 1954 *U.S. Cong. & Ad. News* 4752. For its definition of the close corporation, see INT. REV. CODE OF 1954, § 1371(a).

40. Accordingly, a close corporation could be defined as *an incorporated enterprise whose common stock is owned by or for not more than twenty-five persons, not counting those who own stock representing neither one per cent or more of the outstanding common stock nor more than a total book value of \$10,000.*

The definition refers to stock held "by or for" a shareholder, so that stock held by a trust or a corporation may be attributed to the trust beneficiary or the corporation's controlling shareholder. Shareholders thus cannot avoid having their enterprise classed as a close corporation by distributing their stock to "controlled entities." Barring such "attribution," on the other hand, a trust, corporation, or unincorporated association would presumably be deemed a separate person. Courts might well be guided by the attribution of stock ownership rules set forth in INT. REV. CODE OF 1954, § 318.

Book value is used here because, unlike other measures of value, it is virtually always ascertainable and it generally reflects the corporate assets available to satisfy tort claimants. If accounting practices tend to understate the value of corporate assets, so that a corporation has fewer shareholders with stock valued at over \$10,000, the conservatism will, to the benefit of tort victims, increase the probability that the enterprise will be deemed a close corporation. The converse is true when more liberal accounting practices are followed.

before the start of each year. A suitable statutory provision is outlined in the margin.⁴¹

The proposed statute must take two additional factors into account. First, since public corporation shareholders are not to be held (on the theory that they are essentially passive lenders) it would seem that passive close corporation investors should also avoid personal liability. Like passive lenders generally, they are unlikely to have a voice in the corporate policies giving rise to torts or failing to fund resulting liabilities adequately; they too have no real influence over the steps the enterprise takes to insulate shareholders from personal loss.

Second, the statute should cover the preferred or senior security owner who holds substantial power over the enterprise, either because he holds a corporate office or because his security has general voting privileges. Such a member of the firm should not escape personal liability simply because his stake in the business is not denominated "common stock." Statutory provisions for passive and controlling interests are set out in the margin.⁴²

41. *For purposes of determining shareholder liabilities, an enterprise which was a close corporation on any day of the first nine months of the preceding calendar year shall be conclusively presumed to be a close corporation throughout the present calendar year. In all other cases an enterprise shall be conclusively presumed not to be a close corporation.* Thus in October of each year, shareholders may determine whether they are participating in a close enterprise, and if they are, they have three months to obtain insurance or take other precautions.

If an enterprise has no operating history in the prior year, this provision would allow a closely held concern to operate as though it were not a close corporation, at least for the year of its incorporation. Rather than grant such immunity to a newly incorporated enterprise, the statute should also provide that *if a corporation did not exist in such nine month period, it shall be conclusively presumed to be a close corporation if it was such at any time during the three months preceding the tort for which shareholder liability is sought.* Shareholders could protect themselves against possible fluctuations in their corporation's status by funding their corporation's tort liabilities as though they were personally liable for them. Since the possibility of fluctuation terminates in the year succeeding incorporation, shareholders would not be unduly burdened.

42. To protect the passive owner of common stock but reach the active holder of preferred or senior securities, the statute creating shareholder liability should provide that *Any person who holds stock or securities in a close corporation for other than investment purposes shall be personally liable for torts the corporation commits while he owns such stock or securities.* Stock held for investment purposes is here to be distinguished from stocks held for purposes of gaining control or a right to participate in the enterprise. The difference, often stressed under our security laws, between stock held for investment as opposed to resale purposes is not relevant. For the latter use of investment purpose see 1 L. LOSS, *SECURITIES REGULATION* 665-87 (2d ed. 1961).

Under the statute a court could impose liability upon the owners of stock (whether preferred or common) and bonds whenever the owner manifested anything more than purely passive investment intentions. Since a person actually sharing management powers within a corporation or having the power to do so because of substantial stock ownership is unlikely to be a merely passive investor, the statute should provide that *Any person who actively participates in the management of an enterprise, as an officer or director, or who owns more than ten per cent of the corporation's outstanding common stock, shall be presumed to hold his stock or securities for other than investment purposes.* With this presumption, a court and—more important—those connected with a close corporation should

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The obligations the statute will impose upon passive and active investors in the close corporation parallel the distinction presently drawn between passive and active partners in the limited partnership.⁴³ Presumably, courts will resort to partnership law when they deal with the close corporation (which in fact is often termed the “chartered” or “incorporated partnership”). With the statutory repeal of limited tort liability, these two economically similar enterprises will more nearly bear the same risks.

While all active holders in the close corporation will be liable for corporate torts, it is expected that shareholders will require their enterprise to meet tort claims before they themselves are compelled to do so. It is also expected that shareholders will agree, probably in the corporate charter, to apportion the losses they bear among themselves. If through oversight the holders fail to agree on a contribution arrangement, a small stock- or bond-holder may incur a disproportionate share of the corporate liability. To prevent such inequity, the statute should provide for *pro rata* contribution among all shareholders.⁴⁴

Insurance Schemes as an Alternative to Statutory Liability

Compulsory liability insurance could serve as an alternative to personal liability for shareholders. It would have several advantages. Insurance could be required of publicly held as well as close corporations, thus offering broader protection to the tort victim. Investors would not

have little difficulty in separating passive investors from the active participants in the business. Only in an extraordinary case should a person not within the statutory presumption be deemed to hold his stock or securities for other than investment purposes.

43. Forty-two states, the District of Columbia and the Virgin Islands all operate under some version of the Uniform Limited Partnership Act. See 8 UNIFORM LAWS, ANNOTATED 9 (Supp. 1966). While in a limited partnership the limited partners are liable for partnership obligations only to the extent of their investment, this protection is not available to a partner who takes any active part in the management of the business. *Holzman v. de Escamilla*, 86 Cal. App. 2d 858, 195 P.2d 833 (4th Dist. 1948).

44. The statute could provide that *any owner of stock or securities who pays a corporate tort judgment shall be entitled to contribution from those also liable for the tort. Unless otherwise explicitly agreed, each contributor shall indemnify the person so paying a tort judgment in the same proportion that the par or stated value and paid-in-surplus attributable to his stock or securities bears to the total par or stated value and paid-in-surplus of stock or securities held by persons liable for the corporate tort.* Under this normative pattern for contribution, the indemnity investors owe the payor of a tort judgment that exceeds corporate assets is proportionate to the capital they have invested in the corporation. Par, or in the case of no par stock, stated value, is the initial measure of the amount of capital an investor has placed in an enterprise. But to account for a corporation which sets the par or stated value of its stock and securities at less than their market value, paid-in-surplus is also included as a measure of the capital invested. Investors may agree to some other apportionment of liability; however, if such an agreement is not explicit, a court is not to infer it. The protection afforded by this contribution provision is thus not to be upset by vague or loosely indicated understandings.

be intimidated by the threat of ruinous personal liability. Successful plaintiffs would have access to a minimum fund, while shareholder liability may offer nothing but a claim upon judgment-proof stockholders.⁴⁵ Finally, an insurance plan would escape the intricacies and loopholes of a statutory definition of close corporations.

Still, compulsory insurance does not offer an unmixed blessing. Since the necessary type and amount of insurance vary from corporation to corporation,⁴⁶ a flexible insurance program is essential. But the decisions in such a system cannot be left to the individual corporations. A state regulatory commission will have to supervise, review, and revise corporate insurance requirements. The cost of creating and supporting such a regulatory apparatus is likely to be prohibitive: The commission would have to make continuous decisions on business risks for companies occupying virtually the entire private sector of the economy.⁴⁷

Perhaps a compulsory insurance program could simply establish a minimum coverage for all corporations. But that minimum, if geared to average needs, will be too low for some businesses and too high for others. In addition, many corporations will have to pay an insurance carrier to fund liabilities that they could meet more cheaply as self-insurers.⁴⁸

To mitigate the administrative costs of a compulsory insurance scheme,⁴⁹ the state may prefer a hybrid arrangement. The state could

45. Of course, even insurance companies have occasionally become judgment-proof, that is, unable to indemnify their policyholders. For example, a member of the Illinois bar handled several cases last year in which failure of the insurer thwarted recovery from an insolvent corporation. Telephone interview with member of the Illinois bar Dec. 13, 1966.

46. The following excerpt illustrates the kind of variations to be expected.

Products liability [insurance] rates are worked out jointly by the National Bureau of Casualty Underwriters and the Mutual Insurance Rating Bureau. However, for about one quarter of the risks . . . there are no uniform rates, because the hazard in some industries varies too much from enterprise to enterprise. For the remaining three quarters of insurance uniform rates have been established according to industries and, in some cases, kinds of product.

Morris, *Enterprise Liability and The Actuarial Process—The Insignificance of Foresight*, 70 YALE L.J. 554, 569-70 (1961).

47. There exists no comparable program from which costs could be inferred. For the cost of present insurance regulation programs, see *infra* note 49.

48. A compulsory insurance program that expects premiums to be bargained out freely and fairly in the market place may not be realistic for the close corporation. The smaller an enterprise, the less capable it is of ascertaining its individual risks so as to prove a right to insurance premiums which deviate from the normal rate. See Morris, *supra* note 46, at 560. Moreover, the smaller enterprise is typically unable to bargain effectively with insurers. See, e.g., Andres, *What is Wrong with Taxicab Insurance Rates?* 15 LAW & CONTEMP. PROB. 563 (1950). The extensive and costly regulation of premiums is, therefore, probably a necessary incident to any compulsory insurance scheme for close concerns.

49. In 1957, 18 states operated their insurance departments with less than \$100,000, 13 states with \$100,000-200,000, and the remainder were topped by New York with a budget

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impose shareholder liability on all close corporations and compulsory insurance on all public-issue enterprises. But stockholders in many close corporations might rather have their corporation buy the required insurance than expose themselves to personal liability. And shareholders in some small corporations which were classified as "public" might find insurance so expensive that they would prefer personal liability. Both groups could be accommodated by allowing each corporation to elect between compulsory insurance and shareholder liability.

Another alternative to compulsory insurance would be a provision for declaration of realizable assets. A corporation could exempt itself from the insurance requirement by filing an affidavit with the Secretary of State that it maintains net assets of a certain minimum realizable value. If at any time the corporation's liquidation value declined, additional insurance would have to be obtained. To avoid the need for extensive state supervision, corporate officers filing a false affidavit could be subject to strict civil liability and criminal prosecution in case of wilful misrepresentation.⁵⁰

Compulsory insurance, then, involves a good deal of schematizing to cover the tort victim without imposing mammoth administrative costs on the state. A personal liability statute, while no less complex, would have some characteristic advantages.⁵¹ First, the public would be spared the expense of the regulatory apparatus that would have to accompany

of \$4,000,000. F. CRANE, *AUTOMOBILE INSURANCE RATE REGULATION 62* (1962). Some of these states clearly lacked resources for an adequate regulatory program. S. KIMBALL, *ESSAYS ON INSURANCE REGULATION 105* (1966). In view of these substantial expenses incurred for regulatory efforts that are relatively minimal, the cost of expanding insurance regulation to evaluate the premiums paid for liability coverage by every corporation in America will not be insignificant.

50. The following table shows the number of active corporations in various asset size classes:

Assets	Number of Corporations
Under \$100,000	757,841
\$100,000 to \$999,999	450,622
\$1,000,000 to \$49,999,999	74,321
\$50,000,000 and over	3,031
Total corporations with assets	1,285,815

Source: U.S. DEPT. OF COMMERCE, BUREAU OF THE CENSUS, 1966 STATISTICAL ABSTRACT OF THE UNITED STATES 494 (Data for 1963).

In the table, assets are measured without a deduction for liabilities. If all corporations are required to maintain a total of \$1,000,000 in assets and insurance, it is evident that over 90 per cent of them will be compelled to purchase some insurance, and that half will have virtually no opportunity to self-insure.

51. A shareholder liability statute limited to close concerns would embrace most corporations, since close corporations far outnumber public-issue enterprises. *Symposium—The Close Corporation*, 52 Nw. U.L. Rev. 345 (1957).

any compulsory program. Second, each enterprise could obtain the type and amount of insurance best suited to its peculiar business risks and financial situation. Third, the amount of insurance carried will not be determined by the political pressures that frequently induce legislators to set unrealistically low requirements.⁵² Fourth, should the corporation's estimate of its potential liability prove too low, the assets of the shareholders automatically provide a second fund. Fifth, so long as shareholders were willing to risk everything they had, they would be free to enter into a risky undertaking for which insurance is either unavailable or obtainable only at prohibitively expensive rates. Finally, if shareholders are to be personally liable for the torts of their corporations, they will merely receive the same treatment that the law has long accorded the members of the partnership.⁵³ If a corporation is instead required to carry a specified amount of insurance, it operates under a statutory restriction not imposed on its partnership cousin, even though the two forms of enterprise are often functionally indistinguishable.

Of course, where shareholders are free to choose the best program for funding the torts of their enterprises, they are also free to choose an inadequate program. But where they are personally liable for all judgments their corporations cannot meet, they have every incentive to plan carefully and even over-cautiously. There is no reason to assume that shareholders who are better acquainted with the peculiarities of their business than some far-away bureaucrat are less able to exercise sound judgment on what insurance provisions they need.⁵⁴

52. Thus the cab that struck John Mull was required to carry only \$5,000 of liability insurance. N.Y. VEHICLE & TRAFFIC LAW OF 1929 § 17, *as amended*, Laws of 1940, ch. 646. The taxi that struck John Walkovszky was compelled to carry only \$10,000. N.Y. VEHICLE & TRAFFIC LAW § 371(1)(a).

53. "A partnership . . . does not insulate the businessman from personal liability because there is, at least theoretically, no legal distinction between the partners and the partnership." *Symposium—The Close Corporation* 52 Nw. U.L. Rev. 345, 353 (1957).

54. A state which enacts a shareholder liability, compulsory insurance, or hybrid plan should apply its law to any corporation, whether domestic or foreign, which does business within its borders and there commits a tort. A domestic corporation which does business outside of the state would thus suffer no competitive disadvantage vis-à-vis corporations organized elsewhere, and a foreign corporation which enters the state for business purposes would be subject to the same liabilities as domestic concerns.

If a corporation has enough contacts with a state to be capable of committing a tort within its borders, presumably it would be found to be doing business there. If a corporation is in doubt as to whether it is doing business within a particular state, it should take steps to fund liabilities which might arise from its contact with the state in question. The question as to where a tort is committed can generally be ascertained by resort to common law doctrine. *See, e.g.*, RESTATEMENT OF CONFLICT OF LAWS § 377 and comment *a* (1934).

Presumably other jurisdictions would apply the substantive law of a state wherein the plaintiff was injured by a defendant corporation doing business there. Query, however, whether this would be true in a jurisdiction with a strong public policy against shareholder liability.

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Appendix

The following illustrates a shareholder liability statute for close corporations:

Section one: A close corporation is an incorporated enterprise whose common stock is held by or for not more than twenty-five persons, not counting those who own stock representing neither one per cent or more of the outstanding common stock nor more than a total book value of \$10,000.

Section two: If an enterprise was a close corporation on any day of the first nine months of the preceding calendar year, it shall be conclusively presumed to be a close corporation throughout the present calendar year. If a corporation did not exist during such nine month period, it shall be conclusively presumed to be a close corporation if it was such at any time during the three months preceding the tort for which shareholder liability is sought. In all other cases, an enterprise shall be conclusively presumed not to be a close corporation.

Section three: Any person who holds stock or securities in a close corporation for other than investment purposes shall be personally liable for torts the corporation commits while he owns such stock or securities. Any person who actively participates in the management of an enterprise, as an officer or director, or who owns more than ten per cent of the corporation's outstanding stock shall be presumed to hold his stock or securities for other than investment purposes.

Section four: Any owner of stock or securities who pays a corporate tort judgment shall be entitled to contribution from those also liable for the tort. Unless otherwise explicitly agreed, each contributor shall indemnify the person so paying a tort judgment in the same proportion that the par or stated value and paid-in-surplus attributable to his stock or securities bears to the total par or stated value and paid-in-surplus of stock or securities held by persons liable for the corporate tort.