Incorporating Responsibility

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"Limited liability" is the rule that shareholders are not liable for the debts of the corporations they own. Critics of limited liability argue that it encourages corporations to ignore the harms they cause and cuts off recovery for deserving plaintiffs. Defenders of limited liability reply that it helps the economy by reassuring investors that they cannot lose their life savings merely by buying a single corporate share. Both claims are clearly right, so the debate rages on.

This Article proposes a solution to the dilemma of limited liability that gives both sides what they want: recovery for tort victims and safety for investors. The solution is "incorporation responsibility"—the rule that whichever state incorporates a business becomes responsible for that business's unpaid debts. Thus, if a Delaware corporation commits a tort that it cannot rectify, the State of Delaware would compensate the victims.

This proposed scheme of incorporation responsibility tracks the logic and law of American corporate federalism. The "genius" of American corporate law is that states compete for incorporation fees by offering appealing laws. This process works well for many corporate rules, but it currently malfunctions for limited liability because states are rewarded for expanding limiting liability, even where doing so imposes disproportionate costs on victims. With incorporation responsibility, states will internalize the costs and benefits of limited liability and can be trusted to craft rules that are both just and efficient.

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Introduction

A taxi knocked John Walkovszky off his feet, but it was limited liability that kept him down.

The story is familiar.[1] Walking down a New York City street, Walkovszky was severely injured by a negligently operated cab. He sued for compensation. However, ownership of the twenty-cab fleet had been parceled out among ten otherwise empty corporate shells. The corporations were empty because "during the course of the corporation's existence all income was continually drained out" and paid to investors.[2] As for the principal shareholder who had received these payments, the Alexander Calder-esque corporate structure would protect him too. "The law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability," the court explained in denying Walkovszky's claim.[3]

Limited liability is the rule that investors in a business entity are not liable for the entity's debts.[4] Limited liability is the most litigated[5] and perhaps the most controversial doctrine in corporate law.[6] Limited liability stokes heated opinions because it prioritizes the beneficiaries of a harmful business at the expense of its victims. A company can harm millions of people and then file for bankruptcy, leaving its victims with almost nothing while shareholders keep their profits.[7] Yet what else can be

1. *Walkovszky v. Carlton*, 223 N.E.2d 6 (N.Y. 1966), is a principal case in many of the leading Business Associations casebooks. *See, e.g.*, STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, LLCS, AND CORPORATIONS 190 (11th ed. 2021); ALAN PALMITER, FRANK PARTNOY & ELIZABETH POLLMAN, BUSINESS ORGANIZATIONS: A CONTEMPORARY APPROACH 340 (3d ed. 2019).

2. *Walkovszky*, 223 N.E.2d at 6, 7.

3. *Id.* at 7.

4. In academic debates, limited liability is also referred to as "owner shielding," Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1336, 1339-1340 (2006), or "affirmative asset partitioning," Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 394 (2000).

5. Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063, 1063 (2006); *accord* Peter B. Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, 90 n.59 (2010).

6. In 2015, Ted Sichelman compiled a list of the fifty most-cited private law articles of all time. Ted Sichelman, *Most Cited Private Law Articles Published in the Last 25 Years*, NEW PRIV. L. BLOG (Apr. 22, 2015), https://nplblog.law.harvard.edu/2015/04/22/most-cited-private-law-articles-published-in-the-last-25-years [https://perma.cc/R4W5-R5D7]. On that list, only three were arguably corporate law papers. The two highest-cited of them were attacks on limited liability: Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (ranked twentieth); and Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996) (ranked fortieth).

7. For a contemporary example, consider the case of Purdue Pharma. *In re* Purdue Pharma L.P., 69 F.4th 45 (2d Cir. 2023), *cert. granted sub nom.* Harrington v. Purdue Pharma L.P., 144 S. Ct. 44 (2023) (No. 23-124). This company broke numerous laws marketing and selling addictive and harmful opioid drugs such as OxyContin. *Id.* at 59. It is bankrupt with no hope of paying its debts, yet its owners will keep billions in profits in their own pockets and out of the hands of the victims. *Id.* (noting that Purdue Pharma distributed eleven billion dollars to its

done? Businesses create jobs, develop new technologies, and generate wealth. Without limited liability, investors would be hesitant to finance businesses in the first place.

Limited liability's divisiveness is premised on a dilemma: we can protect investors or victims, but not both. This Article argues that the dilemma is only apparent. We can protect both investors and victims. Shareholders can feel safe, and victims can recover, so long as *someone* other than the investors pay them. What is needed is a responsible guarantor.

In fact, there is a guarantor that can justly and efficiently compensate the victims of corporate harm. That ideal guarantor is a corporation's state of incorporation, the state that grants it a charter. Thus, if a Delaware corporation files bankruptcy unable to pay one million dollars owed to its tort victims, the State of Delaware could pay one million dollars to those tort victims. If incorporating states pay, then we no longer have to decide between helping investors and victims.

Of course, sending the bill to incorporation states is not a free lunch. Taxpayers in the state underwrite these recoveries. Allocating costs to them may seem unfair. These citizens did not cause the victim's harm, nor could they directly prevent the corporation from undertaking the harmful acts. Nevertheless, incorporation state responsibility is both fair and efficient.

It is fair that states should pay for some harms of their corporations because incorporation states are in the business of selling indulgences. States reap billions in incorporation fees by designing laws that systematically cut off recovery for victims.[8] State competition in corporate law has been likened to a product market.[9] When someone designs a product in such a way as to cause preventable harm, and then profits from indiscriminate sale, it is fair that they should pay to remediate some of the harm.

It is also efficient for states to take on this new function. The "genius" of American corporate law is that it encourages states to experiment

owners); *Id.* at 81 (noting that the owners' financial burden under the reorganization plan will be around six billion dollars).

8. Delaware makes about two billion dollars each year from its chartering operations, plus indirect benefits like remunerative employment for Delaware-based lawyers. *Delaware Division of Corporations: 2022 Annual Report*, DEL. DIV. OF CORPS. 3, https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2022-Annual-Report-cy.pdf [https://perma.cc/CZY2-KMDK]. Peter B. Oh has characterized veil-piercing, the main exception to limited liability, as a remedy for unjust enrichment. Peter B. Oh, *Veil-Piercing Unbound*, 93 B.U. L. REV. 89, 89 (2013). But shareholders are not the only ones who sometimes enjoy unjustified gains. States share in the enrichment through charter fees.

9. *See, e.g.*, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280-81 (1985); Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1078 (2008) ("Regulatory markets are no different from product markets . . . . [B]oth corporate law and securities law are products consumed by firms.").

with improvements to their corporate law.[10] Good laws draw more incorporations (or allow higher fees for existing incorporations), so states' incentives are largely aligned with corporations and their investors. Yet nothing currently aligns states' interests with corporations' victims. To the contrary, entities enjoy cheaper capital with limited liability, and may pay more in incorporation fees in gratitude, precisely because victims' losses are nowhere in the state's calculation. States do not experiment to find new and effective ways to balance the benefits of limited liability against social cost; instead, interstate competition now uniformly leads to maximally limited liability,[11] regardless of whether that rule is socially deleterious.[12] It is widely recognized that limited liability leads *corporations* to create negative externalities;[13] yet *states* are also externalizing, by designing products fine-tuned for externalization.

This Article's proposal converts a race to the bottom into a race to the top. Once states become liable for a portion of corporate harm, they will have an incentive to take that harm into account. States will respond accordingly. Some states may raise incorporation fees to cover their expected losses. Other states may keep their current fees but redesign their corporate law to encourage probity; they may return to familiar solutions, like mandating the purchase of liability insurance. Or states may experiment with new ideas, like mandating an annual risk audit or the inclusion of stakeholder representatives in risk committees. If any of these ideas stick, we can expect that the result will be more efficient than the status quo, which permits states to ignore the obvious social costs of their incorporation decisions.[14]

Incorporation responsibility supports justice and efficiency without leading to many of the problems readers might predict. Importantly, this proposal does not exacerbate moral hazard.[15] Corporations will take ex-

10. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1 (1993).

11. To the contrary, the only innovation and experimentation we observe is the tendency of states to expand limited liability, conjuring up new entity types and permutations, such as the limited liability limited partnership. *See* STEPHEN BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS 77 (2016).

12. *See* Lynn M. LoPucki, *Corporate Charter Competition*, 102 MINN. L. REV. 2101, 2104 (2018) (arguing that charter competition leads to deregulation, without applying this principle to limited liability).

13. *See infra* Section II.B.

14. Indeed, society would benefit even if states preserved limited liability as it stands, with no other changes apart from compensating victims. If states can pay the costs of victims out of current charter fees, it will prove what limited liability defenders have long argued: that we already have the most efficient possible system, because its social benefits (from which fees are drawn) more than match the social cost. *See* Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L.Q. 433, 449 (1995) (arguing that "limited liability generates social benefits that offset the social costs" it creates). If this proposal changes nothing else, it will still mark a confident resolution of a contentious debate.

15. "Moral hazard" refers to the tendency of individuals to take excessive risk as a result of a "condition that insulates someone from the risk of or responsibility for an action." *Moral Hazard*, BOUVIER LAW DICTIONARY 710 (Stephen Michael Sheppard ed., compact ed.

cessive risks if states insulate shareholders from liability, as incorporation responsibility likely would—but states *already* encourage this exact form of excessive risk-taking by granting limited liability. Incorporation responsibility *never* makes this problem worse than the status quo, and it provides a powerful incentive for states to make the problem better.[16]

Nor does this proposal saddle states with unpayable debts. States have numerous options for addressing their new liabilities, from risk-control rules, to mandatory insurance, to higher franchise fees. For those liabilities that remain, even small states are rather large and effective risk bearers: a billion-dollar obligation imputed to little Delaware is still only about $1,000 per citizen (and just half of that citizen's pro rata earnings from franchise fees in 2022).[17] States can weather the occasional large tort much better than tort victims. In any event, it is probably misleading to focus on these large torts. Most insolvent corporations are smaller businesses, such as a gas station that closes without reserving funds to address environmental damage to the site and nearby humans, or Carlton's little taxi venture that hurt Walkovszky. State liability for small businesses could make a meaningful difference to victims without a large budgetary impact.

Incorporation responsibility is a novel proposal, but it is not without precursor. Several scholars have wondered why limited liability *for shareholders* is the only rule worth debating.[18] Thirty years ago, Bob Thompson questioned "why shareholders should face expansive liability that other corporate providers of capital do not."[19] Mitu Gulati, Bill Klein, and Eric Zolt went further, stating that personal liability for "other participants such as creditors, suppliers, customers, directors, officers, and employees . . . at first blush . . . might be fair game."[20] Michael Simkovic

2011). Prominent examples of potential moral hazard include the tendency to neglect care of property once it is insured, *Moral Hazard*, 44 AM. JUR. 2D *Insurance* § 1198, Westlaw (database updated Jan. 2024), and for banks to take on excessive risk when they expect a government bailout. Steven L. Schwarcz, *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility,* 102 MINN. L. REV. 761, 764 (2017).

16. The proposal would increase moral hazard if it produced benefits for voluntary creditors, but our focus on tort victims rules this out. The Appendix includes more details about how to prevent indirect benefits to voluntary creditors.

17. *See supra* note 8; *QuickFacts: Delaware*, U.S. CENSUS BUREAU, https://www.census.gov/quickfacts/fact/table/DE/PST045222 [https://perma.cc/V3BG-WYWF] (providing a population estimate for Delaware in 2022 of 1,019,459).

18. *See, e.g.*, Mark J. Loewenstein, *Veil Piercing to Non-Owners: A Practical and Theoretical Inquiry*, 41 SETON HALL L. REV. 839, 841 (2011) (considering and rejecting the idea of extending liability to non-investors).

19. Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 34 (1994).

20. G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887, 930 (2000); *see* Michael Simkovic, *Limited Liability and the Known Unknown*, 68 DUKE L.J. 275, 303 (2018) (arguing that "unlimited liability should apply to financial investors in firms generally—shareholders, creditors, and warrantholders"); *cf.* Martin Petrin, *The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Inter-*

appears to endorse liability for these non-shareholder groups in some cases as well.[21] These scholars all observed that shareholders are not the only ones who contribute to, control, and derive benefits from a corporation.[22] However, none of them considered applying liability to the one truly essential participant in the firm—the state that charters it.[23]

Another intellectual forebearer to this project is mandatory insurance. If corporations are forced to buy insurance from an insurance company, the insurance company will impose fees and restrictions that tend to force corporations to internalize their costs. Incorporation responsibility basically obliges corporations to buy insurance *from their incorporation state*, and it obliges the state to sell it.[24]

While incorporation responsibility would be new to corporate law, it is far from radical when viewed with a wider lens. Schematically, incorpo-

section of Corporate and Tort Law, 59 AM. U. L. REV. 1661, 1662-65 (2010) (discussing how the responsible officer doctrine undermines the limited liability of officers and directors).

21. Simkovic, *supra* note 20, at 300-03.

22. A closely related insight is that shareholders are not "owners" of the firm, with whatever special responsibilities that arise therefrom. BAINBRIDGE & HENDERSON, *supra* note 11, at 73-74; *see also* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250-51 (1999). Shareholders are just one patron group among many, which may have bargained for distinctive residual control and profit rights.

23. To push the point further, the United States is already a party to several regimes of charter-state liability, in which a state bearing some kind of authorizing relationship to a corporation bears absolute liability for injuries caused by that corporation. One is a component of space law, which arises from a series of widely adopted treaties. For example, the Liability Convention has been ratified by ninety-eight countries and signed by nineteen more. *See Status of International Agreements Relating to Activities in Outer Space as at 1 January 2023*, COMM. ON THE PEACEFUL USES OF OUTER SPACE 12 (Mar. 20, 2023), https://www.unoosa.org/res/oosadoc/data/documents/2023/aac_105c_22023crp/aac_105c_22023crp_3_0_html/AC105_C2_2023_CRP03E.pdf [https://perma.cc/9A8T-PQW4]. Under this convention, if an object falls from space and causes injury, the victim can obtain compensation from the state that permitted its launch, regardless of whether the object was launched and owned by a private actor. Article II under the Liability Convention provides that "[a] launching State shall be absolutely liable to pay compensation for damage caused by its space object on the surface of the earth or to aircraft flight." Convention on International Liability for Damage Caused by Space Objects, art. 2, Mar. 20, 1975, 24 U.S.T. 2389, 961 U.N.T.S. 13810. The "launching States" are those from whose territory a space object is launched, or who procure a launch elsewhere. Convention on Registration of Objects Launched into Outer Space art. I, Sept. 15, 1976, 28 U.S.T. 695, 1023 U.N.T.S. 15. The state need not own the object nor have any control over the object after launch. *Liability for Damage Caused by Objects Launched into Outer Space: Summary of Points Raised in Working Group II* (Oct. 26, 1964), *reprinted in* 3 MANUAL ON SPACE LAW: TRAVAUX PRÉPARATOIRES AND RELATED DOCUMENTS 284-97 (Nandasiri Jasentuliyana & Roy S.K. Lee eds., 1981). The mid-century framers of space law considered it important that victims be compensated and left it to states to decide how to do so—banning local launches, requiring payments, demanding indemnification, and imposing substantive regulatory arrangements on commercial actors whose objects are the proximate cause of injury on earth.

Apart from space law, some other areas of law provide absolute state liability for torts of their private actors, at least within limits. *See, e.g.*, *2004 Protocol to Amend the Paris Convention*, NUCLEAR ENERGY AGENCY 20 (Feb. 12, 2004), https://www.oecd-nea.org/jcms/pl_20361/2004-protocol-to-amend-the-paris-convention [https://perma.cc/N3LG-YJ4H] (imposing liability for nuclear accidents on the state containing the facility, without regard to ownership or fault, within certain thresholds).

24. As for why this proposal might be better than a mere obligation to buy insurance, see *infra* Section V.B.2.

ration responsibility is a proposal that the government backstop an identified class of business liabilities. That is a strategy that the legal system often uses to overcome some injustice of market failure. Consider just a few: when privately owned nuclear powerplants cause damage greater than their owner can pay, the state containing the powerplant must pay the cost of remediation.[25] When banks fail, the federal government pays the unpaid claims of depositors.[26] When polluting firms fail, the federal government will pay the price of remediation.[27] When any corporation is unable to pay its pension obligations to retirees, the federal government will vindicate those pensioners.[28] When privately owned objects (such as satellites) fall from space and injure people or property on the earth, international treaties attribute liability to the nation from which the object was launched.[29] A trans-substantive perspective reveals an attractive legal principle: when governments wish to allow or support a risky category of business activity, they accept responsibility for the residual costs of that activity. From this perspective, corporate law is currently an outlier, and incorporation responsibility is a step toward coherence.

This Article aims to change the terms of the debate, putting the spotlight on a powerful new approach to an old problem. It does not include all the practical details about how precisely to implement the proposal.[30] Nor does it address the political challenges of persuading government actors to implement this change; none of the leading articles in this debate outline a lobbying strategy.[31] Nevertheless, skeptical readers should not regard incorporation responsibility as a complete fantasy. Federal law can impose incorporation responsibility,[32] so there is no need to convince in-

25. 42 U.S.C. § 2210(c) (2018) (indemnifying licensees under certain conditions).

26. *See* 12 U.S.C. § 1821 (2018).

27. *See* 26 U.S.C. § 9507 (2018) (establishing the "Hazardous Substance Superfund"); 42 U.S.C. § 9611 (2018) (detailing how the Superfund's funds are to be used to counteract hazardous substance damage when responsible parties are unidentifiable or not able to pay); S. REP. NO. 96-848, at 13 (1980) (stating that the Superfund is meant "to finance response action where a liable party . . . cannot pay the costs of cleanup and compensation").

28. *See Employee Retirement Income Security Act (ERISA)*, U.S. DEP'T OF LAB., https://www.dol.gov/general/topic/retirement/erisa [https://perma.cc/96WN-HHME] (explaining that the Employee Retirement Income Security Act of 1974 "guarantees payment of certain benefits through a federally chartered corporation" if a defined benefit plan is terminated).

29. *See supra* note 23.

30. A separate Appendix returns to many details about the operation of the proposal, answering questions that may not have occurred to many readers, but which are important to the practical implementation of the proposal.

31. *See, e.g.*, Hansmann & Kraakman, *supra* note 6 (proposing unlimited liability without explaining how such a proposal would be politically viable).

32. More concretely, federal law is capable of preempting state corporate law. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 597 (2003) ("[T]he internal affairs doctrine is just an understanding, not a crisp constitutional rule, and all corporate law could be federal law."). Congress could pass a law preempting state corporate law except where a state charter is subject to charter-state liability. The United States Constitution ensures states immunity from many forms of liability. *See* U.S. CONST. amend. XI. But sovereign immunity faces many exceptions. It does not protect a state that violates rights ensured by the Fourteenth Amend-

dividual states that this is in their interest. If charter-state liability is in the national interest, there is hope for national legislation to realize it.

Only a roadmap now, and then the Article begins in earnest.

Part I explains the law of limited liability. Part II discusses the state of the scholarly literature, introducing the arguments persuasive to limited liability's critics and defenders respectively. Part III sketches the Article's proposal. Part IV argues for the desirability of the proposal and addresses several policy-based objections. Part V considers certain objections to the proposal. A brief conclusion wraps things up.

I. The Law of Limited Liability

The principle of *respondeat superior* renders an employer or principal vicariously liable for the torts of its employees and agents.[33] The typical rationale for this form of vicarious liability is that it is efficient and fair that those who benefit from and control a business should account for the costs of that business; otherwise, they might hire agents and encourage them in profitable but harmful practices.

When a tort is committed in a corporate context, the law must again apportion liability. The law might treat equity investors as analogous to the tortfeasor's principal. They are the ones on whose ultimate behalf a corporation's agents conduct business and incur debts. They are the ones who profit from corporate conduct and should internalize its social cost. They also possess residual control, insofar as they elect the managers.

Such a theory has at times prevailed. Prominent jurisdictions held investors jointly and severally liable for the debts of their corporations until the late nineteenth century,[34] and some corporations voluntarily

ment, including property rights. U.S. CONST. amend. XIV, § 5 ("The Congress shall have power to enforce, by appropriate legislation, the provisions of this article."). Nor does it prevent equitable suits to prevent further violations of federal law, at least when those suits are nominally brought against a state official instead of the state itself. *Ex parte* Young, 209 U.S. 159-60 (1908). A law against chartering corporations without suitable guarantors might provide a basis for such an injunction. Most importantly, sovereign immunity is waivable. Coll. Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd., 527 U.S. 666, 675 (1999). The federal government can constitutionally insist upon waiver as a condition for participating in a program. *See, e.g.*, Alexander v. Sandoval, 532 U.S. 275, 279-80 (2001). There are limits on these conditions. *Coll. Sav. Bank*, 527 U.S. at 687. The contours of these limitations remain in flux. *See* Allen v. Cooper, 589 U.S. 248, 251 (2020) (denying statutory waiver of sovereign immunity in a copyright scheme).

33. RESTATEMENT (THIRD) OF AGENCY § 2.04 (AM. L. INST. 2006) ("An employer is subject to liability for torts committed by employees while acting within the scope of their employment."); Gen. Bldg. Contractors Ass'n v. Pennsylvania, 458 U.S. 375, 392 (1982) ("The doctrine of *respondeat superior*, as traditionally conceived and as understood by the District Court . . . enables the imposition of liability on a principal for the tortious acts of his agent and, in the more common case, on the master for the wrongful acts of his servant."); LYNN M. LOPUCKI & ANDREW VERSTEIN, BUSINESS ASSOCIATIONS: A SYSTEMS APPROACH 8 (2021) (explaining the rule of *respondeat superior*).

34. Mark I. Weinstein, *Share Price Changes and the Arrival of Limited Liability in California*, 32 J. LEGAL STUD. 1, 2 (2003) ("Prior to 1931, California law provided pro rata unlimited liability for shareholders of California corporations."). *Cf.* Andrew Verstein, *Enterprise*

maintained this treatment well into the twentieth century,[35] on the theory that shareholders were analogous to partners and thus the ultimate owners of the business. Specific statutory regimes such as banking law showed persistent interest in shareholder liability.[36] And general partnerships to this day continue to impose liability on partners for the partnership's debts, consistent with the traditional understanding of the partnership as a mutual agency relationship among the partners. Investor liability was and could be widespread.

However, investor liability is no longer widespread. Instead, all jurisdictions now recognize some form of limited liability for shareholders.[37] Thus, shareholders may not be held liable for unpaid corporate debts solely by virtue of being shareholders. This is true even if the shareholders have received substantial dividends from their ownership over time. For example, a corporation founded with a million-dollar equity contribution from a single shareholder might generate $300,000 in profits every year, which it pays out as dividends, for twenty years. At the end of that period, a toxic tort may be discovered that entitles its victim to $500,000. Even though the shareholder has received a 600% gross return on her investment, the shareholder cannot be forced to pay a portion of this tort; if the business has less than $500,000 to pay the victim, the victim will simply go unpaid.

Limited liability faces four important limits. First, general partnerships can be formed without a state charter and thereby forgo limited liability.[38] Second, limited liability only protects investors against liability that would have been incurred solely by virtue of their status as investors.

Without Entities, 116 MICH. L. REV. 247, 247 (2017) (discussing the absence of limited liability in early reciprocal exchanges).

35. *E.g.*, Mark I. Weinstein, *Don't Buy Shares Without It: Limited Liability Comes to American Express*, 37 J. LEGAL STUD. 189, 189 (2008) (noting that American Express acquired limited liability in 1965).

36. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 31 (1992); Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability*, 90 NOTRE DAME L. REV. 1, 6-9, 10 (2014) (briefly discussing the history of double liability in banking and the academic debate surrounding it); Alessandro Romano, Luca Enriques & Jonathan R. Macey, *Extended Shareholder Liability for Systemically Important Financial Institutions*, 69 AM. U. L. REV. 967, 967 (2020); 9 C.J.S. *Banks and Banking* § 69, Westlaw (database updated Aug. 2023) ("The imposition of an additional liability upon stockholders of a banking corporation is an incident of incorporation which falls peculiarly within the regulatory power of the state in which the bank is incorporated and located.").

37. *See, e.g.*, MODEL BUS. CORP. ACT § 6.22(b) (AM. BAR ASS'N 2023) ("A shareholder of a corporation is not personally liable for any liabilities of the corporation . . . except (i) to the extent provided in a provision of the articles of incorporation . . . and (ii) that a shareholder may become personally liable by reason of the shareholder's own acts or conduct."); DEL. CODE ANN. tit. 8, § 102(b)(6) (2024) (providing that shareholders shall not be personally liable for a corporation's "debts"). *See also* Hansmann & Kraakman, *supra* note 6, at 1923 (explaining that limited liability became universal in the mid-twentieth century).

38. *E.g.*, UNIF. P'SHIP ACT § 306 (UNIF. L. COMM'N 2013). Likewise, common-law trusts and unincorporated associations lack full limited liability.

If the investor would have been liable for some other reason, such as that she personally committed the tort in question, she remains liable. Third, most states include some important but rather technical limitations on limited liability. For example, debts that arise after a corporation is terminated can create personal liability for shareholders.[39]

Fourth, several "entity disregard" theories permit the debts of an entity to be attributed to its shareholders, but only if exacting conditions are met. The best known of these theories is often called "piercing the corporate veil." Under this theory, a shareholder is liable if (1) the entity is dominated and controlled by its owner or otherwise lacks a meaningfully separate existence and (2) injustice would follow if corporate personhood were nevertheless respected.[40] The first prong ensures that shareholders face no liability if the corporation's separate existence is maintained. For example, the corporation ought to keep accurate financial records, document corporate actions such as meetings, and clearly indicate what capacity individuals are acting in.[41] Prophylactic observance of corporate separateness is not challenging to do, so piercing the corporate veil is rarely successful against a sophisticated defendant. Thus, while the world of limited liability indeed has boundaries, most investors face no risk of crossing them.

One more note about boundaries: because of the substantial similarity of rules across jurisdictions, it is rarely important to ask which state's rule of limited liability governs a given dispute.[42] Nevertheless, small difference do exist.[43] For most corporate law questions, the applicable law is the law of the chartering state. This is pursuant to the internal affairs doc-

39. *See, e.g.*, DEL. CODE ANN. tit. 8, § 278 (2024) (providing that actions shall not abate if brought within three years after dissolution); MODEL BUS. CORP. ACT § 14.07(c) (AM. BAR ASS'N 2023) (establishing liability for actions brought within three years). Shareholders are generally liable pro rata for these debts up to the full amount of undistributed corporate assets or the amount that shareholders have received in a liquidating distribution. *E.g.*, MODEL BUS. CORP. ACT §14.07(d)(2) (AM. BAR ASS'N 2023).

40. *E.g.*, Tamko Roofing Prods., Inc. v. Smith Eng'g Co., 450 F.3d 822, 827 (8th Cir. 2006).

41. *See, e.g.*, Semmaterials, L.P. v. Alliance Asphalt, Inc., No. CV 05-320-S, 2008 WL 161797, at *2-3, *6 (D. Idaho Jan. 15, 2008).

42. 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 8:18 (rev. 3d ed. 2023) ("Piercing law is sufficiently general (and vague) in the various states such that [the choice of law] probably does not determine the results in very many cases."); *see, e.g.*, Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1575 (10th Cir. 1990) (noting that "California's standard for piercing the corporate veil does not appear to be materially different from Utah's"); Am. Heritage, Inc. v. Nev. Gold & Casino, Inc., 259 S.W.3d 816, 829 (Tex. App. 2008) ("The parties make much of whether Texas or Nevada law applies to this alter ego finding, but, for purposes of this case, we do not discern a meaningful difference between the laws of the two states concerning the unity element of the alter ego doctrine.").

43. *See* Northern Laminate Sales, Inc. v. Matthews, 249 F. Supp. 2d 130, 140 (D.N.H. 2003) ("Although the standards do not vary widely in most states, the standards may diverge enough to be outcome determinative.").

trine.[44] Most states regard limited liability to be an internal affair, and so defer to the law of an entity's charter state to decide what form of limited liability is available.[45] Thus, a Texas resident, injured in Tennessee by a Floridian truck driver, working for a Delaware-chartered corporation headquartered in Georgia, could recover from an investor residing in Illinois if, and only if, *Delaware* law provided shareholder liability under those circumstances. The chartering state effectively sets the scope of limited liability and its exceptions.[46]

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44. LoPucki & Verstein, *supra* note 33, at 76; Model Bus. Corp. Act §15.01(a) (Am. Bar Ass'n 2023) ("The law of the jurisdiction of formation of a foreign corporation governs . . . the internal affairs of the foreign corporation . . . .").

45. *See* Dassault Falcon Jet Corp. v. Oberflex, Inc., 909 F. Supp. 345, 349 (M.D.N.C. 1995) (explaining that "most, if not all, jurisdictions . . . use the 'internal affairs doctrine' as their choice of law for piercing the corporate veil").

46. However, not all jurisdictions fully accept the internal affairs doctrine. California, for example, recognizes a wide public-policy exception from the internal affairs doctrine. Lidow v. Superior Court, 141 Cal. Rptr. 3d 729, 737 (Ct. App. 2012) (holding that when an allegation "goes beyond internal governance and touches upon broader public interest concerns," such as wrongful termination, then state law may govern, not the internal affairs doctrine). New York likewise retains a wide "greatest interest" analysis. Tyco Int'l, Ltd. v. Kozlowski, 756 F. Supp. 2d 553, 560 (S.D.N.Y. 2010) ("[T]he internal affairs doctrine is applied only as one factor in an analysis where the 'law of the state with the greatest interest in the issue governs.'" (quoting BBS Norwalk One, Inc. v. Raccolta, Inc., 60 F. Supp. 2d 123, 129 (S.D.N.Y.1999))); Intercontinental Planning, Ltd. v. Daystrom, Inc., 248 N.E.2d 576, 582 (N.Y. 1969) ("[T]he law of the jurisdiction having the greatest interest in the litigation will be applied and . . . the facts or contacts which obtain significance in defining State interests are those which relate to the purpose of the particular law in conflict." (quoting Miller v. Miller, 237 N.E.2d 877, 879 (N.Y. 1968))). Nor do all states consider limited liability to be an internal affair. Internal affairs are "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders." Edgar v. MITE Corp., 457 U.S. 624, 645 (1982). Tort victims are not members of the corporate nexus of contract and did not agree to accept the chartering state's sense of the proper limits of liability.

Where the internal affairs doctrine does not confer the law of the chartering state to disputes over limited liability, courts must engage in some other conflict-of-law analysis. In most cases, that analysis still leads back to the chartering state's law (albeit for different reasons). *See, e.g.*, Soviet Pan Am Travel Effort v. Travel Comm., Inc., 756 F. Supp. 126, 131 (S.D.N.Y. 1991) ("Because a corporation is a creature of state law whose primary purpose is to insulate shareholders from legal liability, the state of incorporation has the greater interest in determining when and if that insulation is to be stripped away."); *see also* Fletcher v. Atex, Inc., 68 F.3d 1451, 1456 (2d Cir. 1995) ("Because Atex was a Delaware corporation, Delaware law determines whether the corporate veil can be pierced in this instance."); Sarah C. Haan, *Federalizing the Foreign Corporate Form*, 85 St. John's L. Rev. 925, 940 (2011) ("Uniquely among the states, New York typically applies the law of the state of incorporation to veil-piercing claims without invoking the internal affairs doctrine.").

The ability of the charter state to set the limited liability rules and exceptions has been controversial. *Compare* Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 Harv. L. Rev. 387, 411 (1992) (arguing that shareholder liability should derive from the state of incorporation), *with* Hansmann & Kraakman, *supra* note 6, at 1921-22 (arguing that shareholder liability should accord with the tort law of the state where the injury takes place). *See generally* Gregory Scott Crespi, *Choice of Law in Veil-Piercing Litigation: Why Courts Should Discard the Internal Affairs Rule and Embrace General Choice-of-Law Principles*, 64 N.Y.U. Ann. Surv. Am. L. 85, 90 (2008) (advocating for ordinary choice-of-law analysis rather than internal affairs). Removing limited liability from the internal affairs doctrine would solve the problem of states maximally limiting liability, since states could no longer capture fees by maximizing limited liability. However, such a proposal would fail to achieve the benefits discussed *infra* Part IV. Charter-state liability does not just eliminate a pernicious tendency to grow

II. The Merits of Limited Liability

This Part briefly recapitulates the main arguments offered for and against limited liability in recent years. Section II.A discusses a clash between two classes of potentially risk-averse individuals: shareholders and the victims of corporate torts. Limited liability offers protection to one at the expense of the other. Section II.B turns to the potential inefficiency of allowing corporations to internalize benefits and externalize costs. Section II.C explains how limited liability can lead to more efficient patterns of shareholding. Section II.D considers administrability.

A. Risk Aversion

Debate about limited liability began as the introduction to this Article framed it: critics of limited liability made a distributional argument highlighting the injustice of leaving tort victims uncompensated while the tortfeasor's shareholders retain past profits. Defenders of limited liability argued that risk-averse investors would put their money under the mattress, rather than finance new businesses, if exposed to vicarious liability for corporate debts. The dilemma is between justice and economic growth.

This initial formulation of the issue is now deemed naïve. Most importantly, both positions neglect the possibility of insurance. Potential victims need not risk heart-wrenching and uncompensated losses: they can buy life insurance, health insurance, and umbrella insurance policies to ensure payment.[47] Nor should unlimited liability strike terror in the hearts of investors. Corporations can buy large insurance policies to cover their own potential torts, minimizing residual risks to shareholders. If there were no limited liability, insurance companies would likely offer policies covering individual investors against residual liability arising out of their portfolio.[48] Thus, insurance is available to whomever faces outsized liabilities. The status quo of limited liability and the reform pro-

limited liability, it also creates a salutary incentive to innovate efficient, novel, and balanced limited liability rules. It also preserves uniformity of law for a given corporation, which is desirable and unavailable if limited liability were carved out of the internal affairs doctrine. Accordingly, a hypothetical reform to splinter the law of limited liability is inferior to this Article's proposal of reforming it. *See infra* Section V.B.1.

47. BAINBRIDGE & HENDERSON, *supra* note 11, at 69.

48. Hansmann & Kraakman, *supra* note 6, at 1901. Some scholars have questioned the availability of insurance. *See, e.g.*, Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1906-07 (1994). But very large amounts of insurance are uncontestably available. *See generally* PAULA JARZABKOWSKI, REBECCA BEDNAREK & PAUL SPEE, MAKING A MARKET FOR ACTS OF GOD: THE PRACTICE OF RISK-TRADING IN THE GLOBAL REINSURANCE INDUSTRY (2015) (describing vast insurance operations covering natural disasters and more).

posal of shareholder liability differ largely in who must pay for insurance.[49]

While no one thinks insurance is a sure-fire solution, its possibility has refocused the debate to three issues that insurance cannot solve. Critics argue that limited liability diverts investments to inefficiently risky and harmful projects. Defenders of limited liability argue that it improves investment market quality and is vastly more administrable than alternatives.

B. Inefficient Externalities

A business project is socially efficient only if its benefits to shareholders (and others) exceed the costs it imposes on tort victims (and others). When the victims of a business can sue and recover for harm, we can be more confident that shareholders will finance only socially efficient projects.[50] The tort system, therefore, contributes to social welfare by forcing investors to internalize the social cost of their investment.[51] Deciding between two projects that generate the same cash flows, only one of which leaks pesticides into the local drinking water reservoir, investors should and do have an incentive to finance the cleaner option that will not instigate a class action from local poison victims.

Limited liability undermines this tidy relationship by allowing investors to disregard some costs.[52] Suppose a corporation worth $500 million can pay $1 million to reduce the damage of a possible chemical leak from $10 billion to a mere $1 billion. Will investors support such risk-mitigation technology? Since even the smaller leak is costly enough to bankrupt the company, rational investors will not support the leak-safety investment. It increases costs, and the only benefit it brings is reducing the scale of a tort judgment the company could never pay anyway. In a regime of limited liability, managers are encouraged to disregard risks and harms, however large, that exceed the value of the corporation's assets. That means harmful and risky projects will be excessively financed,

49. Even this overstates the differences, however. If corporations must buy the insurance, those costs fall on some combination of corporate patrons: the corporation may pay lower dividends to shareholders, lower wages to workers, lower prices to suppliers, or raise prices to consumers. Potential tort victims include shareholders, workers, suppliers, and consumers. Conversely, insurance-buying potential victims have less money to spend as customers, imposing indirect losses on businesses and their patrons.

50. A project that generates one million dollars in profits to shareholders and imposes ten billion dollars in tort liabilities is a socially wasteful project, and it is one that shareholders will not finance if they bear responsibility for those losses.

51. *See* Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357, 363-70 (1984) (arguing that liability should be set equal to harm, or higher if enforcement is not assured).

52. *See* Simkovic, *supra* note 20, at 284 ("Judgment proofing can lead to overinvestment in risky activities, underinvestment in safety precautions, and underinsurance.").

and safety consistently undervalued. Empirical studies have confirmed this theoretical prediction.[53]

Defenders of limited liability argue that encouragement of risk may be appropriate given preexisting pressures toward excessive caution. Executives lose their jobs if the company goes bankrupt; they do not need the threat of shareholder liability to try to avoid big lawsuits. And the tort system is sometimes excessively costly, which may excessively deter risky conduct.[54] Limited liability may be considered a form of back-door tort reform.

Yet these considerations cannot refute the claim that limited liability leads corporations to excessively harm third parties. Executive risk aversion cannot lead to offsetting caution for events that increase the harmfulness, but not the likelihood, of an event sufficient to trigger insolvency.[55] Nor can executives insist upon caution at closely held or controlled firms, where shareholders are better able to enforce their preferences. Executive risk aversion at most reduces the degree to which limited liability encourages excessive risk. As for the tort system, even if unlimited liability leads to undue caution, that is fully compatible with limited liability increasing harmful conduct.[56] Accordingly, critics of limited liability are probably right that limited liability leads corporations to create excessive social harm—though defenders could be right that this harm must be weighed against flaws in our existing managerial and tort systems.

C. Efficient Shareholding

Limited liability is praised for its contribution to economic growth, though this analysis has lately grown more abstract and less explicitly causal. Early scholars praised limited liability in sweeping terms, largely

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53. *See, e.g.*, Pat Akey & Ian Appel, *The Limits of Limited Liability: Evidence from Industrial Pollution*, 76 J. FIN. 1, 3 (2021); *see also* Felipe Aldunate, Dirk Jenter, Arthur Korteweg & Peter Koudijs, *Shareholder Liability and Bank Failure* 1, 34 (CESifo, Working Paper No. 9168, 2021), https://ssrn.com/abstract=3882368 [https://perma.cc/4VK9-43UV] (finding that double liability improved bank stability, relative to single liability).

54. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 447 (1992) ("In other words, advocacy of unlimited tort liability mistakenly assumes the efficiency of the tort system.").

55. *See supra* note 53 and accompanying text.

56. A tort system that awards twenty-five percent more than plaintiffs deserve is not restored to neutrality if some defendants ultimately pay almost nothing; the tort system would remain excessive for solvent companies, even though impotent against those who chance insolvency. Backdoor tort reform also tames liability in an uneven and inequitable way: excessive tort liability is curtailed, but only for the businesses that engage in sophisticated asset protection strategies. *See* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 147 (1998). Sole proprietors or unsophisticated corporations that do not plan for doomsday remain exposed to the ravages of the system. Indeed, exempting sophisticated victims from a broken tort system risks diffusing political energy from more explicit and logical reform strategies.

by pointing to the gains produced by corporations.[57] However, the historical record is far from decisive, with many of the greatest gains made by firms without limited liability.[58] Instead, the debate now emphasizes the functional role of diversification and liquidity, which limited liability supports.

Diversification refers to the ability of investors to spread their money across many investments. An investor whose eggs are all in one basket will suffer if anything bad happens to the basket. Diversification permits investors to eliminate the risk that their plans will be ruined by the bad performance of just one company. So reassured, diversified investors are willing to allow managers to pursue a wider range of socially valuable projects than are undiversified investors.[59] An investor whose assets are all invested in a single company may want that company to avoid bankruptcy at all costs—yet great companies, like Apple, must sometimes risk bankruptcy.[60] Diversified investors can take the wide and long view, encouraging managers to pursue all good bets (with positive net present value), trusting that the losing bets will be offset by wins at other companies. Thus, the economy can more efficiently grow to exploit its good projects if investors are diversified.[61]

57. *See, e.g.*, Nicholas Murray Butler, President, Columbia Univ., Address at the 143rd Annual Banquet of the Chamber of Commerce of the State of New York: Politics and Business (Nov. 16, 1911), *in* 143 ANNUAL BANQUET OF THE CHAMBER OF COMMERCE OF THE STATE OF NEW YORK 43, 47 (1911) (asserting that the "the limited liability corporation is the greatest single discovery of modern times," including in terms of its "industrial" effects); *accord* BAINBRIDGE & HENDERSON, *supra* note 11, at 31-32.

58. *See* Macey & Miller, *supra* note 36, at 55; Weinstein, *supra* note 35, at 194; Weinstein, *supra* note 34, at 2-3; Verstein, *supra* note 34, at 266, 278; E. Merrick Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351, 1356 (1948); *see also* Ryan Bubb, *Choosing the Partnership: English Business Organization Law During the Industrial Revolution*, 38 SEATTLE U. L. REV. 337, 339 (2015) (discussing English entrepreneurs' preference for the partnership form).

59. *See* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 502 (1976) (arguing that investor liability would discourage "substantial entrepreneurial investments by risk averse individuals"); Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 616 (1986) ("[L]imited liability encourages business managers to venture into activities they would not otherwise undertake."); BAINBRIDGE & HENDERSON, *supra* note 11, at 47 ("By reducing a project's riskiness to the entrepreneur, limited liability thus may encourage business risk taking and, as a result, economic growth.").

60. *See* Jack Nicas, *Apple Is Worth $1,000,000,000,000. Two Decades Ago, It Was Almost Bankrupt*, N.Y. TIMES (Aug. 2, 2018), https://www.nytimes.com/2018/08/02/technology/apple-stock-1-trillion-market-cap.html [https://perma.cc/4VE5-4TWU].

61. Limited liability yields several benefits beyond diversification. *See* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 661-68 (1996) (explaining the benefits produced by centralized management, relative to active control by investors); Jack L. Carr & G. Frank Mathewson, *Unlimited Liability as a Barrier to Entry*, 96 J. POL. ECON. 766, 769 (1988) (arguing that unlimited liability limits firm growth and competition for new projects); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 95-96 (1985) (arguing that unlimited liability deters transfers of control, which would have tended to induce managers to work more effectively).

Limited liability supports diversification because investors would be cautious about investing small sums in many companies if doing so might expose them to limitless losses.[62] Investors would be more likely to concentrate their investment in a smaller set of companies that signaled safety and probity.

Likewise, liquidity—the ability of investors to easily buy and sell—makes it easier for corporations to prepare for the long haul.[63] Some of the most socially valuable projects require years of investment before they bear fruit—think about transcontinental railroads and telephone lines, electric cars, new treatments for chronic diseases—yet individual investors cannot be so patient. We all face needs (tuition payments, medical bills, retirement expenses) over the nearer term. Liquidity allows early investors to sell to later ones, so that businesses can hold capital for decades without any single investor giving up the capital for long.[64]

Limited liability supports liquidity in two ways. First, it reassures buyers: if you have some extra cash, you can safely invest it for a little while, without fearing that you might lose it all *plus your house*. By contrast, unlimited liability casts a pall over every transaction.[65] Second, unlimited liability makes investors themselves demand restrictions on each other's trading. That is because unlimited liability makes investors care about the identity of their co-investors. Richer investors can soak up more of the corporation's debts.[66] The quality of a corporation's investors

62. *See* Brian Blake, Case Comment, *Piercing the Corporate Veil:* Minno v. Pro-Fab, Inc., 36 OHIO N.U. L. REV. 1191, 1200 (2010) ("[Unlimited liability] stunts the diversification of portfolios, inhibiting economic growth."); Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for A Better Standard*, 3 DEPAUL BUS. & COM. L.J. 51, 54 (2004) (explaining that "limited liability reduces the entity's and its shareholders' need to monitor its agents, which makes passive investing and diversification a more rational strategy, reducing the costs of operating the entity"); Henry G. Manne, *Our Two Corporate Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967) (arguing that without limited liability "small investments in corporations would tend to come only from individuals who were nearly insolvent already").

63. Other benefits of liquidity include price accuracy, Easterbrook & Fischel, *supra* note 61, at 95-96; Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 DUKE L.J. 191, 223-24 (2015), and efficiency enhancing transfers of corporate control, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (arguing that an active market for transferring control is efficient).

64. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387 (2003).

65. And because this is a context where the seller knows more about the business than the buyer, buyers will rationally fear that the shares for sale are the ones most likely to lead to liability. Economists refer to this phenomenon as "adverse selection," and it is one of the principal drivers of trading costs. *See* Fox et al., *supra* note 63, at 217-21. This can lead to a "market for lemons" in which high-quality securities are only rarely sold. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488 (1970).

66. In fact, unlimited liability is the default rule for partnerships, but it is paired with a requirement that partnership agreements provide for transfer of partnership status. The result is that partnerships are tragically illiquid. Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107, 121 (2005) ("Partnerships, however, are relatively illiquid forms of investment, making exit difficult.").

is an asset to be conserved under unlimited liability; with limited liability, no investor minds if the pool of investors shifts.[67]

While they may seem abstract, these market quality arguments have struck prominent limited liability critics as sufficiently problematic to amend their position. For example, Hansmann and Kraakman appear willing to trim their sails from joint and several shareholder liability to mere pro rata liability, largely out of concern for these market quality concerns.[68] Thus, critics and defenders alike take these economic considerations seriously, they just differ in their willingness to compromise them.

D. Administrability

Some defenders of limited liability have argued that there is no practical way to implement a regime of shareholder liability. First, shareholders own small stakes and live in many states. The cost to reach them for collection, and the legal challenges in establishing jurisdiction,[69] may be daunting.[70]

Second, shareholders change over time, which leads to both practical and conceptual problems in identifying which shareholders are liable: those who hold at the time creditors sue, or those who held at the time the wrongdoing took place?[71] The former will lead to strategic responses, with sophisticated shareholders selling toxic shares just before the risks of unlimited liability become visible.[72] Yet the latter applies only messily to wrongdoing that accrues over time.[73]

67. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 394 (4th ed. 1992); Blake, *supra* note 62, at 1200 ("Unlimited liability causes share values to be dependent on future cash flows and the wealth of individual shareholders . . . .").

68. Hansmann & Kraakman, *supra* note 6, at 1900. *See also* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1582 (1991) ("On the assumption that the role of the shareholder ought not to be significantly changed, the pro rata rule seems desirable."); Manne, *supra* note 62, at 262 (recognizing pro rata liability as "an alternative" to unlimited liability, albeit a problematic one, that avoids some problems with unlimited liability).

69. *See* Alexander, *supra* note 46, at 388; BAINBRIDGE & HENDERSON, *supra* note 11, at 63.

70. *See* Robert Charles Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 863 n.160 (1979). Clark focused on individual actions, and later objectors raised and rejected the possibility of class actions against desperate shareholders. *See* Francis X. Shen, *The Overlooked Utility of the Defendant Class Action*, 88 DENV. U. L. REV. 73, 119 (2010) (observing that "defendant class actions . . . are very rare in practice"); David L. Shapiro, *Class Actions: The Class as Party and Client*, 73 NOTRE DAME L. REV. 913, 919 (1998) (observing that "defendant class actions are rare and pose special problems of representation and due process").

71. *See* Hansmann & Kraakman, *supra* note 6, at 1896.

72. BAINBRIDGE & HENDERSON, *supra* note 11, at 63.

73. *See* LoPucki, *supra* note 6, at 56 n.240.

Third, some shareholders live in jurisdictions that are unlikely to recognize and support a U.S. court's judgment.[74] Faraway shareholders can act as though limited liability remains the law of the land, so long as it is the law of their own land. And U.S. investors who want to partake of this kind of limitation can buy shares of foreign-holding companies, which then own U.S. shares on their behalf. Even without an international shell game, wealthy U.S. investors may ask judgment-proof Americans to hold a tiny tranche of equity securities while buying for themselves only bonds (few shareholder liability proposals contemplate imposing liability on creditors of a business, such as bondholders). All these efforts make it hard for courts to assign liability to a party likely to pay.

Insofar as the interposition of judgment-proof investors permits beneficial owners to evade liability, limited liability becomes inevitable. Reform efforts achieve nothing more than fee-channeling to the functionaries who build and minister to the liability-blocking structure.[75]

Critics of limited liability have challenged the extent of these problems. Within bankruptcy, national jurisdiction is permitted,[76] and courts find it economical to adjudicate entitlements of thousands of parties.[77] As for the clever use of holding companies, judgment-proof foreign entities can be restricted from shareholding.[78] Attribution rules can identify upstream investors as beneficial owners liable for the debts of their downstream strawmen.[79] Insofar as clever lawyers nevertheless manage to defeat shareholder liability, the costs incurred along the way still raise costs for the firms risky enough to warrant such strategies, indirectly forcing them to take some account of their social cost. And the status quo also

74. Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 397 (1992).

75. *See* Hansmann & Kraakman, *supra* note 6, at 1886 ("[U]nlimited liability would impose the transaction costs of rearranging asset holdings and the inefficiency of the resulting distorted pattern of wealth-holding.").

76. *See* LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS § 3.03[D], at 140-41 (3d ed. 1997).

77. Hansmann & Kraakman, *supra* note 6, at 1900. Interestingly, in the 1920s, creditors of insolvent banks lacking limited liability were able to recover roughly fifty percent of what they were owed from shareholders. Macey & Miller, *supra* note 36, at 55; *see also* Berry K. Wilson & Edward J. Kane, *The Demise of Double Liability as an Optimal Contract for Large-Bank Stockholders* 1, 5 (Nat'l Bureau of Econ. Rsch., Working Paper No. 5848, 1996), https://ssrn.com/abstract=225633 [https://perma.cc/CME4-S2AM] (noting that the recovery rate for stockholders at national assessments was not significant lower from 1930 to 1934 than at other times).

78. *See* Henry Hansmann & Reinier Kraakman, *Do the Capital Markets Compel Limited Liability? A Response to Professor Grundfest*, 102 YALE L.J. 427, 433 (1992).

79. Existing doctrine already permits veil piercing to the detriment of nominal non-owners who nevertheless exercise "equitable ownership." BCL-Sheffield LLC v. Gemini Int'l, Inc. (*In re* Tolomeo), 537 B.R. 869, 878 (Bankr. N.D. Ill. 2015); Swenson v. Bushman Inv. Prop., Ltd., 870 F. Supp. 2d 1049, 1058-60 (D. Idaho 2012); Freeman v. Complex Computing Co., 119 F.3d 1044, 1051 (2d Cir. 1997). Existing doctrines turn on functional control. A regime intended to prevent circumvention of shareholder liability would need to focus on enjoyment of profits, since many small investors lack control (whether they invest directly or through a nominee).

includes plenty of wasted costs in structuring businesses to minimize liability.[80] In a world of shareholder liability, some of those costs would be saved, since some firms would conclude that limited liability can only be obtained with a degree of structuring that is not cost-justified.

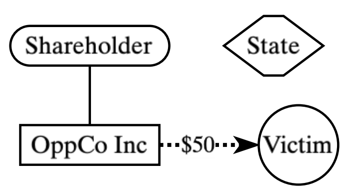
Critics of limited liability are right to deny that it is administratively necessary; some form of shareholder liability could probably be implemented. Still, it is widely accepted that shareholder liability would be costly and challenging to implement. Critics and defenders of limited liability differ in whether they think the game is worth the candle.

III. The Law of Incorporation Responsibility

The forgoing Part discussed a series of policy considerations advanced or undermined by limited liability. This Part explains a new approach to limited liability, intended to do better on each of those criteria and more: incorporation responsibility. Under this approach, states are liable for the unpaid tort liabilities of the limited liability entities they incorporate.[81] States would be welcome to customize their entities in light of this rule, perhaps expanding or contracting the extent of shareholder liability.

To see incorporation responsibility in action, imagine that OppCo Inc. (a corporation) commits a tort, injuring Victim. Victim obtains a hundred-dollar judgment against OppCo. OppCo has assets worth only fifty dollars, so it can pay only half of what it owes to Victim. OppCo's sole shareholder has sufficient assets to pay Victim's claim, but the shareholder would not be liable under the rule of limited liability. Under the status quo law of limited liability, Victim goes undercompensated. Figure 1 depicts the status quo result.

Figure 1. Status Quo

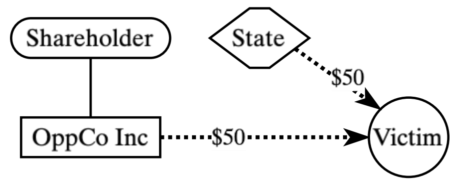


80. *See* Hansmann & Kraakman, *supra* note 6, at 1916 (emphasizing that "[l]arge-scale evasion of tort liability already occurs under limited liability"); BAINBRIDGE & HENDERSON, *supra* note 11, at 82 (referencing monitoring costs to prevent tortious conduct by a firm's agents under a system of limited liability).

81. *See infra* Appendix. In any case, non-tort creditors can contract out of limited liability if they prefer full recourse.

The results are different under incorporation responsibility because the incorporation state would be liable for the additional fifty dollars. Figure 2 depicts the result under the proposed scheme of incorporation responsibility.

Figure 2. Incorporation Responsibility

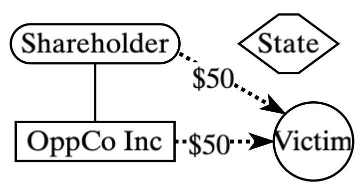


Under the regime of incorporation responsibility, the victim would receive full compensation because the state would be obliged to pay fifty dollars to her. Here, incorporation responsibility is the difference between full compensation and half compensation. In some cases involving insolvent corporations, incorporation states would incur significant liability.

Whether the state ultimately bears the cost of its fifty-dollar payment to Victim would be a matter of the state's own law. This latter item—a state-specified right of contribution—is the second important feature of incorporation responsibility. In some cases, the state will have stipulated that someone else is liable to the state for the state's cost in covering the entity's debts.

For example, existing corporate law makes shareholders liable for a corporation's debts when the elements of veil-piercing are present.[82] Figure 3 demonstrates the availability of relief under the status quo.

Figure 3. Status Quo, Piercing

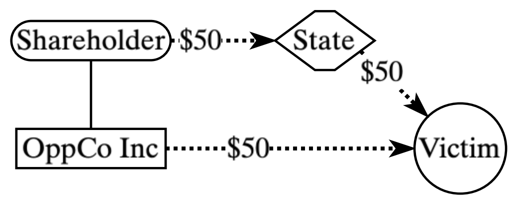


Under the status quo, the victim would take fifty dollars from the corporation and an additional fifty dollars from a shareholder who had run OppCo in a way that ignored corporate formalities and otherwise contributed to fraud or injustice.

82. *See supra* notes 40-41 and accompanying text.

A state could substantially preserve this result under incorporation responsibility. In that case, a liable incorporation state would pay the plaintiff's unpaid claim and then consider whether any piercing-type action should be brought against a shareholder. A successful veil-piercing action by the incorporation state, involving the very same factors currently used in veil-piercing actions, would entitle the state to contribution from the liable shareholder. In the example above, the incorporation state could investigate whether OppCo operated in a way that would render OppCo's shareholders liable under the traditional veil piercing rules. If so, the incorporation state could recover fifty dollars from OppCo's shareholders to offset the fifty dollars previously paid to the victim. Figure 3 displays the flow of funds in a case like this, when a state has cause to recover funds from corporate shareholders.

Figure 4. Incorporation Responsibility, Piercing



In many cases, a state's contribution rights will substantially reproduce the substantive outcomes of the status quo. In this example, both the status quo and incorporation responsibility cost the shareholders fifty dollars, impose no net cost on the state, and make the victim whole.[83]

Yet despite the contribution option, the status quo and reform proposal differ in many cases. There is no requirement that the contribution requirement track existing law in all respects; states could, for example, move to incorporation responsibility while abolishing veil piercing or expanding it. We discuss some possible experiments in Section IV.B.[84]

This Part provided an overview of the basic operation of incorporation responsibility. Many of the details were omitted for the present. For those who want to know how liability must be apportioned when differ-

83. The only difference is who must act. Under the status quo, the victim must do the work and bear the risks in proving the applicability of veil piercing. Under incorporation responsibility, the victim could rest easy once it establishes OppCo's liability; the incorporation state bears the risk and must take the steps necessary to obtain contribution. Of course, incorporation responsibility is compatible with outright preservation of piercing the corporate veil, too, such that the state would only compensate the victim after the victim demonstrated that veil-piercing was not a viable path for recovery.

84. The forgoing examples presume that incorporation states can dictate the extent of limited liability arising from the entities they incorporate. This is consistent with the view that limited liability is a rule governed by the law of an entity's incorporation state.

ent states incorporate various entities in a corporate group, or how it is possible to limit this proposal's solicitude to involuntary creditors and not contractual creditors, an Appendix is available to offer important clarifications and elaborations. Most readers probably do not need those details to appreciate the normative question of whether such a program is a good idea, so it is to the normative case that we now turn.

IV. The Merits of Incorporation Responsibility

The simplest case for incorporation responsibility is that it cuts the Gordian knot that has tangled a generation of scholars, by refusing both the problematic status quo and the problematic reform proposals. Unlike the status quo, which sometimes prevents innocent creditors from recovering what they are owed, incorporation responsibility provides recourse. Someone will pay when the corporation cannot. And unlike reform projects to institute shareholder liability, incorporation responsibility protects investors. Entrepreneurs can continue to start companies, and workers can still save for retirement, without fearing that someone else's tort could wreck their financial future. Thus, all risk-averse parties are accommodated.

Incorporation responsibility also prevails in light of the three arguments that now dominate the limited liability discourse. Defenders of limited liability argue that investors cannot diversify and trade their investments if faced with unlimited liability.[85] Incorporation responsibility will protect diversification and liquidity just as well as limited liability, because investors remain fully protected.

Defenders likewise argue that shareholder liability is not administrable and would lead to a wasteful game in which investors hide their assets in overseas holding companies and victims claw them back.[86] Incorporation responsibility cuts through this mess. The buck stops with liability for the state of incorporation. Plaintiffs do not have to fly all around the world levying on hidden bank accounts.

Finally, critics of limited liability argue that it leads to inefficient risk taking by failing to ensure that any decision-maker consider tort victims.[87] With incorporation responsibility, that problem is solved. The state becomes liable for the unpaid torts of the corporations it charters, and therefore must account for the likely costs of the corporations its law creates.

This last point requires elaboration. Obviously, states cannot directly alter corporate conduct: states are not corporate directors, and state of-

85. *See supra* Section II.C.
86. *See supra* Section II.D.
87. *See supra* Section II.A.

ficers do not physically stand inside the boardroom. Nevertheless, states have numerous powers at their disposal. If states want corporations to control risk in a particular way, states can simply mandate that action. With incorporation responsibility, states incur liability from some corporate conduct and may consider mandates to alter it.

This Part proceeds through three sections. Section IV.A sings the praises of internalization in lawmaking.[88] If states charge for incorporations and bear liabilities from them, then they will adopt laws that maximize the net social benefit, rather than the private benefit to their corporate clients. This will lead states to experiment more to try to write better laws, as Section IV.B discusses.

A. Internalization

States charge for incorporation. If they provide desirable corporate laws, they can charge higher fees to more applicants. This gives states a reason to determine what corporate law constituents desire. For example, consider a recent change to Delaware law, permitting boards to issue new shares without receiving shareholder approval.[89] This proposal has potential advantages, in letting the corporation more dexterously address practical problems in its capital structure, and potential downsides, in weakening one check on managerial excess. If a state considered such a change, it would be wise to canvass the potential losers (e.g., shareholders who may lose influence) and winners (e.g., managers who may gain influence). If the state went forward with the proposal, we would have some reason to think that the change was efficient.[90] That is because all of the

88. This Article presents states as already engaged in cost-benefit analysis, but urges inclusion of important costs that are systematically neglected. It is therefore in the spirit of scholars of cost-benefit analysis who document and would address failings in other domains of law, such as environmental regulation. *See*, *e.g.*, MICHAEL A. LIVERMORE & RICHARD L. REVESZ, REVIVING RATIONALITY: SAVING COST-BENEFIT ANALYSIS FOR THE SAKE OF THE ENVIRONMENT AND OUR HEALTH (2020).

89. Act of July 17, 2023, sec. 7, 84 Del. Laws. ch. 98 (amending DEL. CODE ANN. tit. 8, §242); *see* Allison L. Land & Edward B. Micheletti, *Proposed Changes to Delaware Law Would Facilitate Ratification of Defective Corporate Acts, Disposition of Pledged Assets, Stock Splits and Changes to the Number of Authorized Shares*, SKADDEN (May 25, 2023), https://www.skadden.com/insights/publications/2023/05/proposed-changes-to-delaware-law [https://perma.cc/R43M-YXPZ].

90. In fact, the actual responsiveness to various constituencies has been debated for decades. Some have argued that the law is broadly pro-shareholder, since shareholders ultimately decide whether to authorize a reincorporation to Delaware. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289 (1977); ROMANO, *supra* note 10, at 17-18. Others have argued that managers make the proximate decision of where to incorporate, so the law is likely tailored to them. LoPucki, *supra* note 12, at 2116-19. Jonathan R. Macey and Geoffrey P. Miller have argued that Delaware lawyers control the process and so design laws favorable to their own interest, subject to the weak constraint of manager or shareholder rebellion. Jonathan R Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471-72, 483 (1987). But it is

constituents had a seat at the metaphorical table and had their interests reflected, as refracted through the corporation's willingness to maintain a costly charter. Put another way, we feel confident that states make good decisions where they internalize the costs of those decisions.

Limited liability is different because states do not internalize the cost of their law; instead, they "externalize" the costs of their incorporations (and allow corporations to externalize some of the costs of their businesses).[91] Such externalization lets states expand limited liability without limit.[92]

Externalization biases lawmaking in favor of socially costly action. To see how, consider two hypothetical proposals and how a state might consider them. First, Henry Hansmann and Richard Squire propose a va-

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undeniable that the system provides states *some* incentive to consider the point of view of *all* the voluntary patrons of the firm.

91. An "externality" is defined as "[a] consequence or side effect of one's economic activity, causing another to benefit without paying or to suffer without compensation." *Externality*, BLACK'S LAW DICTIONARY (9th ed. 2009).

92. In some cases, the state itself or its citizens may be victims who obtain less than full compensation from the acts of entities the state incorporates, such as when a Delaware corporation pollutes in Delaware. *See, e.g.*, Cris Barrish, *DuPont, Spinoffs Reach $50 Million Settlement with Delaware over 'Forever Chemicals' Pollution*, WHYY (July 13, 2021), https://whyy.org/articles/dupont-spinoffs-reach-50-million-settlement-with-delaware-over-forever-chemicals-pollution [https://perma.cc/6CNK-VZ9D] (describing the settlement of Dupont, a Delaware corporation, with the state of Delaware over water pollution). But this is an extremely limited channel for driving home costs to the incorporation state. Many of the injuries a corporation causes will occur far from its incorporation state. This is a natural consequence of the fact that the United States has many small jurisdictions; a Rhode Island corporation's victims will not be limited to Rhode Islanders. New Yorkers summer in Newport, and Hasbro sells toys to Americans far from its place of incorporation in Pawtucket. *Hasbro, Inc. Entity Summary*, R.I. DEP'T OF STATE, https://business.sos.ri.gov/CorpWeb/CorpSearch/CorpSummary.aspx?FEIN=000015908 [https://perma.cc/34RY-E66E]. This interstate spillover is amplified by the fact that corporations can incorporate far from their headquarters; many Delaware corporations have no business operations there at all. For example, Take-Two Interactive Software, Inc., is an American video game developer headquartered in New York but incorporated in Delaware, with a registered agent listed at 251 Little Falls Drive, Wilmington, Delaware (the address of the "Corporation Service Company"). *Investor Relations*, TAKE 2 GAMES, https://ir.take2games.com [https://perma.cc/9JY7-9LHT]; *CSC Office Locations*, CSC, https://www.cscglobal.com/service/about/csc-office-locations [https://perma.cc/RC9V-KTWR]; *Delaware Department of State Business Entity Search System*, STATE OF DELAWARE, https://icis.corp.delaware.gov/Ecorp/EntitySearch/NameSearch.aspx [https://perma.cc/9EGF-FJNC] (providing the Corporation Service Company address for Take-Two Interactive Software, whose corporate file number in Delaware is #2353224). *See also* Leslie Wayne, *How Delaware Thrives as a Corporate Tax Haven*, N.Y. TIMES (June 30, 2012), https://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html [https://perma.cc/N2T3-Z9NZ] (reporting that an office building located at 1209 North Orange Street in Wilmington, Delaware, is the registered address for more than 285,000 businesses, including "American Airlines, Apple, Bank of America, Berkshire Hathaway, Cargill, Coca-Cola, Ford, General Electric, Google, JPMorgan Chase, and Wal-Mart"); Rupert Neate, *Trump and Clinton Share Delaware Tax 'Loophole' Address with 285,000 Firms*, THE GUARDIAN (Apr. 25, 2016, 7:00 AM), https://www.theguardian.com/business/2016/apr/25/delaware-tax-loophole-1209-north-orange-trump-clinton [https://perma.cc/54ST-USAS] ("This squat, yellow brick office building just north of Wilmington's rundown downtown is the registered address of more than 285,000 companies. That's more than any other known address in the world, and 15 times more than the 18,000 registered in Ugland House, a five-storey building in the Cayman Islands").

riety of interventions that would tend to reduce the protection of limited liability where the corporation generating liabilities is a subsidiary of a single parent corporation (rather than, say, a number of human beings).[93] Second, Steven Bainbridge proposes to eliminate veil piercing altogether.[94] Both proposals have merits and risks. Which will states consider?

Under the status quo system of externalization, Bainbridge's proposal is the only one with any hope of support. The beneficiaries of the Hansmann-Squire proposal are mostly out-of-state creditors whose interests do not figure in a state's calculation. Tort victims are not at the table, so they are on the menu.

Things look different if states are liable for some unpaid corporate debts. Then states would have a reason to drill down into the details of Hansmann and Squire's idea. The proposal creates costs, in that some corporations may opt to incorporate elsewhere to avoid the proposal's reach. But it also creates benefits, by reducing the number of plaintiffs who recover nothing against a corporate shell and so have a claim against the incorporating state. With incorporation responsibility, states will evaluate changes to limited liability the way that they evaluate changes to share issuance rules: by gathering the relevant information and trying to make tradeoffs. Truly egregious reforms will look unattractive because the state stands in for the victims.

The net result in any given case may be unpredictable and error prone, and different states may come to different conclusions. But states would come to regard limited liability rules alongside all the other instruments of corporate policy: a dial to be optimized, rather than merely set to eleven. When someone proposes an interesting reform option, the state will have a reason to consider it. It is to interesting reform proposals we now turn.

B. Innovation

It is not just that internalization would make states more protective of third parties and less protective of shareholders. Internalization also means that states would begin to explore altogether new axes of varia-

93. For example, they propose a sufficient condition for denying limited liability: that the subsidiary fails to produce accurate balance sheets for the relevant span of time. Henry Hansmann & Richard Squire, *External and Internal Asset Partitioning: Corporations and Their Subsidiaries*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 251, 271 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2015). This proposal reduces limited liability because it shifts the burden of proof to the defendant and eliminates the need for the plaintiff to prove injustice.

94. Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001); Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77 (2005). LoPucki and Verstein contemplate a less extreme variation, *supra* note 33, at 160.

tion, potentially discovering elegant and efficient liability systems never yet attempted.

At present, all states have settled on simple, stable, and similar limited liability rules. All states provide full limited liability to all chartered entities,[95] with a limited exception for veil piercing and its cousins. No state has adopted an interesting and different formulation of limited liability, nor has any state engaged in any recent modification or experimentation with the doctrine, because states currently have a single objective—maximizing the attractiveness of the incorporation to those who pay for it. Under incorporation responsibility, states face two objectives: maximizing franchise fees *and* minimizing franchise liability. Different states may balance these objectives in different ways. Some may increase incorporation fees to defray costs. Others may intervene in corporate law to try to limit their liability.

This Section considers a half dozen strategies states might attempt. Whether any particular reform is efficient cannot be known from theory alone. But incorporation responsibility would give states a reason to gather information about new possibilities and try some out.

1. Raise Franchise Fees

The most natural solution to the introduction of state liability is for states to raise their franchise fees so that the corporations that create problems ex post are paying to cover those costs ex ante. Incorporation responsibility makes incorporation states into a form of insurer for corporations, and it is understandable that states would behave like insurance companies and charge customers an implicit premium.[96]

Like insurers, states could charge different customers different amounts to reflect the insurer's expected costs. States could charge higher fees to corporations engaged in businesses most likely to generate third-party liability. For example, if mineral extraction occasionally leads to costly environmental hazards, while software companies rarely impose involuntary harm on third parties, states might naturally charge more to companies in the former business than the latter. This higher fee would lower current profits for companies in risky industries, beneficially channeling investment toward areas that generate profits less harmfully.

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95. In some states, limited partnerships must have a general partner subject to unlimited liability. But even this requirement is systematically dodged by elevating a corporation or limited liability company (LLC) to that role.

96. *Cf.* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 412-13 (2012) (arguing that banks should be permitted two kinds of charters, one of which is safer due to higher capital requirements).

2. Encourage Risk Control

Incorporation responsibility would make states receptive to rules that limit costly harms to third parties because the state would internalize some of those costs. Some candidate risk-control rules are familiar. States already require some industries to buy insurance,[97] and they previously required firms to keep a buffer of capital on hand for the benefit of creditors.[98] Requiring more insurance would protect third parties against loss, raise operating costs for more harmful businesses, and enlist insurance companies as pseudo-regulators with prudential requirements of their own.[99] Requiring higher capital buffers could have adverse consequences,[100] but it is plainly appropriate in some industries,[101] and incorporation responsibility would give states a reason to ask whether others could be logically covered.

Other ideas may be somewhat novel. Scholars sometimes propose that boards be charged with a duty to take account of risks to third parties,[102] or that boards have designated individuals to look after these outsiders.[103] Advocates for board diversity mandates sometimes argue that these mandates may cause corporations to be less likely to take risks that are costly for third parties.[104] Scholars have offered many such proposals,

97. *See, e.g.*, CAL. LAB. CODE § 3700 (West 2024) (requiring workers compensation insurance for all employers).

98. *See Minimum Capital Requirement*, DLA PIPER (Sept. 7, 2023), https://www.dlapiperintelligence.com/goingglobal/corporate/index.html?t=03-minimum-capital-requirement [https://perma.cc/EEL7-TDVJ] (listing minimum capital requirements around the world, with the United States now at zero). The global trend has been to lower minimum capital requirements. *See*, *e.g.*, Jessie Chenghui Tang & Ross Keene, *Recent Changes in the Registered Capital System in China*, JONES DAY (May 2014), https://www.jonesday.com/en/insights/2014/05/recent-changes-in-the-registered-capital-system-in-china [https://perma.cc/2RAS-V4FR] (describing China's recent elimination of its minimum capital requirements).

99. Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 197 (2012).

100. *See*, *e.g.*, Steven Shavell, *Minimum Asset Requirements and Compulsory Liability Insurance as Solutions to the Judgment-Proof Problem*, 36 RAND J. ECON. 63, 64-65 (2005) (arguing that capital requirements raise the cost of doing business, limiting competition and capital formation). Hansmann and Kraakman doubt the merits of insurance and capital requirements, though they also provide clues to regulators about where those requirements are most likely to be helpful. Hansmann & Kraakman, *supra* note 6, at 1927-28. Perhaps some state would like to experiment.

101. *Cf.* 12 C.F.R. § 3.10 (2023), (setting capital requirements for banks). Suffice it to say that legal capital buffers are not always useful. *See generally* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL (3d ed. 1990) (arguing that legal capital as required in the mid-twentieth century often provides no benefit to creditors).

102. Robert Hockett, *Are Bank Fiduciaries Special?*, 68 ALA. L. REV. 1071, 1115 (2017); Saule T. Omarova, *Bank Governance and Systemic Stability: The "Golden Share" Approach*, 68 ALA. L. REV. 1029, 1032-33 (2017); Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1, 28 (2016).

103. Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 241 (2013).

104. *See, e.g.*, Terry Morehead Dworkin & Cindy A. Schipani, *The Role of Gender Diversity in Corporate Governance*, 21 U. PA. J. BUS. L. 105, 113 (2018).

which might finally be considered by lawmakers under an incorporation responsibility regime.

3. Alter Background Priority Rules

Limited liability is only one factor determining the compensation for tort victims. Another is the system of creditor priority established under state law and preserved within the federal bankruptcy system. This system of priority has two distinguishing features. First, it respects "priority" designations among creditors. For example, a bank may condition its loan upon obtaining a security interest in the debtor's property. Then, the other unsecured creditors are entitled to repayment from that property only if a surplus exists after the bank has recovered in full.[105] Second, U.S. law puts tort victims at the bottom of the priority heap.[106] Even relatively well-capitalized firms can fail to pay tort victims much, because the money mostly goes to the secured creditors.

This system of priority has been extensively debated. Critics of the status quo have proposed several modifications intended to ameliorate the severe consequences for involuntary creditors. Elizabeth Warren proposed setting aside a portion of any bankruptcy estate, say twenty percent, for the benefit of unsecured creditors.[107] Others have proposed elevating involuntary creditors to the top of the priority scheme.[108]

Under any of these schemes, losses to tort victims would tend to be lower, since they are imposed partially on the senior creditors too. None of these schemes have proven attractive to state governments, but it is possible that they would look more attractive if states stood in the shoes of uncompensated victims. In that case, it is the incorporating state that would benefit from the new protections.[109] States could keep their incor-

105. This is the rule of absolute priority.

106. Not all involuntary creditors end up here. For example, insofar as tax liens are a form of involuntary credit, federal bankruptcy law tends to elevate them above other creditors. *See* 11 U.S.C. § 507(a) (2018) (listing in the bankruptcy code the priority of unsecured claims); Sunz Ins. Co. v. Payroll Mgmt. (*In re* Payroll Mgmt.), 630 B.R. 627, 642-43 (Bankr. N.D. Fla. 2021) (holding that Internal Revenue Service tax liens that are the result of a tax assessment can attach to commercial torts claims and will have priority over later security interests that were not properly executed, even if the tax lien was recorded after the security interest).

107. Memorandum from Elizabeth Warren to the Council of the American Law Institute (Apr. 25, 1996), *as reprinted in* LYNN M. LOPUCKI, ELIZABETH WARREN & ROBERT M. LAWLESS, SECURED TRANSACTIONS: A SYSTEMS APPROACH 665, 665-67 (9th ed. 2020).

108. *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279, 1325-27 (1997). LoPucki offered a more context-specific rule, under which unsecured creditors are on par with secured creditors except when they are on notice of their lower priority. LoPucki, *supra* note 48, at 1964-65.

109. Right now, states have a financial incentive to permit victimization of involuntary creditors to the benefit of secured creditors, since that tends to lower the cost of secured credit to corporations—states' fee-paying clientele. This is analogous to externalization in favor of shareholders.

porations cheap and attractive despite taking on new liability if they restructured priority in ways that protected the most vulnerable class, whose interests they come to share under incorporation responsibility.

4. Expand Shareholder Contributions

Incorporation responsibility permits states to functionally reduce limited liability by stipulating a wide variety of cases in which shareholders must offset a state's losses. At the extreme, a state might provide that shareholders are fully liable whenever the state must pay on a corporation's behalf. More moderately, states could cap shareholder risk or impose it only sparingly. Past regimes of shareholder liability have sometimes provided for multiple liability, with shareholders liable for twice or thrice their capital contribution.[110] Most critics of limited liability now ask for pro rata liability,[111] and a state could take up that approach through contributions.

There is no reason that shareholder contribution rules must track the existing literature. In fact, there are many new variations on shareholder liability that could be considered. Defenders of limited liability see the regime as an implicit subsidy, channeling resources to important projects that might otherwise be too risky.[112] Accordingly, the law could condition limited liability on the social value of the project.[113] Limited liability could be robust where firms undertake risky but important medical or defense research. It could be weakened for firms that endanger the environment or financial system, or commit crimes, with no offsetting social benefit.[114]

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110. Blumberg, *supra* note 59, at 600.

111. *See, e.g.*, Hansmann & Kraakman, *supra* note 6, at 1894 (describing the pro rata rule as "clearly the superior alternative for publicly held corporations").

112. *See* Ribstein, *supra* note 54, at 447 (arguing that socially valuable projects may not be insurable and therefore require limited liability).

113. During the recent COVID-19 pandemic, corporations were reluctant to reopen due to fears of liability to employees and customers for any infections on their premises. Pamela Glass, *Barge Industry Seeks Temporary Liability Shield from Covid-19 Lawsuits*, WORKBOAT (June 22, 2020), https://www.workboat.com/coastal-inland-waterways/barge-industry-seeks-temporary-liability-shield-from-covid-19-lawsuits [https://perma.cc/RD8M-SCA7]. Some states sought to reassure corporations by providing liability shields against such suits, even though cutting off liability-imposed costs raised concerns among employees and customers. Chris Marr, *Covid-19 Shield Laws Proliferate Even as Liability Suits Do Not*, BLOOMBERG LAW (June 8, 2021, 5:31 AM), https://news.bloomberglaw.com/daily-labor-report/covid-19-shield-laws-proliferate-even-as-liability-suits-do-not [https://perma.cc/4HD7-ME23]. Under incorporation responsibility, states could reassure these businesses without leaving customers and employees unprotected.

114. *Cf.* Kathryn R. Heidt, *Liability of Shareholders Under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA)*, 52 OHIO ST. L.J. 133, 172-73 & n.280 (1991) (arguing for relaxation of limited liability for environmental violations); Conti-Brown, *supra* note 96, at 409 (arguing for relaxation of limited liability for banks bailed out by the government); Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. LEGAL STUD. 689, 716-17 (1985) (advocating abolition of limited liability for "knowable tort risks"); Christopher D. Stone, *The Place of En-*

Since one rationale for shareholder liability is to prevent unjust enrichment of shareholders, states could condition limited liability on the absence of such enrichment. A state could require shareholders to indemnify states only up to the sum of a given shareholder's dividends received, to roughly limit losses to past gains. That would help fund the victim's recovery but assure shareholders that they can never lose more than they have gained. Such a rule is dynamic: potential contributions rise as profits do.

The state could also condition shareholder liability on facts about the corporation that reflect shareholder control and culpability. For example, in publicly traded corporations, individual investors rarely have any influence over the corporation's conduct.[115] Imposing liability on individuals without any control might seem unfair or chill their willingness to invest. By contrast, at closely held corporations, it is typical for shareholders to have some direct or indirect influence over the decisions of the enterprise. Some scholars have noted that it would be nice to distinguish between those two contexts,[116] protecting small shareholders in large firms more than others.[117] States could do precisely this, providing limited liability to tiny investors or investors in public companies but not others.[118]

Other scholars have noted that some arguments in favor of limited liability turn on risk aversion: individuals are often disproportionately cautious in the face of large potential losses and must be protected if they are to be coaxed into taking their savings out from under their mattresses.[119] These scholars often acknowledge that institutional investors, such as large corporations and investment funds, do not suffer from the same

terprise Liability in the Control of Corporate Conduct, 90 YALE L.J. 1, 74 (1980) (advocating abrogation of limited liability for criminal penalties, punitive damage awards, and "perhaps even civil liabilities arising under federal statutes whose policies do not appear fully discharged by compensation").

115. BAINBRIDGE & HENDERSON, *supra* note 11, at 76.

116. *Id*. at 302-04.

117. *See, e.g.*, Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148-49 (1980) (advocating unlimited liability for small, closely-held corporations, in both tort and contract, and suggesting that directors of large, publicly-traded corporations be made personally liable to involuntary creditors); George W. Dent, Jr., *Limited Liability in Environmental Law*, 26 WAKE FOREST L. REV. 151, 178 (1991) (arguing for vicarious liability on controlling shareholders).

118. To some degree, current practice already tracks this. No public corporation has ever had its veil pierced. And close corporations are much more likely to satisfy the existing elements of veil piercing. When just a few individuals own all the shares, they are likelier to take corporate property home after work for personal use (or vice versa). They are likelier to instruct and deal with employees, regardless of whether their job title would otherwise allow those communications.

119. *See, e.g.*, Posner, *supra* note 59, at 502 (arguing that unlimited liability would "discourage even substantial entrepreneurial investments by risk-averse individuals—and most individuals are risk averse").

degree of risk aversion.[120] States could preserve limited liability for natural persons but impose some measure of contribution on shareholders who are legal persons.[121]

A state could further condition limited liability on its own capacity to pay, requiring liable investors to personally contribute only when the state's own balance sheet demands it—waiving contribution when the state is flush, or when a designated pot of money is full (implicitly, an insurance fund for corporate torts).[122] Such a policy would have downsides, such as a lack of predictability and a temptation for investors to dump shares when states face budget crunches, but it would also serve as a rough mechanism for risk-sharing. When a gigantic tort occurs, neither taxpayers nor shareholders would have to go it alone.

5. Expand Non-Shareholder Contributions

Corporations have many patrons, and the state could design new schemes of contribution involving them. For example, the state could stipulate that bondholders, officers and directors, or long-term suppliers are liable in contribution for unpaid debts.[123] This liability could be unconditional or conditioned upon designated features, such as the practical ability of the individual to prevent the liability-inducing wrongdoing.

Imposing contribution responsibility on non-shareholder groups has been explored or proposed by scholars in the past.[124] One rationale for this idea is that individuals who might be held liable for torts in the event of corporate bankruptcy gain an incentive to guard against costly torts. They become gatekeepers, and non-shareholders are sometimes in a good position to keep the gate. For example, executives literally run the corporation. If they fear the personal consequences of costly torts, they may personally act with greater care and demand it of their subordinates. Creditors also play an important role in monitoring corporate risk-

120. *See, e.g.*, Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 513-14 (1994) (arguing that enhanced liabilities should be imposed on financial holding companies); PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 681-92 (1st ed. 1987) (suggesting abolition of limited liability among firms within "corporate groups").

121. *Cf.* Hansmann & Squire, *supra* note 93, at 251-252 (defining "external" asset partitioning as limited liability protecting human shareholders and deeming it more justifiable).

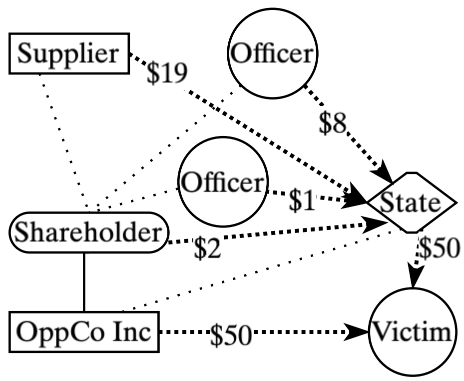
122. Robert Rhee's proposal to post a bond, which is then collectivized, is in this spirit. Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417 (2010).

123. My earlier proposals regarding priority among a corporation's creditors would effectively make such creditors contribute more to the compensation of a corporation's tort victims than they do now.

124. *See supra* notes 18-21 and accompanying text. *See also* Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 334-35 (2004) (proposing liability for corporate officers).

taking,[125] particularly when secured assets are involved.[126] A bondholder who fears liability when financing potential tortfeasors might take steps to ensure that its borrower is well-capitalized and not engaging in unauthorized risky conduct. If suppliers were sometimes liable for corporate torts, a seller of hazardous materials might ask for assurances that a customer will use the materials safely.[127] Figure 5 depicts some of these options.

Figure 5. Expanded Non-Shareholder Contributions



In this figure, a $100 tort is half paid by the state because OppCo is insolvent and can only afford to pay $50 to Victim. The state then collects $1 from the officers who ran OppCo in such a way as to generate unpayable debts, $2 from shareholders who elected those managers and collected corporate dividends, $8 from bondholders who financed the risky ventures without demanding or exercising covenants that could limit risk, and $19 from a monopolist supplier that charged prices affordable to OppCo only if OppCo cut corners on safety. States could pick and choose among such alternative contribution sources, fine-tuning the mix according to incentives and administrative concerns.

125. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 (2006).

126. Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 51-53, 57-59 (1982).

127. Even where a corporate participant lacks the leverage to encourage probity, it may sometimes seem appropriate to recover profits from creditors, managers, and counterparties who were richly compensated during the period of the tort; the case for recovering illusory gains is as strong for non-shareholders as for shareholders.

6. Ask for more information

States can reduce their incorporation liabilities if they know more about their applicants and registrants. Ex ante, if states can identify attributes of an incorporation application that predict subsequent harm and lawbreaking, they can consider those attributes in incorporation decisions; when problematic firms seek to incorporate, the state can deny the application or approve it only subject to special risk-control provisions or higher fees. Ex post, if states know who has invested in a corporation and where investors' assets are located, states will have an easier time collecting from those investors if they are later adjudged liable to the state; easier recovery makes the state's own expected burden smaller. Whether before incorporation or after liability, states face lower costs if they know more about their corporations and shareholders.

States do not currently demand the sort of information that they would need to be selective with incorporations or to dependably find shareholders who have satisfied the traditional veil-piercing test. Delaware, for example, does not require any beneficial-owner information from corporations. The most important state for corporate law has literally no idea who forms and owns its corporations. California demands only the most superficial investor information, without any assurance that it remains timely.[128] The United States lags the world in generating basic information about who forms, owns, and operates business entities.[129] The likely reason is that states internalize the benefits of privacy in the form

128. Both California's Articles of Incorporation and Statement of Information forms require the name, phone number, and email of a "Contact Person" (i.e., a person to whom all correspondences related to the submission will go). The Articles of Incorporation form requires the names and signatures of all incorporators, as well as the number of shares authorized. *Articles of Incorporation of a General Stock Corporation (Form ARTS-GS)*, CAL. SEC'Y OF STATE (June 2023), https://bpd.cdn.sos.ca.gov/corp/pdf/articles/arts-gs.pdf [https://perma.cc/7DQG-29QX]. The Statement of Information requires no additional information about shareholders, although information about directors and key officers is required. *Statement of Information (From SI-550)*, CAL. SEC'Y OF STATE (Mar. 2022), https://bpd.cdn.sos.ca.gov/corp/pdf/so/corp_so550_112021.pdf [https://perma.cc/KS82-ZT8A]. The Statement of Information also must be signed, but this signature may be anyone's, whereas the Articles of Incorporation form must be signed by the incorporators.

129. LOPUCKI & VERSTEIN, *supra* note 33, at 607-10 (explaining that between 2015 and 2020 the European Union and the United Kingdom adopted and implemented provisions requiring beneficial ownership information be publicly available, while a comparable information-gathering law in the United States had not been adopted). The United States leads the world in desirable jurisdictions for entities trying to avoid ownership transparency. Carl Pacini & Nate Wadlinger, *How Shell Entities and Lack of Ownership Transparency Facilitate Tax Evasion and Modern Policy Reponses to These Problems,* 102 MARQ. L. REV. 111, 119 (2018). The United States ranks first on the Financial Secrecy Index, which ranks countries based on financial secrecy and scale of offshore financial activities. *Financial Secrecy Index 2022,* TAX JUST. NETWORK (2022), https://fsi.taxjustice.net [https://perma.cc/LG8L-F9K8]. Very recently, a federal law was adopted to increase transparency, but even this law faces myriad restrictions. *See U.S. Beneficial Ownership Information Registry Now Accepting Reports*, FIN. CRIMES ENFORCEMENT NETWORK (Jan. 1, 2024), https://www.fincen.gov/news/news-releases/us-beneficial-ownership-information-registry-now-accepting-reports [https://perma.cc/4QY7-PHWT].

of incorporation fees from happy customers, and they have no offsetting reason to request the information.

With incorporation responsibility, states would have a reason to collect basic information about their entities. If they did so, states would help themselves be choosy in chartering and vigilant in enforcement.

Importantly, this information would also produce public benefits.[130] Accurate information could greatly help law enforcement activities. At present, with this information lacking, anonymous entities can be used to facilitate money laundering by terrorist organizations, criminal groups, and kleptocrats.[131] With incorporation responsibility, states will have a voluntary reason to collect information conducive to the rule of law generally.

Excessive intrusion into the private lives of shareholders and others is undesirable. But even privacy advocates may prefer greater state involvement in the surveillance business. States, after all, are positioned to balance the benefits of information gathering against its intrusiveness. By contrast, the federal government increasingly acts to gather this information in ways that do not expressly weigh the benefit of the information against the preferences of corporations for privacy.[132]

* * *

This Section has outlined dozens of ways states could respond to incorporation responsibility. The point of this Section is not to endorse any of these alternatives. Each has flaws, and perhaps the flaws outweigh the benefits. The point is merely to illustrate that incorporation responsibility is compatible with a variety of alternative experiments in liability. And under each of these alternatives, the victim obtains compensation, whereas the status quo can leave the victim largely uncompensated. Under some of these schemes, some corporate patron gains an incentive to discourage the corporation from externalizing harm—either to protect itself

130. States would likely differ in their precise responses to incorporation responsibility, which would generate data useful to scholars and regulators. First, if any state substantially recreates the existing limited-liability regime, franchise fees and all, it will suggest that defenders of limited liability were right all along—this regime really is quite efficient; it can pay its own debts. Second, Michael Simkovic argues that regulators can learn about industry-specific risk levels by auctioning off limited liability to only some firms in each industry. Simkovic, *supra* note 20, at 281-82. High bidding rates are a sign of brewing unaddressed risks. While Simkovic's proposal generates regulatory information based on a single federal standard, multiple states trying different implicit auctions could potentially generate even more information.

131. *See, e.g.*, *Anonymous Companies—Frequently Asked Questions,* GLOB. WITNESS (Mar. 17, 2014), https://www.globalwitness.org/en/archive/anonymous-companies-frequently-asked-questions [https://perma.cc/5C2N-LWU3]. *See also* City of Almaty v. Ablyazov, 226 F. Supp. 3d 272, 275-76 (S.D.N.Y. 2017) (discussing the complex forensics required to track money through numerous entities).

132. *See* Corporate Transparency Act, Pub. L. No. 116-283, div. F, tit. LXIV, 134 Stat. 3388, 4604-25 (2021) (codified at 31 U.S.C. § 5336).

from contribution or just to lower the franchise fee or insurance premium paid by the corporation. Under other schemes, the state itself has an incentive to create laws that discourage inefficiently harmful conduct. Either way, someone with skin in the game will have a reason to integrate all the available information—and to generate more information upon which to base decisions.

V. Responsibility in Context

Many objections can be offered against incorporation responsibility. This Part addresses several. To preview: one may fear that incorporation responsibility will have adverse consequences for states or the production of corporate law. States may be bankrupted by incorporation responsibility, or fear of liability may discourage states from incorporating at all. Although incorporation responsibility certainly changes the nature of corporate federalism, it is far from clear that it harms states or discourages them from the competition to produce corporate law. To the contrary, incorporation responsibility creates new ground for competition that may let some states compete and prosper as they never did before. State competition is accordingly addressed in Section V.A.

Section V.B considers alternative proposals, such as removing limited liability from the internal affairs doctrine or mandating private provision of insurance. Though both look simpler than this proposal, they are both unable to achieve the benefits of incorporation responsibility and may leave us worse than we started.

If incorporation responsibility is such a good idea, why has debate raged over limited liability for so long? Section V.C attempts to address the root intellectual cause of the problem: an undue (and uncharacteristic) focus of corporate law scholars on what the right rule should be, rather than on how the right rule out to be determined.

A. State Competition

Incorporation responsibility requires that states respond appropriately to residual liability. For this intervention to be efficient, states must explore plausible variations on the law and then use these variations to compete for incorporation fees. There are good reasons to think they will do so.

However, it is worth thinking through some pathological responses. For example, some states may find the prospect of residual liability terrifying. After all, by accepting a $90 filing fee from some little-known applicant, a state might unknowingly assume liability for billions of dollars' worth of asbestos liability. The state's benefit comes nowhere close the potential cost. Such a state may close its incorporation efforts altogether. For example, New Mexico formed only 627 corporations in 2020.[133] Given a $50 franchise fee, the state's take from incorporations was under $40,000. New Mexico might reason that no risk of liability could be justified for a mere $40,000.

It is not clear how seriously we should consider such a response. New Mexico's 627 corporations could easily reposition themselves as Colorado corporations. Both states use the Model Business Corporation Act, so the relevant lawyers would not have to do much to deliver the same results. There is no iron law that competitive markets must always have fifty sellers, or that states that incorporate 0.13% of all corporations must not be permitted to drop to 0%.[134] As long as *several* states remain in the incorporation game, it would be fine if some opted out.

And the leading states would not drop out of the race so readily. Delaware obtains one-third of its government's revenue from incorporations, a whopping two billion dollars annually.[135] California brings in about one billion dollars.[136] These are large sums, and they understate the states' commitment to keeping the incorporation business alive. State entity laws are written and maintained by a powerful lobby—the state's corporate bar.[137] Their expertise is valuable insofar as their corporate laws are widely used. The leading Delaware and California law firms are strong supporters of their state's continued participation in the incorporation market. As a matter of political economy, they would not permit their states to abandon their domestic corporate laws because of the faintest risk that liability might someday arise. And the more states that bow out of the market for incorporations, the greater the gains for the states (and lawyers) that remain.

To be sure, the lawmakers and bureaucrats who set incorporation standards and limited liability rules may be risk averse in light of new liability rules. Their personal careers may be imperiled if a large liability materializes. Taxpayers may recall the governor whose functionaries approved an incorporation, or drafted a law, that resulted in a budget deficit. It is therefore safer for these actors to excessively restrict incorporation under the state's laws. It is not as though state actors individually obtain millions of dollars if new corporate law rules attract business.

133. Email from Randall Rodriguez, N. M. Office of the Sec'y of State, to author (Sept. 13, 2021) (on file with author).

134. About 500,000 corporate charters were issued in 2020 (author's research notes on file with author).

135. *See supra* note 8.

136. Gabriel Petek, *The 2020-21 Budget: Expanding the Minimum Franchise Tax Exemption*, CAL. LEGIS. ANALYST'S OFF. 2 fig.1 (Mar. 2020), https://lao.ca.gov/reports/2020/4207/min-franchise-tax-exemption-032320.pdf [https://perma.cc/S46J-ERLF].

137. Macey & Miller, *supra* note 90, at 472.

Yet government officials do not always behave cautiously. There are offsetting forces that promise to largely preserve the efficient functioning of corporate competition. For one thing, bureaucrats and lawmakers know that any potential corporate liabilities would likely arise down the road, perhaps long after the individual leaves office for greener pastures, whereas the incorporation fees and legal fees from widespread chartering generate benefits now. The state actors' unfortunate tendency to fear losses (without regard for the potential benefit) is matched in part by the unfortunate tendency to prize certain current gains more than uncertain future losses. There is no reason to suppose the former force will dominate the latter. And again, it is crucial only that a few states basically strike a rational balance so that a market for incorporation remains—it could be that dozens of states fearfully close their incorporation shops, and everything will be fine for the few states who manage this challenge.

Even cautious states have many options to remain competitive in incorporation.[138] Far from ending competition, one nice feature of this liability-inflected competition is that it introduces new dimensions for competition.[139] At present, the market for incorporations has only a few criteria on which states can compete. Delaware sells competence and private ordering.[140] Nevada sells lax fiduciary duties.[141] Most other states compete on price. But no group competes for sustainable probity. Even the many states that permit public benefit corporations have failed to signal that the state has any special commitment to businesses internalizing their costs, nor has any state built a strong reputation as the leader in this market. Indeed, benefit corporations have been perceived as empty marketing tactics, with states enablers in the greenwash.[142]

With incorporation responsibility, state can credibly commit to sustainable probity and gain a reputation for doing so. Some state—say, New Mexico—might realize that it cannot compete against Delaware on its own terms, but that it could position itself as a home to the world's most respectable corporations. The state could adopt stringent rules ensuring that its charters only go to safe businesses that rarely impose costs on third parties. The state's own fisc would be at risk if it created ineffective rules or vetted poorly. States would not greenwash if they were at risk for the leftover harms of their corporations. The state's credible commitment

138. *See supra* Part IV.B.

139. For documentation of states' tendency to generate and share novel corporate provisions, see Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REGUL. 209, 214 (2006).

140. Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA L. REV. 935, 939 (2012).

141. *Id*. at 952.

142. *See* Elizabeth Bennett, *As Greenwashing Soars, Some People Are Questioning B Corp Certification*, BBC (Feb. 6, 2024), https://www.bbc.com/worklife/article/20240202-has-b-corp-certification-turned-into-corporate-greenwashing [https://perma.cc/B4RQ-555F].

to harbor only upstanding businesses would let businesses from that state present themselves to suppliers, customers, and employees with a bit more glamour. They might win projects and business from individuals who prefer to deal with those who clean up their messes. And just as corporate friendliness has taken on a life of its own—with states seeking incorporations in part to encourage businesses to locate within the state (even though there is no necessary connection between these two actions), states may enjoy benefits outside of their incorporation fees if they become associated with some conception of sustainable capitalism. Ethical vacationers may visit; ethical businesses may relocate.

Environmental, social, and governance factors aside, states might explore new ways to compete for traditional incorporations. New York and Florida might experiment with different ways to keep costs under control, with the former insisting upon mandatory insurance and the latter demanding an obligatory "risk monitor" be appointed to corporate boards. Corporations would sort themselves according to which burden they prefer to shoulder. Among states with similar rules, some might invest more in filtering incorporation applicants or charging risk-adjusted premiums. Michigan may offer a big tent, allowing anyone incorporation (for a price), while Connecticut might protect its brand and its treasury by incorporating only firms it deems safe (and thereby earn a low franchise fee befitting the low risk). Whatever variations prove salient, we should not think incorporation responsibility is only about removing states from incorporation competition; instead, it will channel some to new avenues of competition.

B. Comparison to Other Solutions

Incorporation responsibility seeks to encourage incorporation states to make socially efficient incorporation decisions by making them a residual insurer. But one could instead take away their control over liability. There would be no fear of charter-state externalization if limited liability were instead determined by the law of the state where the tort occurs. So one alternative to this proposal is to determine limited liability by *lex loci* rather than the internal affairs doctrine.

Another alternative is to agree that mandatory insurance is appropriate, but to question whether states should provide it. Instead, corporations could be required to purchase insurance policies.

This Section explores and rejects these two alternative reform solutions.

1. *Lex Loci*

One alternative to the problem of corporate law externalities is to remove limited liability from the scope of the internal affairs doctrine. Instead, the liability of shareholders for corporate torts would be decided by the law of the jurisdiction where liability was incurred. For example, if a Delaware corporation pollutes a river in North Carolina, North Carolina law would say whether Delaware shareholders are liable. This system would remove Delaware's temptation to garner charters by ignoring victim interests.

Yet this alternative suffers from its own problems. Symmetrically, North Carolina tort law might become too expansive, since North Carolina legislators know that much of the money extracted would come from out-of-staters. Elected officials have been known to favor policies that allow in-state voters to recover more, at the expense of corporations that are more often headquartered elsewhere. As the former Chief Justice of one state supreme court put it,

> As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because the in-state plaintiffs, their families, and their friends will reelect me.[143]

Even if states did not set out to beggar out-of-state shareholders, even a fairhanded effort to establish limited liability locally would be inferior to incorporation responsibility. One reason is complexity and confusion. If limited liability were a function of local law, a shareholder could never be sure what her legal risks are: if a single company employee or product crosses into a high-liability state, the shareholder could become personally liable. Risk-averse shareholders might treat the firm's limited liability rule as whatever rule in the world is least protective. Sophisticated investors could invest money to form multivariable assessments of risk, taking account of the places where their corporation does business and commits torts. This is messy stuff.

Another reason is the genius of corporate law. If limited liability is stripped out of corporate law, it ceases to be part of the product states customize to win incorporation business. States will no longer try different variations on limited liability, since the states with power over the rule do not gain charters by improving the rule. Likewise, economies of scope in experimentation will not be realized. In theory, a state can benefit tort victims by altering governance rules, litigation standards, or any other aspects of corporate law. They will explore these options if they retain residual liability. They will not do so if residual liability lies with

143. RICHARD NEELY, THE PRODUCT LIABILITY MESS: HOW BUSINESS CAN BE RESCUED FROM THE POLITICS OF STATE COURTS 4 (1988).

shareholders or tort victims, depending on where the tort arises on a case-by-case basis.

2. Insurance

Incorporation responsibility is somewhat like a scheme of mandatory insurance. Corporations must buy and states must sell an insurance policy covering a class of involuntary creditor. A reasonable question is whether a better reform is just to require corporations to buy insurance. The question is particularly salient since some states may respond to incorporation responsibility by buying insurance or by requiring incorporated firms to buy insurance. Given that insurance is going to be purchased in many instances anyway, why not begin there?

The answer to this question, as with so many, begins in Ronald Coase.[144] If transaction costs are zero, initial allocations of responsibilities do not matter for efficiency. If states are forced to bear inefficient risk, they will cheaply contract with insurance companies, and if corporations are required to buy insurance that companies cannot efficiently provide, states can sell residual reinsurance services to the insurance company. Indeed, even potential tort victims can transact with all firms, negotiating for their preferred level of protection against injury.

But transactions costs are not zero, nor are they uniform, so initial allocation sometimes matters. These considerations suggest that the state is usually the best bearer of incorporation risk, at least in the first instance. Four reasons lead to this conclusion:

First, states are able to take actions that insurance companies cannot. States can legislate mandates on corporations. States can empower government prosecutors and create third-party rights of actions. States can legislate penal fines and damages. States can coordinate with other states and law-enforcement agencies. Insurance companies can do none of these things. This means that states can take actions to protect themselves from liability that insurance companies cannot. And, importantly, it is not likely that insurance companies could cheaply bargain for states to perform these functions.

Suppose that thoughtful experts on Texas law determined that gross negligence by a corporate risk committee should be punishable by treble damages, and that any citizen or prosecutor should have the right to sue to recover. These rules would be a simple matter to legislate as part of the Texas Business Organizations Code. But they would be unenforceable or not credible as contractual provisions in an insurance contract. Contracts cannot create third party rights of action, let alone empower and inspire

144. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1 (1960).

state prosecutors. Extra-compensatory penalties are likewise invalid. States can create these rules by statute, but insurance companies cannot.

In theory, insurance companies could lobby the legislature to create these rules, but the process would not be smooth. The state would face competing lobbies as corporations resisted new obligations. Insurance companies would push for new obligations even when unjustified in order to reduce risk relative to the premiums already charged. Citizens would be understandably distrustful of rules designed by identifiable, profit-seeking special interests. Things are likely to be easier and tidier when states legislate to protect their own interests and balance their own budgets.

Second, insurance companies can and do become insolvent. A mandate that corporations purchase insurance puts a lot of pressure on the rules to determine which insurance companies are deemed solvent enough to satisfy this regime. Corporations will be tempted to buy the cheapest, and therefore least solvent, insurance policies. State insurance regulators can vet insurance companies, but the process is imperfect and costly.

More importantly, many states will not happily accept any form of limited liability reform. A state that wishes to frustrate a regime of mandatory insurance (lowering insurance premiums to its chartered firms and thereby increasing firms' willingness to incorporate in the state) can do so by instructing its insurance regulator to be lax in oversight. Lax oversight will harm out-of-state tort victims, whom the state is already inclined to disregard. Only a regime that makes the state the final guarantor will cause states to properly address risk—from its insurance regulator on up.

Third, state responsibility may be the only credible option for large bankruptcies. The commercial insurance market has limited ability to credibly commit to extremely large payouts.[145] In the end, states already provide catastrophic and tail-risk coverage for many natural disasters. For disaster-level corporate obligations, there is no alternative to placing liability on the state.

Fourth, and finally, it is conceivable that the best risk-bearer is not the state, but it does not follow that a private insurance company is better—and depending on the optimal risk-bearer, it may be impracticable for corporations or insurance companies to bargain for the superior risk-

145. LoPucki notes some reason to doubt that insurance companies can solve all our risk-related problems. *See* LoPucki, *supra* note 48, at 1906-07; LoPucki, *supra* note 6, at 72-83; *accord* Simkovic, *supra* note 20, at 289; *see also* Michelle E. Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783, 806-07, 809, 812 (2005) (noting that mandatory insurance required under the Terrorism Risk Insurance Act merely shifts the risk to insurance companies, which are then compensated by the federal government in case of insolvency).

bearing arrangement. Only a state can establish that superior risk-bearing pattern.

To see this, consider a hypothetical scenario in which the ideal bearer of at least some portion of a corporation's unpaid liabilities is whoever supplied goods to the corporation. Imagine that a firm buys a machine from Wholesaler, and that it is socially optimal that Wholesaler bear some liability for the corporation's unpaid debts. Perhaps this is for reasons familiar to products liability (Wholesaler could be a product designer, uniquely positioned to incorporate customer harm into the design), but where products liability for some reason denies recovery. Or perhaps the reason is distinct: the wholesaler may have a technological ability to monitor downstream use of its product, such that it could cheaply monitor downstream users for illegal or risky conduct. The precise details are unimportant, so long as such a possibility is acknowledged.

In this hypothetical, it is optimal that the Wholesaler bear some residual liability. Can that be arranged if an insurance company bears the liability in the first instance? It will prove challenging. The insurer must know the optimality of this arrangement. It must contract with its insured customers to ask them to obtain the contact information of their supplier. The insurer must contact the Wholesaler and persuade them to accept liability for some downstream uses. The insurer will have to pay them a sum that reflects this risk, which they pass on to their customers. Each of these steps is expensive and likely to introduce hold-up problems and errors.

The matter is easier for a state. A state can simply state that anyone who supplies a corporation becomes liable for a stipulated subset of its unpaid debts. A state can legislate legal relationships into existence as a matter of corporate law, just as it legislates them away (with limited liability).

The point here is not to argue for supplier liability. The point is rather to show that more complex liability arrangements are easier to reshuffle when the state is a guarantor then when it is not.

Scholars have long held some sympathy for mandatory liability insurance regimes, but they have never proven fully satisfactory. The following Section explains why the benefits of these regimes are better achieved through incorporation responsibility.

C. The Sources of Enduring Debate

Why has incorporation responsibility not already proven an attractive theory? Of course, it is a novel idea, so most thoughtful people have not yet had the chance to wrestle with it. And for those readers acquainted with it, they may find my arguments insufficient to justify a material change to our corporate liability system. But a third reason for resistance may be deep-seated expectations about the proper way to debate limited liability. Scholars have tended to focus on the benefits and costs of particular rules, rather than seeking to establish a framework out of which many possible rules might emerge. This is understandable, but it is ultimately unwarranted. It is also uncharacteristic of corporate scholars, who are usually wise to this methodological trap.

1. The Cost-Benefit Analysis Approach

One reason for the persistence of controversy over limited liability is that its critics do not think its defenders are wholly wrong: limited liability really does support diversification, liquidity, and administrability. The critics just think those benefits are smaller and less important than protecting victims from excessive risk-taking. The defenders likewise tend to acknowledge that their critics correctly detect the harms of limited liability; they just think that critics err in placing undue weight on those harms relative to the benefits.

While this observation should be uncontroversial, let us briefly review two passages—first from the two most prominent defenders of limited liability and then from its two most prominent critics—citing to essentially the same considerations, but simply drawing different conclusions about magnitude. They agree on the costs, the benefits, and the importance of weighing them, but they come to different estimates of the overall tradeoff.

First, limited liability defenders Steve Bainbridge and Todd Henderson explicitly frame the merits of limited liability as a question of cost-benefit analysis: "Determining whether limited liability in fact promotes optimal risk taking and, accordingly, economic growth thus requires a complex cost-benefit analysis (CBA)."[146] Setting out to compare two things—optimal risk taking and economic growth—they quickly concede that the former constitutes a social cost: "There is no reason to think that limited liability results in an optimal level of risk taking. To the contrary, despite the workarounds available to both voluntary and involuntary creditors, it seems certain that some risks are still externalized onto corporate outsiders."[147] There is a tradeoff between two factors, and on one of them Bainbridge and Henderson agree that the critics have it right. They differ from the critics only in thinking that externalization is not so bad relative to the benefits to corporations and their investors.

Next consider Henry Hansmann and Reinier Kraakman discussing the same tradeoff between investment market quality and risk externalization:

146. BAINBRIDGE & HENDERSON, *supra* note 11, at 49.
147. *Id.* at 51.

> [A]t the margin, control blocks in risky firms would become less attractive and takeover premia would decline under unlimited liability, with a consequent decrease in shareholder monitoring of the management of risky firms. This loss is arguably a real social cost. Nevertheless, it would probably be a small loss in comparison to the potential gains of inducing risky corporations to internalize their full expected tort liability.[148]

Hansmann and Kraakman acknowledge that unlimited liability distorts investment markets and governance, but surmise that this is a price worth paying, given the greater care corporations will take to prevent harms to third parties.[149] They spot the same tradeoff as Bainbridge and Henderson; they just differ in their sense that the costs are worth the benefits.

Thus, everyone agrees that limited liability presents a tradeoff, and they agree on what is being traded off, they just differ in how they estimate the value of what we get relative to what we lose.[150] Both sides utilize this "tradeoff" or "cost-benefit" analysis to analyze limited liability.[151]

No wonder the debate persists. The cost-benefit approach is not an easy position from which to make progress. Where people reason by eyeballing relative costs based on limited information, different people will just see things differently and it is hard to talk our way to consensus. Worse yet, it is easy to doubt the opposing faction proceeds in good faith; if they did, would they not see what is plain to *our* eyes?[152] That is one hint that the cost-benefit approach is not the best way to formulate the debate on limited liability.

And even if most scholars did agree about whether the benefits of limited liability do or do not outweigh its costs, a second problem with the cost-benefit approach would remain. The method is untrustworthy because it asks "us" to evaluate the costs and benefits, even though we—the scholars involved in the debate—are not particularly well informed and have little personal stake in getting things right. We dip our toes in the empirical literature, reflect on the comments made by former clients

148. Hansmann & Kraakman, *supra* note 6, at 1905. They go on: "The potential importance of these [asset shifting] problems is an empirical question that is difficult to answer a priori. But there is reason to believe that they would not be serious." *Id.* at 1910.

149. Hansmann and Kraakman show some restraint in refusing to state clearly that the tradeoff favors their position. *Id.* at 1880-81. However, they do declare a sort of victory by stating that their opponents bear the burden of proof. *Id.* at 1880.

150. The debate is not just over whether to permit limited liability at all. It is also about the scope of exceptions. See *supra* notes 113-122 and accompanying text.

151. *See, e.g.*, BAINBRIDGE & HENDERSON, *supra* note 11, at 49 ("Determining whether limited liability in fact promotes optimal risk taking and, accordingly, economic growth thus requires a complex cost-benefit analysis (CBA)."); Macey, *supra* note 14, at 449 (arguing that "limited liability generates social benefits that offset the social costs" it creates).

152. *See* Dan M. Kahan, *The Cognitively Illiberal State*, 60 STAN. L. REV. 115, 125 (2007) (positing a "problem of cognitive illiberalism" whereby facts are cognitively distorted by political and moral viewpoints).

and law partners, workshop our draft articles for a few months, but we do not spend millions of dollars and many years perpetually revising our argument and proposal. Nor would it be rational to do so, given what is at stake for us: we may hope our articles will impress the readers we value most, but it is not as if we could personally lose millions of dollars if our arguments prove incorrect. Scholars propose, but we do not internalize the costs and benefits of our proposals. Our credibility is limited because we too lack skin in the game.

2. The decision-maker approach

The forgoing method, in which scholars subject limited liability to cost-benefit analysis, stands out as anomalous. As a field, corporate law scholars usually prefer to eschew cost-benefit analysis initially; the first priority is to make sure that the substantive decision is vested in one or more qualified decision-makers.

To see how anomalous and awkward the cost-benefit approach to limited liability is, contrast it to how most other topics in corporate law are handled. As an example, consider the question of how shareholders should get to vote when electing corporate management and, in particular, whether corporations should use cumulative voting.

Cumulative voting is a rule that lets shareholders concentrate their votes in a corporate election, abandoning hope of influencing the entire board in order to better ensure election of just one or a few directors.[153] Cumulative voting has benefits: it empowers small shareholders to communicate their priorities and protect themselves from exploitation. And it has costs: it may lead to discord and strategic voting. Reasonable minds may differ on whether the benefits exceed the costs for a particular corporation, and perhaps whether cumulative voting would be usefully deployed across most or all corporations. But nobody passionately argues for the establishment of universal cumulative voting nor its complete elimination.[154] Everyone accepts that the right answer will be context specific, and that the scholarly community is poorly situated to evaluate the context.

153. For example, in an election of three directors, a 49% shareholder can guarantee herself one seat under a cumulative voting system, but not under a straight voting system. *See* John F. Coyle, *Altering Rules, Cumulative Voting, and Venture Capital*, 2016 UTAH L. REV. 595, 597-98 (2016). The 49% shareholder may do so by casting all her votes into a single candidate, thereby eliminating all hope of electing a second candidate; this will ensure her success, as the other shareholders mathematically cannot distribute their votes to other candidates such that the 49% shareholder's candidate is not among the top three vote-getters. *Id.*

154. Even articles that evaluate cumulative voting on a cost-benefit basis focus their proposals on urging changes to just some state laws (removal of prohibitions, rather than introduction of the opposite mandate). *See, e.g.*, Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95, 107 (2003).

Instead, most people tacitly accept that individual state legislatures are the best decision-makers of the first order.[155] States receive franchise fees from the corporations formed there. States have an incentive to figure out whether the costs of cumulative voting exceed the benefits, because if they get it wrong, their revenues will decline. It does not surprise us that different states have different answers to this question: California makes cumulative voting mandatory for most corporations;[156] Illinois makes cumulative voting the default rule but permits corporations to opt out;[157] Delaware allows corporations to opt *into* cumulative voting.[158] After all, California, Illinois, and Delaware corporations differ in important ways that make different tradeoffs rational. Even corporate law scholars who personally like (or dislike) cumulative voting are not furious that California and Delaware are trusted to make different choices. The "genius" of American corporate law is that it empowers states to try different corporate laws and financially encourages them to maximize the net benefits of the laws they create. Instead of a cost-benefit approach, most of corporate scholarship utilizes a "good decision-maker" approach—we identify an actor with good incentives to decide, and then we let them decide.[159]

If we evaluated limited liability the way we do most of corporate law, we would be surprised to hear scholars debating the merits of our extant uniform rule, rather than trusting states to develop several state-specific variants that maximize their own priorities and reflect their own expert sense of what will work. There must be some reason that limited liability is debated so much differently than the rest of the field.

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155. *See, e.g.*, John W. Edwards II, *Busy Bees and Busybodies: The Extraterritorial Reach of California Corporate Law*, 11 U.C. DAVIS BUS. L.J. 1, 28 (2010) ("Utah's legislature presumably made its own assessment of the relative 'social costs' and benefits that would ensue from permitting, but not requiring, cumulative voting.").

156. CAL. CORP. CODE § 708(a) (West 2024).

157. 805 ILL. COMP. STAT. ANN. 5/7.40(a)-(b) (West 2024).

158. DEL. CODE ANN. tit. 8, § 214 (West 2024).

159. Although this framing is most strongly associated with the corporate federalism debate, it replicates frequently within corporate law jurisprudence. This is the spirit of the business judgment rule: judges should not exercise their own assessment of business risks and benefits; they should instead defer to a body with the expertise and incentive to decide: the board. Cases like *Corwin* go further, channeling decisions to property situated shareholders:

> When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them. The reason for that is tied to the core rationale of the business judgment rule, which is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders).

Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 313-14 (Del. 2015).

Probably limited liability has been evaluated under the cost-benefit model because the decision-maker model has seemed inapt. Incorporation states plainly do not serve as trustworthy decision-makers to determine the availability of limited liability.[160] That is because most of the affected parties lack a seat at the table: states are in privity with the corporations they incorporate, who pay them fees, but they may have no relationship with corporate tort victims who will later sue and find limited liability a bar to recovery. Limited liability protects the state's corporate clients and imposes costs on non-clients, usually citizens of other states.

States accordingly have an incentive to maximally limit liability, taking little account of the downsides.[161] At the extreme, each state has an incentive to compete with other states in offering judgment-proof entities. Some jurisdictions already plainly do this,[162] leading some to predict the "death of liability."[163] Scholars have been forced to offer impressionistic senses of the costs and benefits of limited liability because we know that no one else cares about the costs.

Things would be different if states were liable for some of the unpaid debts of the corporations they incorporate. States would then capture both benefits and costs from the rules they offer. Under such a constraint, states would have an incentive to adopt whatever liability rule maximized social benefit. Perhaps that would be the existing limited liability rule, or perhaps it would be one of the alternatives proposed by reformers. Either way, we could finally be confident that we had the best scheme of limited liability possible.

That is, of course, this Article's proposal. But the point of this Section has been to demonstrate why the proposal strikes such an odd chord to many scholars. Limited liability sits awkwardly in a lacuna for corporate thought. We normally defer to appropriately positioned decision makers, and we normally think states are appropriately positioned to make corporate law. But we somehow know this is false for limited liability, so we find ourselves adopting a non-deferential mode, debating the

160. *See* Hansmann & Kraakman, *supra* note 6, at 1921-22 ("The [internal affairs doctrine] would give rise to an adverse selection problem (a 'race to the bottom') in which states would have an incentive to adopt inefficient corporation statutes that limit the tort liability of shareholders as much as possible and hence benefit shareholders (and the state, through the corporation franchise fees it could charge) at the expense of out-of-state tort victims.").

161. Interestingly, what little variation the United States exhibits, and what little tendency there is to resist maximal protection of shareholders, arises in federal courts. BAINBRIDGE & HENDERSON, *supra* note 11, at 139 ("In general, it appears that federal common law in fact does make it easier to pierce the corporate veil than state law."). Federal judges, of course, do not depend for appointment on officials who seek to protect their incorporation fees because the federal government incorporates almost no entities.

162. *See* Brian Bremner, *The Final Days of a Tax Haven*, BLOOMBERG (Nov. 15, 2017, 4:00 AM), https://www.bloomberg.com/news/features/2017-11-15/the-final-days-of-a-tax-haven [https://perma.cc/RY2E-WHEH] (describing asset protection in Vanuatu).

163. LoPucki, *supra* note 6.

merits of the rules. Our methodology has short-circuited. It would be better to fix things so that states are once again worthy of our deference.

VI. Conclusion

It may seem audacious to propose something as radical as incorporation responsibility, but the truth is that this Article offers a radically modest reform intended to defer to epistemic authorities. Humility compels us to recognize that it is hard to invent the perfect uniform rule to balance the interests of all the corporation's stakeholders. The best we can do is what we usually do: relegate the question to bodies with a financial stake in finding a good answer.

It is those in the existing literature—reformers and defenders alike—who implicitly assert a privileged epistemic position, confidently expounding upon the single, best approach to corporate liability. But even a smart, diligent scholar is in no position to obtain and weigh the data as though their personal fortune depended on it. States are in that position—or they could be, if incorporation responsibility were the rule.

This Article's proposal is modest in another respect: it is consistent with nearly any additional view or proposal that is otherwise attractive. If unlimited shareholder liability is a great idea, states gain a reason to implement it. If piercing doctrines should be trimmed or rationalized, states can do that. And if scholars are in fact fonts of wisdom, if some of our articles really do contain insights persuasive to all those who would listen—well, states will finally have an economic reason to listen.

It is routine in articles about corporate federalism to quote Bayless Manning for the proposition, "We have nothing left but our great empty corporate statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind."[164] One then explains why this is so, or why it has ceased to be so.[165] For our purposes, I will only add that windy beams give no shelter to passersby, and rusty girders can be a dangerous nuisance. If corporate laws are going to support widespread prosperity, they cannot be built to categorically ignore vast domains of harm. Their architects must care, at least a little, about those over whom the corporation towers.

164. Bayless Manning, *The Shareholder's Appraisal Right: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

165. *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *Clark's Treatise on Corporate Law: Filling Manning's Empty Towers*, 31 J. CORP. L. 599, 599 (2006).

Appendix: The Limits of Incorporating Responsibility

This Appendix provides some important details about how incorporation responsibility would have to work. Five important caveats limit the state's responsibility under incorporation responsibility. First, states would incur no new liability for debts owed and unpaid to consensual creditors such as bondholders; incorporation responsibility protects involuntary creditors only. Second, states would incur no new liability where the entity was not incorporated by the state; victims of general partnerships gain no protections. Third, and relatedly, states would not incur liabilities merely because their entities are part of a corporate group whose *other members* are liable for wrongdoing. This solves some complex inter-state attribution problems. Fourth, states would be permitted an affirmative defense in subsequent collection actions if they could establish that the plaintiff would not have fully recovered from corporate shareholders under a regime of unlimited shareholder liability (say, because the shareholders are judgment proof). Incorporation responsibility does not seek to overcome the more general problem of judgment-proof tortfeasors, tragic though it may be. And fifth, incorporation states would be permitted to limit their liabilities by disrupting or contesting collusive settlements and litigation strategies.

In each case, the best response to a possible problem with incorporation responsibility is to restrict its application. Accordingly, the following items operate to limit the scope of the proposal, making it a less radical break from past practice. Those who worry that incorporation responsibility is too extreme a reform need not worry that the Appendix is a trojan horse, smuggling in wider reforms than proposed above.

A. Consensual Creditors

Limited liability protects a shareholder from debts owed by the entity without distinguishing among creditors. Debates about modifications to limited liability have generally focused on liability for involuntary (or non-consenting) creditors. These creditors include tort victims, tax authorities, and regulators imposing fines and cleanup costs in service of public-law goals. Involuntary creditors are a sympathetic constituency because they cannot adjust their behavior to capture some of the purported benefits of limited liability. A tort victim cannot ask a corporation to share with it some of the savings enjoyed through lower capital costs; there is no ready mechanism for tax authorities or regulators to bargain with firms about whether or not shell corporations shall be allowed to deflect liabilities owed by a corporate group. The corporation plays a game against creditors who cannot refuse to play.

By contrast, voluntary (or consensual) creditors command less sympathy from most commentators. Those who agree to lend to a corporation, or to sell to it on credit, often understand that limited liability may limit their recovery. Those creditors can decline to deal with the corporation, or bargain in order to obtain a waiver of limited liability. Many creditors in fact demand recourse to investor funds, suggesting that some of those who decline to so demand may have consciously assumed the risk of nonpayment. Debate over limited liability for contractual creditors is mostly a debate about default rules—whatever most creditors would want (shareholder liability, limited liability) should be selected, since others can contract out of the default.

Limited liability (and its foil, shareholder liability) can distinguish between consensual and non-consensual creditors, or it can treat them alike. Incorporation responsibility does not have that latitude. It must treat consensual creditors with less solicitude. Incorporation responsibility would be untenable if voluntary creditors could sue states for their unpaid debts.

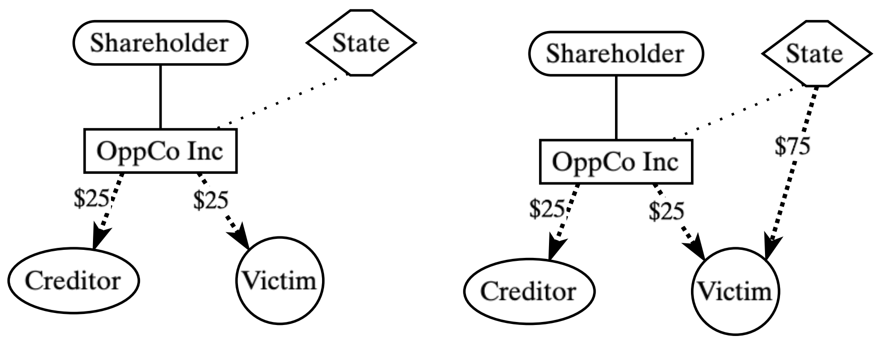
If incorporation responsibility privileged all creditors, then contractual creditors would cease to consider creditworthiness in their transactions with corporations.[166] All corporate debts would be backstopped by the state, so there would be no reason to withhold credit or even charge a higher rate to reflect risk, even with respect to businesses that have no realistic prospect of prospering. This would be magnificently inefficient, with even the least plausible businesses able to borrow in order to limp along. We would still have a thriving buggy whip industry under such a rule.

Figure 6 below shows how incorporation responsibility would address claims by multiple types of creditors. An insolvent debtor, OppCo, owes $100 each to two creditors—one voluntary ("creditor") and one involuntary ("victim"). OppCo has only $50. As is plain, both creditors re-

166. An important debate has taken place about the solicitude appropriate to "nonadjusting" creditors. These creditors are voluntary and contractual, but they do not vet and monitor debtors. For example, a supplier may charge all its customers the same price, even though a financially shaky customer is less likely to pay for the goods; the creditor does not "adjust" the price to reflect the risk that a check might bounce. Many scholars have urged that these kinds of creditors be grouped with tort victims—claimants who are routinely robbed of their legitimate expectations, with no social benefit in the form of market discipline. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics,* 82 CORNELL L. REV. 1279 (1997). To the degree that there are genuinely nonadjusting creditors, they probably ought to benefit from incorporation responsibility in the same way as involuntary creditors. However, most purportedly nonadjusting creditors are really just *less-adjusting* creditors. And insofar as they adjust at all, it is probably appropriate to exclude them from the protections of incorporation responsibility. That is because the benefits of incorporation responsibility are so great that any partially adjusting creditor would be quite tempted to exploit them. Most proposals to help non-adjusting creditors envision a plan to soften the blows they suffer, such as letting them recover pro rata with secured creditors or setting aside some fund from which they can draw. These programs still leave them with some risk of loss, so that notoriously shaky customers may be less desirable counterparties than the rest. By contrast, incorporation responsibility could potentially eliminate all residual risk.

ceive their pro rata share of the corporation's money (25% of their claims), but only the involuntary creditor is permitted further recourse. Its remaining $75 claim is satisfied through the incorporation state's liability. The voluntary creditor gets nothing more. This painful result is necessary to encourage the voluntary creditor to vet and monitor debtors.

Figure 6. Comparing Status Quo (left) to Incorporation Responsibility (right)



Not only must incorporation responsibility only directly protect involuntary creditors, but it must also not confer any indirect benefits on voluntary creditors. Payments by incorporation states must not, for example, pay debts that would otherwise interfere with contractual creditors' claims. For example, suppose OppCo observes that it owes $200 (equally to creditor and victim) and possesses just $50. It might quickly pay the $50 to its voluntary creditor. The creditor is grateful for the $50, as opposed to the $25 it would get if an insolvent OppCo were being divided up in bankruptcy, and it may express that generosity to OppCo's managers or investors when they seek credit for their next venture.

Under the status quo law, the victims would receive nothing from the state, but they would have a right to demand a clawback of the hasty payment to the creditor. The bankruptcy code renders voidable any payments by an insolvent debtor to a creditor within ninety days of bankruptcy.[167] It is the possibility of this recapture that causes voluntary creditors to be less cavalier in extending credit.

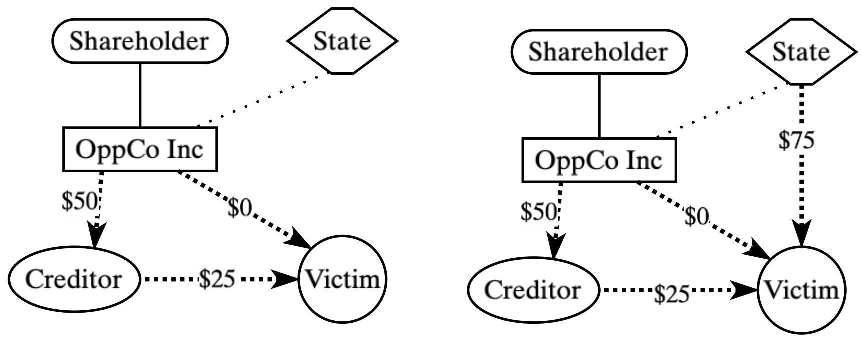
Something equivalent must be preserved under incorporation responsibility. Otherwise, voluntary creditors would become partially indif-

167. 11 U.S.C. § 547(b) (2018). The value transferred is then available for equitable distribution among the creditors. *Id.* § 550(a). The granting of a security interest, which would seem to entitle the creditor to more value in a subsequent bankruptcy, can likewise be voided. *Id.* § 547.

ferent to borrower creditworthiness, to the degree they enjoy indirect state bailouts.

Figure 7 shows the result under the status quo and the analogous outcome under incorporation responsibility.

Figure 7. Comparing Status Quo (left) to Incorporation Responsibility (right)



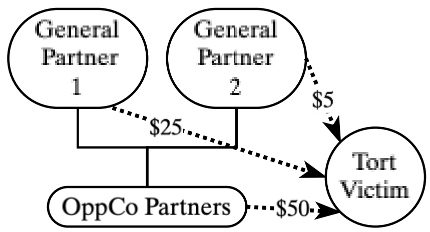
As is plain, the victim remains obliged to seek compensation from the creditor who was overcompensated. The state of incorporation is entitled to reduce its payment to the victim by the amount that the victim ought to obtain from the creditor. This is burdensome and may be only partially successful. If the victim squeezes only five dollars out of the creditor, then she will not be made whole. But this is a problem arising out of background creditor-debtor law and bankruptcy law (discussed *infra* Section C). It is not a problem emerging from the existence of corporations, so solving it is beyond the ambitions of this Article. Imperfect justice here is no worse than the status quo, and it is as good as can be achieved without authorizing wild new inefficiencies.

B. Unincorporated entities

Incorporation responsibility imposes liability for some unpaid debts of entities a state incorporates, but some entities are not incorporated. Importantly, general partnerships are formed by acts of the partners rather than by an affirmative filing and grant from any state. Accordingly, there is no incorporation state to be held liable under incorporation responsibility. This Article's proposal is for incorporation responsibility, not formation responsibility, so victims of general partnerships cannot claim the benefits of this Article's proposal.

As simple as this point is, a demonstration remains useful. Consider a two-person partnership, which commits a $100 tort. The partnership has $50 to pay the victim but no more. Accordingly, the partners are jointly and severally liable. If these partners have $50 between them, the victim will receive full compensation. But if they possess less than that (say, one has only $25 and the other has $5) then the victim will obtain less than full compensation. Incorporation responsibility does not change this. The $20 shortfall is not attributed to any state. Figure 8 demonstrates the flow of payments, both under the status quo and under the proposed regime of incorporation responsibility.

Figure 8. Partner Liability



Non-attribution to a state of unincorporated liability is important to the logic of incorporation responsibility. One goal of incorporation responsibility is to make sure victims are not undercompensated merely by virtue of an entity's creation. That goal is met by this outcome. The victim was not fully compensated, but if the partners had proceeded without an entity (say, as two sole proprietors working simultaneously), the victim would still have been partially uncompensated. The fact is that these partners have only $80 between them. If a plaintiff obtains all $80, then the interposition of an entity did not harm their outcome. Incorporation responsibility has no role to play.[168]

Another goal of incorporation responsibility is to make states consider the potential harms caused by the entities they incorporate and react accordingly. But that goal is not relevant here. As previously noted, no state has conferred the benefit of limited liability on the partnership and its partners. Nor has any state collected a fee for incorporating the entity. The state confers no privileges and charges nothing—there is no need to balance the state's benefit by making it internalize some cost. Indeed, if it did so, states might overreact by severely limiting the proliferation of unincorporated entities, which would create problems for the state but no benefits.

168. Perhaps states should always make tort victims whole when tortfeasors cannot. Indeed, some of this Article's arguments (e.g., concern for compensating victims) may apply equally to general state liability for torts. That sort of discussion fits with the longstanding debate in tort about the purpose of tort law and its alternatives, which is plainly beyond the scope of this paper. As a matter of entity law, this Article seeks to make sure that entities make victims no worse off than they would be in a world without legal entities, but not necessarily better off.

Finally, imposing liability on states for their unincorporated entities would create substantial uncertainty and costly disputes regarding the identity of the incorporation state. When two individuals join to operate a business together for profit, a partnership is formed. But the business may take place across several states, with no single formative act defining the partnership within a given territory. Unlike a corporation, there is no self-evident and mutually exclusive filing that defines the home of the partnership. Fortunately, the formation state of a partnership is rarely dispositive of any legal issues. It is often true that the various candidate states in a dispute will all have similar law on a given issue. Since the main reason to dispute the formation state is to adjust the applicable partnership law, there is currently little need to fight out these issues. But with a scheme of formation state responsibility, insolvent partnerships with insolvent partners would lead to messy fights among states seeking to lay the liability for formation on some other state—all with little social justification.

Somewhat complicated issues arise for the common-law trust, another business entity formed without affirmative engagement with a state corporations office, because some states endow these business trusts with limited liability.[169] Thus, an investor who contributes capital to an enterprise formed as a common-law trust may enjoy corporation-like protection against residual creditors of the trust.[170]

These entities fit poorly within the framework of incorporation responsibility because California, Massachusetts, and other states facilitate a limited-liability framework, but they make no effort to constrain trust formation. On the other hand, many states refuse to recognize the limited liability putatively offered by a trust's home state: Texas and several other states impose liability on trust investors just as if they were general partners of a partnership.[171] In effect, there is no national consensus on who gets to set the law on limited liability for common-law trusts, and accordingly, no consensus on what the rule is and no tidy place for trusts to fall.

One could use incorporation responsibility as part of a package to rationalize this space. The most natural way to do so is to (1) clarify that

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169. *See, e.g.*, Greco v. Hubbard, 147 N.E. 272, 274-75 (Mass. 1925); Goldwater v. Oltmann, 292 P. 624, 629-30 (Cal. 1930).

170. John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History,* 116 COLUM. L. REV. 2145, 2174-2179 (2016).

171. Thompson v. Schmitt, 274 S.W. 554, 559 (Tex. 1925); Am. Nat'l Bank of Shreveport v. Reclamation Oil Producing Ass'n of La., 101 So. 10, 12 (La. 1924); *See also* Ing v. Liberty Nat'l Bank, 287 S.W. 960, 961 (Ky. 1926) ("It is a well settled rule in this state that these unincorporated syndicates are simply partnerships, and that each member of the syndicate is liable personally for the debts of the syndicate."); Willey v. W.J. Hoggson Corp., 106 So. 408, 411-12 (Fla. 1925) (holding that a common-law trust "is nothing but a veiled and futile effort to avoid the liabilities of a copartnership and acquire the privileges and immunities of a corporation without complying with the corporation laws of the state").

states can authorize the creation of limited liability business trusts, which remain protective even when litigation arises in other jurisdictions, (2) impose incorporation responsibility for trusts that invoke this protection, and (3) honor some states' subsequent efforts to prohibit the formation of unincorporated, common-law trusts. Faced with liability, some states will legitimately wish to channel trust users into a statutory trust form that is more accountable to protective regulation or at least raises formation fees to offset the state's eventual liabilities from the trust.[172]

C. Multiple States

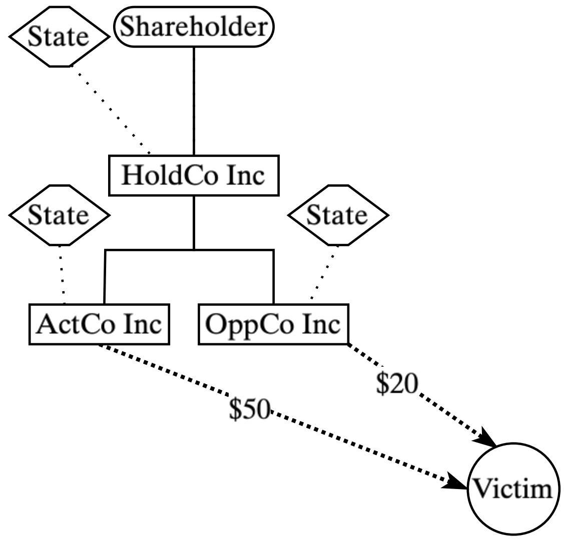
When an entity is liable, its incorporation state may be liable, but other incorporation states of other entities do not become liable just by virtue of their linkage to some entity in the corporate structure. This is particularly important where only some entities in a complex corporate group are liable and insolvent.

To illustrate, consider the following figure, which depicts incorporation responsibility where instead of a single entity perpetrating a $100 tort, two entities, ActCo and OppCo, are each liable for their own $50 torts. ActCo is able to pay this judgment in full; with only $20, OppCo is not. Both entities are owned by a third entity, HoldCo, which has its own shareholders. Figure 9 depicts this structure.

As Figure 9 demonstrates, the victim would have obtained only $70 under the status quo. She is able to recover all of what her tortfeasors have, and no more. The direct and indirect owners of the tortfeasor are protected by limited liability.

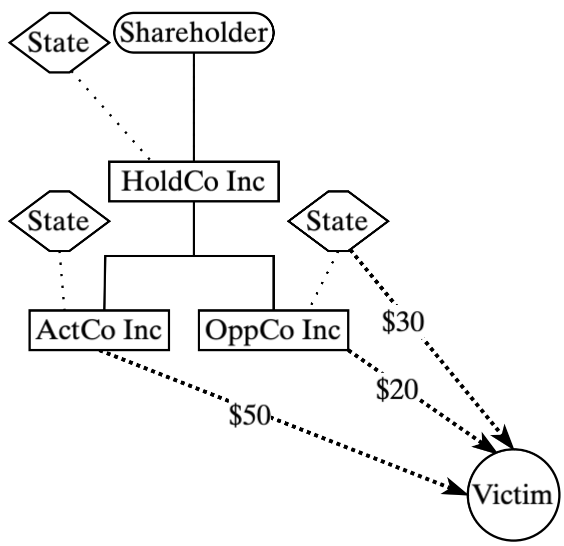
172. If states began offering limited liability to general partnerships, similar issues would arise. The status quo allows parties to form partnerships without any state act, but we can think of this as each state deciding to allow unlimited formation, a kind of silent chartering of each candidate partnership. In that case, we should impose incorporation responsibility on the general partnerships, because the state has essentially permitted chartering without ex ante filing. For now, states do not confer the benefits of limited liability without an ex ante filling, allowing the proposal to be limited to entities that pass through that crucible.

Figure 9. Status Quo for a Corporate Group



By contrast, the victim obtains full compensation under the incorporation responsibility proposal. Figure 10 shows how the investor obtains the missing thirty dollars by seeking recourse from OppCo's incorporation state.

Figure 10. Incorporation Responsibility for a Corporate Group

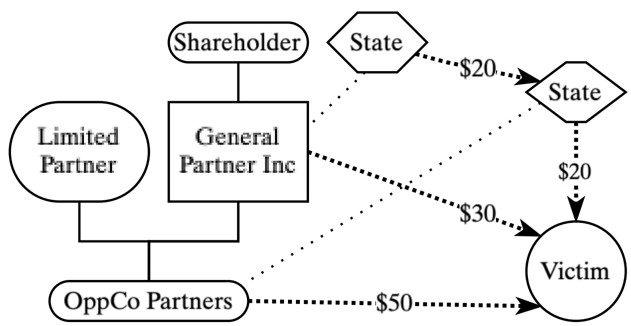


Incorporation responsibility helps the victim at the expense of an incorporation state. However, incorporation responsibility does not create legal risk for all incorporation states. The state that incorporates ActCo Inc can breathe easily, because that corporation paid its debts in full. Nor does HoldCo's state of incorporation have anything to fear, since HoldCo was never liable for anything. Only OppCo failed to pay its debts, so only its incorporation state will be obliged to compensate the victim.

However, when multiple states incorporate entities, it is possible for them to each bear liability, including to one another. Consider now a master limited partnership structure, in which a limited partnership is formed in one state, with its general partner incorporated in another state. This familiar structure gives de jure limited liability to the investors, by virtue of limited partnership law that protects limited partners, and de facto limited liability to the managers, who actually own and control the general partner as a limited-liability entity.

Consider what happens if the limited partnership causes a $100 tort at a time when it and its general partner have very few assets. Figure 11 demonstrates the familiar structure and the perhaps unfamiliar flow of payments.

Figure 11. Multiple Incorporations



The tort victim can recover all the assets that OppCo Partners have (say, $50) as well as all that the general partner has (say, $30). She can recover nothing from the limited partner, because the law of OppCo's formation assigns no liability to limited partners (consistent with the status quo law of every state). Nor can she recover from General Partner's shareholders because the law of its incorporation provides limited liability for shareholders (consistent with the status quo law of every state). Thus, entity law has caused the victim to be $20 short of compensation. A scheme of incorporation responsibility would permit her to seek $20 from OppCo's incorporation state, since it is the one that prevents the victim from suing the limited partners. This makes Victim whole, and it is the end of her participation in the drama, though it is not the end of the story.

Having paid for OppCo's sins, OppCo's incorporation state will wish to explore channels for obtaining contribution. That state may note that it had left a window through which liability could flow to the general partner, since its limited partnership law does not protect general partners from liability (consistent with the status quo law of every state). It was only the chartering act of another state that closed that window, by conferring limited liability on General Partner Inc. It is only because of General Partner Inc's law of incorporation that liability was not extended up to the ultimate beneficial owner of the management company. As a claimant on General Partner Inc, OppCo's incorporation state may now sue General Partner's incorporation state.[173] Ultimate liability resides with the state that blocks liability for an entity it incorporates, rather than merely deflecting it elsewhere.

D. Judgment-proof shareholders

A goal of incorporation responsibility is to prevent incorporation states from using their corporate law towards undercompensation and externalization. But even in a world without legal entities, some deserving plaintiffs would be disappointed. When a natural person operates a business in her own personal capacity, she may cause harms greater than her executable net worth. At some point, the defendant is judgment proof and the plaintiff recovers less than her entitlement.

This is often tragic, and many tort theorists urge reform, such as a system of universal insurance for injuries.[174] However, incorporation responsibility is not the tool to operate that reform. A crucial reason is that incorporation responsibility seeks to restore plaintiffs to the position they would have been without the interposition of limited-liability entities, not to confer even greater rights than plaintiffs would have had in a world without entities. To accomplish this goal of neutrality, incorporation responsibility must make some allowances for judgment-proof individuals to reduce plaintiff recoveries.

The best way to achieve this result is to permit incorporation states an affirmative defense to their prima facie obligation to a plaintiff demanding residual compensation. The state would be permitted to prove that the shareholders of the corporation, if liable, would not have been able to fully pay the plaintiff. To the degree the plaintiff would not have recovered from a general partnership, the state would not be obliged to make her whole for the unpaid debts of a corporation. The theory is that

173. It may also have been reasonable for the victim to sue General Partner's incorporation state directly. It is that state's law that prevents the victim from suing the shareholders, so we could simplify the suit by leaving claims on OppCo's incorporation state aside.

174. *See, e.g.*, Stephen D. Sugarman, *Doing Away with Tort Law,* 73 CALIF. L. REV. 555, 644 (1085); Kenneth S. Abraham & Lance Liebman, *Private Insurance, Social Insurance, and Tort Reform: Toward a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75, 108 (1993).

her lack of compensation is not the fault of the corporate charter, it is the fault of natural persons causing more damage than their own wealth can compensate.

To see this, compare four cases in which a victim suffers a $100 injury from an entity possessing only $50, owned by investors who themselves own only $20 of additional assets. Figure 12 and 13 display these four cases.

On any facts, a victim will recover $50 from the entity. Under the status quo, the victim's recovery against a corporation would stop there (upper left). If the entity were a partnership, status quo law would permit her to recover $20 from the partnership's investors, the partners (upper right). Limited liability effectively costs the victim $20. An addition $30 will be go uncompensated, regardless of entity type, because the shareholders simply do not have sufficient wealth to make the victim whole.

A naïve deployment (lower left) of incorporation responsibility would oblige the state of incorporation to pay $50 to the shareholder, completing her quest for $100. But a properly calibrated system of incorporation responsibility (lower right) would permit the state to establish that only $20 could be recovered from the shareholders, and thus only send $20 to the plaintiff.

Figure 12. Comparing Status Quo Corporation (left)
to Status Quo Partnership (right)

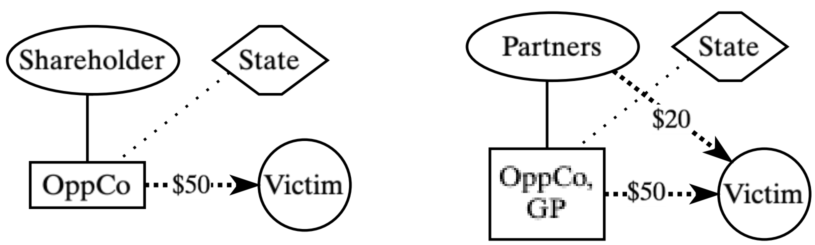
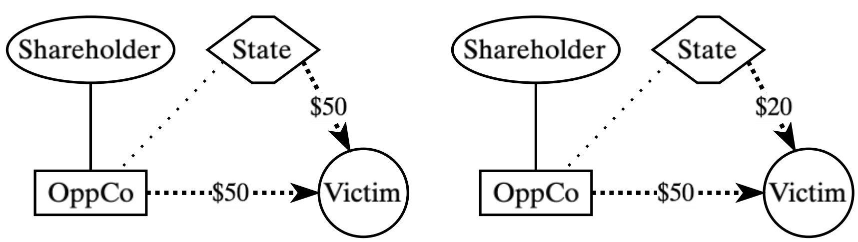


Figure 13. Comparing Naive Incorporation Responsibility (left)
to Incorporation Responsibility with
Judgment Proof Investor Defense (right)



Properly designed, an affirmative defense will align recovery for incorporation responsibility with the status quo treatment of general partnerships.

It will often be difficult for states to make their affirmative defense as to shareholders. It is expensive and error-prone to investigate the assets of an individual, making use of this affirmative defense highly imperfect. But incorporation states could take steps to make this easier for themselves. They could demand beneficial owner information from the entities they incorporate, and state corporate law could impose a duty on shareholders to comply with state asset investigations. Perfection would be impossible, but a passible degree of accuracy would allow states to make plans for expected liabilities and settle some cases with victims prior to any liability investigation.[175]

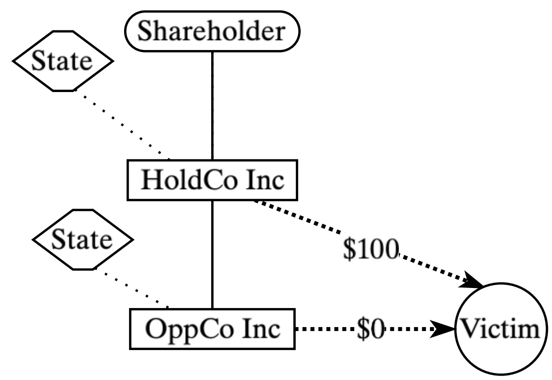
E. Collusion

Incorporation responsibility will be unfeasible if plaintiffs and defendants collude to run up the liabilities for the incorporation state. Consider a case where OppCo and HoldCo are both answerable for a tort; perhaps HoldCo could be held liable as OppCo's principal on an agency theory of vicarious liability. If vigorously litigated, the resulting judgment would let the plaintiff recover from either corporation. The plaintiff's actual injury is \$100. HoldCo has plenty of money, but OppCo has nothing. Under the status quo, a plaintiff would sue both OppCo and HoldCo and then ultimately collect \$100 from HoldCo.

Figure 13 shows that result.

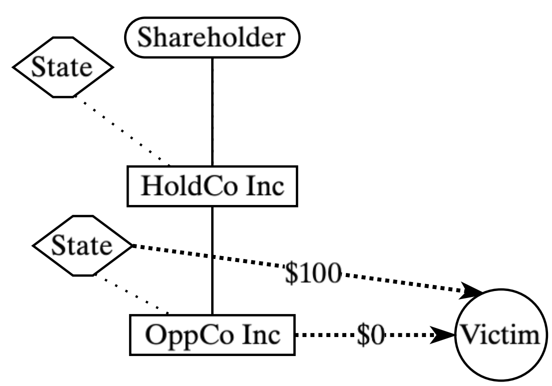
175. Unlike contractual creditors, involuntary creditors are unlikely to have special knowledge about the quality and wealth of investors. Accordingly, there would be no risk of adverse selection if states were to adopt a uniform policy of offering, say, fifty percent of claim value to victims prior to any investigation into investor wealth. The parties could accept whatever discount reflects the typical result in investigation.

Figure 13. Status Quo, Other People's Money



The plaintiff would start to recreate this same litigation strategy under incorporation responsibility. But OppCo's managers may soon approach her with a settlement offer: they will confess a judgment in favor of Victim for the entire $100. While the gesture is appreciated under the status quo, it is not of great assistance; the plaintiff must still sue and subdue HoldCo, the deep-pocket defendant. But under incorporation responsibility, OppCo's offer is a slam dunk. The plaintiff can accept the settlement and then present it as a bill to OppCo's incorporation state. Figure 14 shows the resulting flow of funds.

Figure 14. Incorporation Responsibility, Other People's Money



The plaintiff enjoys swift and certain success, and no corporate money is actually transferred to the victim. Indeed, OppCo could even sweeten the pot by suggesting other torts to which it could confess, running up the plaintiff's bill to arbitrarily high numbers.

This collusive strategy should not surprise us. Incorporation responsibility amounts to a form of contingent liability insurance; a corporation pays incorporation fees to the incorporation state to assume excessive liabilities that could otherwise be attributed to investors. And like any insurance scheme, it tempts the insured to settle on excessively generous terms.

Insurance companies solve these problems by contractually reserving for themselves the power to veto putative settlements and the twin power to control the insured's litigation strategy, allowing them to hold out against lavish settlements and use litigation to thwart meritless claims.[176] Similar preventative strategies are necessary to make incorporation responsibility viable.

An incorporation state that anticipates a high likelihood of liability must be allowed to intervene in the proceedings. Where the parties reasonably anticipate this possibility, they must give notice to the state as an essential party. States could also require the entities they incorporate to provide notice on pain of penalties for corporate decisionmakers. As parties to the action, the state of incorporation can scrutinize the facts and contest weak suits.

Whether contemporaneously with the primary action or subsequent to it, an incorporation state must be permitted to sue other parties for contribution. A state liable for $100 of OppCo's liabilities should be able to sue HoldCo as an unmolested principal.

Difficult problems remain. Perhaps instead of refraining from suing HoldCo, the victim agrees to settle with HoldCo for a mere dollar. Should the state be permitted to upset that settlement? What if Victim litigates against HoldCo less than vigorously and the action is dismissed with prejudice? Should the state be permitted to overturn the judgment? These questions are particularly acute since the facts needed to prove a case against HoldCo may be in Victim's possession, and Victim lacks an incentive to assist the incorporation state.

While these problems are real, they should not be overstated. Plaintiffs will be reluctant to release deep-pocket defendants without powerful assurances unless they are sure that they will get their money from the incorporation state. And there is a real risk the incorporation state will discover the collusion and contest it. It may therefore be rare that these schemes are reliable and tempting.

To the degree they are, we must not be naïve about the problems pervading all multi-party litigation. Strategic behavior is ubiquitous, even under the status quo.[177] This is unfortunate, and it would be better if incorporation responsibility could improve upon these low standards. But giving states modest rights to protect themselves from collusion likely removes any splinters in incorporation responsibility other than the beams we all have in our eyes.

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176. *See* Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1118-19 (1990).

177. *See, e.g.*, Gabriel V. Rauterberg & Sarath Sanga, *Fair Settlements in Multidefendant Torts* (Apr. 26, 2018) (unpublished manuscript) (on file with author).