Essays

Corporate Judgment Proofing: A Response to Lynn LoPucki's *The Death of Liability*

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In *The Death of Liability*,¹ Professor Lynn M. LoPucki argues that American businesses are rendering themselves judgment proof.² Using the metaphor of a poker game, Professor LoPucki claims American businesses are increasingly able to participate in the poker game without putting "chips in the pot."³ He argues that it has become easier for American companies to play the game without having chips in the pot because of the ease with which a modern debtor can grant secured credit,⁴ because of the growth of the peculiar form of sale known as asset securitization,⁵ because foreign havens for secreting assets are now available,⁶ and because firms can use traditional ways of

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1. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996).

2. The adjective "judgment proof" and the verb "to judgment proof" have different but imprecise meanings. Many businesses that are in bankruptcy or liquidation can be—and commonly are—characterized as "judgment proof" even though the management of those companies never took any action that one would describe as "judgment proofing." As I use the verb in this Essay (and as I understand Professor LoPucki to use it), management has judgment proofed its firm only if the managers knowingly operate with a sum of free assets and insurance coverage that is less than the present value of the firm's expected liabilities. Assume that a catastrophic event (whose economic consequence would bankrupt the firm) has a one-in-ten-thousand probability of occurring in a ten-year period. Because the probability of its occurrence is so low, the present value of that liability would be small, even though the liability from that event might greatly exceed the firm's assets and insurance coverage. If the managers maintain a combination of assets and insurance coverage that exceeds that expected value, they have not judgment proofed their firm.

3. LoPucki, *supra* note 1, at 3.

4. *See id.* at 14-19.

5. *See id.* at 23-30.

6. *See id.* at 32-38. It is unclear whether Professor LoPucki considers foreign havens suitable for corporate judgment proofing. *See infra* note 21 and accompanying text.

avoiding legal liability—such as scattering their assets among subsidiary corporations.⁷

In Part I, I describe Professor LoPucki's thesis, and in Part II, I present an empirical response to it. Part II is composed principally of data collected from the Compustat database, which contains financial information on almost all American public companies. The data on secured debt, asset-to-liability ratio, and the presence of insurance show that the story Professor LoPucki tells is fictional. Part III explains why. It offers reasons that firms choose not to judgment proof themselves and considers various barriers to judgment proofing. The analysis explains not only why judgment proofing is less prevalent today than Professor LoPucki suggests, but also why it is unlikely ever to grow into a serious problem in the United States.

I. LOPUCKI'S THESIS

It is important to understand what in Professor LoPucki's thesis is explicit, what is implicit, and what is unclear. First, Professor LoPucki does not say merely that certain persons and firms have found ways to avoid their just liability by putting their assets beyond the reach of their creditors. A debtor's divestiture of assets in the face of creditors' claims or operation with too little capital are well-known and ancient practices. The infamous *Twyne's Case*⁸ cast a shadow over modern commercial security law by suggesting that a debtor commits a fraudulent conveyance when he secretly conveys security to a creditor while retaining possession of the property. Taking secret security, making fraudulent conveyances, operating with insufficient capital, and distributing one's assets to shareholders in preference to creditors have been practiced for hundreds of years; they are explicitly *not* the subject of Professor LoPucki's complaint.

He makes a stronger claim. Through his poker game metaphor, he claims that "[m]ajor players *are* reducing their stakes"⁹ and that "[s]ome large businesses now employ [judgment-proofing strategies] and market forces are driving their competitors to do the same."¹⁰ Thus, he claims not that a few businesses are doing the things that businesses and individuals have always done, and not only that it is now possible with modern devices to do these things more broadly, but that American businesses *are*, in fact, judgment proofing themselves,¹¹ and that there is a trend for a larger number of all

7. See LoPucki, *supra* note 1, at 20-23.

8. 76 Eng. Rep. 809 (Star Chamber 1601); see also Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1169-75 (1995) (describing the effect of *Twyne's Case* on the development of fraudulent transfer law).

9. LoPucki, *supra* note 1, at 3 (emphasis added).

10. *Id.* at 5.

11. Professor LoPucki asserts, "Probably most individuals and businesses are either judgment proof, or capable of rendering themselves so between commencement of civil action against them and the entry

firms to do the same.¹² His assertion is not merely that devices are available; it is an empirical assertion that these devices are being used more systematically than ever before and that their use will become more widespread in the future.

It is important also to understand who Professor LoPucki believes are the victims of these transactions. The victims are not conventional unsecured creditors with contract claims; they are creditors with claims imposed by tort and statute.¹³ Professor LoPucki recognizes that contract creditors—creditors ranging from banks to finance companies to suppliers—can and will bargain for protection.¹⁴ He is concerned about people who are sometimes referred to as “involuntary” creditors,¹⁵ creditors whose claims are thrust upon them as a result of an accident or a violation of a statutory obligation of the debtor. Common examples include parties injured by auto accidents, asbestos exposure, and environmental contamination, and any other victim of tort liability, whether the liability arises from an intrauterine device, a breast implant, or a cigarette.

Although he does not say so in clear terms, Professor LoPucki should be less concerned with the run-of-the-mill tort claimant—the person who is injured in a collision with a truck owned by General Electric—than with victims of mass torts. Victims of random and conventional negligence are usually covered by insurance,¹⁶ and where that is not true, the costs of paying

of judgment.” *Id.* at 4-5 (footnote omitted). If he claims only that a large share of the individuals in American society have only trivial assets available for unsecured creditors, he is surely correct, but the point is neither novel nor interesting. The same would have been true of American society from the time of the Pilgrims and of most societies from the time of antiquity.

As to businesses being “capable of rendering themselves [judgment proof] between the commencement of a civil action” and the entry of judgment, there is some question. If Professor LoPucki means merely that any defendant can give away its assets between the time a complaint is filed and served and the time of judgment, he is surely correct. If he is suggesting that most do so, he is probably wrong. If he is suggesting that those who do dispose of their assets without receiving corresponding value can do so with impunity, the statement is inaccurate. The paradigmatic fraudulent conveyance is a transfer to one’s spouse, children, or shareholders after a suit has been filed and in response to a prospective judgment.

12. *See id.* at 5.

13. *See id.* at 7.

14. For example, he writes: “Contract liability can be preserved through private contracting. The paradigmatic transaction is one in which a closely held corporation seeks a bank loan. Banks routinely condition such loans on personal guarantees from the owners.” *Id.*

15. *Id.* at 45.

16. As Kenneth S. Abraham and Lance Liebman observe, “We rely on both tort law and giant programs of public and private insurance to compensate the victims of . . . injury . . . [I]nsurance programs dwarf tort law as a system of reimbursement.” 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, 75-76 (1993). In fact, only 10.5% of compensation for accidents comes from tort liability; 69% comes from first-party insurance, and an additional 14.9% comes from workers’ compensation. *See* DEBORAH R. HENSLER ET AL., COMPENSATION FOR ACCIDENTAL INJURIES IN THE U.S. 108 (1991). The 10.5% from tort liability, moreover, includes payments from defendants’ insurers. *See id.* at 175. And as Paul Bargren notes, 95% of consumer tort costs are insured. *See* Paul Bargren, *Joint and Several Liability: Protection for Plaintiffs*, 1994 WIS. L. REV. 453, 476. Of course, these data say nothing about negligence victims who go entirely uncompensated, but, as Abraham and Liebman note, the vast majority of Americans are covered by some form of insurance. *See* Abraham & Liebman, *supra*, at 80.

their claims are not significant enough to encourage judgment proofing. Even if a pharmaceutical company were to find it within its interest to judgment proof itself, it would have plenty of assets with which to answer run-of-the-mill negligence and products liability claims. LoPucki's real concern is with mass torts and large-scale statutory liability.

Note, finally, that Professor LoPucki should be concerned principally with injuries caused by business enterprises, not with torts by individuals. It is a rare individual who can cause enough personal injury or property damage to make it worth his while to escape liability. Most of us seriously injure others only with our automobiles. Most personal automobile liability has been dealt with by state law that requires insurance or proof of financial responsibility.¹⁷ Among sole proprietors, the only persons who might fit Professor LoPucki's area of concern are physicians.

In the end, the boundaries of Professor LoPucki's claims are fuzzy. The grandiose title, which echoes Grant Gilmore's famous attack on contract doctrine,¹⁸ the assertions about "major players,"¹⁹ and the disclaimer of any interest in contract liability lead me to believe that Professor LoPucki is concerned principally, if not exclusively, with the tort and statutory liability of public commercial firms.²⁰ Nevertheless, his discussion of exemptions and "foreign havens" suggests that he is speaking of individuals, for exemptions and foreign havens strategies are unavailable for, or not suited to, corporate judgment proofing.²¹ In the face of these conflicting indications about the boundaries of his thesis, I give him the benefit of the doubt by addressing my

17. See ROBERT H. JOOST, *AUTOMOBILE INSURANCE AND NO-FAULT LAW* § 1:8 (2d ed. Supp. 1996) (observing that 41 states have laws requiring automobile liability insurance); see also 6B JOHN ALAN APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4299 (1979 & Supp. 1996-1997).

18. See GRANT GILMORE, *THE DEATH OF CONTRACT* (2d ed. 1995).

19. LoPucki, *supra* note 1, at 3.

20. LoPucki's general thesis might also be interpreted to be the claim that both corporate and individual liability are dying at the hands of judgment-proofing strategies employed by both firms and individuals. While it may be true that many, or even most, individuals are judgment proof against substantial liability claims, that is something that has always been true, and has not been of much concern since liability claims against individuals are generally small and are often covered through insurance (e.g., for uninsured motorists) or security (e.g., mortgages). More interesting and controversial, and thus my primary focus, is Professor LoPucki's claim that corporations are consciously judgment proofing to avoid paying their tort and statutory liability, see *id.* at 5, which is much more substantial than that generated by individuals.

21. Exemptions are one salient example. See 11 U.S.C. § 522(b) (1994) (awarding exemptions of the type discussed in LoPucki, *supra* note 1, at 10-11, to individuals only). As Lawrence Ponoroff and F. Stephen Knippenberg observe, "[E]xemptions are pivotal to the individual fresh start in bankruptcy." Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235, 240 (1995). For state law exemptions, see, for example, FLA. CONST. art. X, § 4(a); MICH. CONST. art. X, § 3, which provides a homestead and personalty exemption from process; and TEX. PROP. CODE ANN. § 42.001 (West 1997), which provides a personal property exemption from garnishment, attachment, execution, or other seizure.

Foreign havens such as the Cook Islands trusts that Professor LoPucki describes, see LoPucki, *supra* note 1, at 33-38, are principally used by individuals and not by corporations. See 2 DUNCAN OSBORNE, *ASSET PROTECTION* § 19:04 (1995) (describing offshore trusts as appropriate for wealthy professionals, entrepreneurs, and heirs).

analysis principally to potential judgment proofing by publicly traded companies. Most individuals have always been judgment proof, and few private companies can cause sufficient statutory or tortious liability to cause a significant social problem. If Professor LoPucki is mainly concerned with contract liability, he has turned upon his own thesis. If he is actually concerned with individuals or private companies, he is dealing with a problem of modest social consequence.²²

Professor LoPucki identifies four judgment-proofing strategies. First is the granting of secured debt.²³ Under both state law and federal bankruptcy law, the typical perfected secured creditor must be fully satisfied before money is paid to a competing tort or statutory claimant.²⁴ There are some exceptions to these rules, but they are not significant for tort claimants.²⁵ Professor LoPucki correctly identifies Article 9 of the Uniform Commercial Code as a convenient and inexpensive way of granting secured credit and as a law that facilitates the granting of more secured credit than the former law would have allowed.²⁶

Second, Professor LoPucki identifies "ownership strategies,"²⁷ i.e., ways in which a potential debtor can put its assets into the hands of third parties while yet continuing to enjoy the benefits normally associated with ownership. The most obvious of these is to create liability in a thinly capitalized subsidiary and then to devise a way to transfer the profits that are generated in the subsidiary into the hands of the parent. A second method, analogous to the granting of a perfected security interest, is asset securitization, in which companies sell their intangible assets to a person who is allowed to collect the payments on those assets in preference to those who have tort and other claims against the original seller.²⁸ A variation on this theme is the "sale and

22. LoPucki's focus is, accordingly, primarily on mass tort claims against firms, since, with the possible exception of some physicians, firms are the only ones that have both the potential liability exposure (i.e., the exposure that could result in a mass tort claim) and the funding to make the liability-avoiding schemes that LoPucki outlines feasible. And yet what is new in LoPucki's scenario is not the liability-avoiding measures, but the mass tort claim itself. Professor LoPucki treats the increasing number of tort claims as an entirely natural feature of the legal landscape and takes it for granted that it would be unjust to prevent plaintiffs in tort cases from collecting huge judgments. But one might argue that any increase in unsatisfied tort claimants is due to the rising number and size of tort claims and not to the amount of assets available. The number of tort claims has in fact increased dramatically in recent years. See Deborah R. Hensler, *Trends in Tort Litigation: Findings from the Institute for Civil Justice's Research*, 48 OHIO ST. L.J. 479, 481 (1987) (noting a five-fold increase in product liability suits from 1975 to 1985).

23. See LoPucki, *supra* note 1, at 14.

24. See, e.g., U.C.C. §§ 9-201, 9-301 (1996); 1 COLLIER ON BANKRUPTCY ¶ 103(x1) (Laurence P. King ed. 1996) [hereinafter COLLIER] ("The Bankruptcy Code recognizes the rights of secured creditors by providing for them to be paid first from the proceeds of their collateral.")

25. Notable exceptions protect purchase-money claimants and statutory lien creditors, such as holders of federal and state tax liens, see 11 U.S.C. §§ 544-545; see also 5 COLLIER, *supra* note 24, at ¶ 544 LH, and mechanic's liens, see U.C.C. § 9-310.

26. See LoPucki, *supra* note 1, at 19.

27. *Id.*

28. For a general description of asset securitization, see Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994).

leaseback" of tangible assets—a transaction that puts the asset beyond the reach of creditors, but allows the original owner to enjoy its use for a fee.²⁹

Professor LoPucki's third category is "exemption strategies."³⁰ Under the law of all states³¹ and under the Federal Bankruptcy Code,³² certain assets may be held by individual debtors free from the claims of other parties. Typically, these assets are items such as homesteads and life insurance. Such laws cannot be used by firms that do business as corporations or partnerships.³³

A fourth category identified by Professor LoPucki is "foreign haven strategies."³⁴ Under these strategies, an individual might put his assets in a trust in the Cook Islands, for example, and continue to enjoy the benefits, yet, under Cook Island law, be able to keep them free from the reach of creditors in the United States.

As I suggest above, the last two categories—exemption strategies and foreign haven strategies—are not relevant to corporate liability.³⁵ They apply, if at all, only in insignificant ways to firms in commercial activity and cannot be used to protect corporate assets against tort and statutory claims of any magnitude.

II. ECONOMIC THEORY AND REALITY

A. *The Theoretical Problem*

It is impossible to quarrel with Professor LoPucki's claim that it would be a wonderful thing to play poker with the assurance of no loss and with the possibility of great gain. Before I explain why this poker game probably does not exist and why it is unlikely ever to exist, let me belabor the obvious by using an example to show why an investor would welcome the opportunity that Professor LoPucki posits.

Consider an investor who could borrow at 8% and earn a return on equity of 20%. If this person put up \$10 million of his own money and raised \$90 million by selling equity to others, he would have to share the \$20 million

29. As Professor LoPucki recognizes, the first two strategies, granting secured credit and selling assets, will not suffice by themselves to judgment proof a debtor. If the transaction is for new value, and if the assets acquired (the loan in the first case and the proceeds of the sale of the asset in the second) are held in the debtor corporation and used in its business, these transactions "judgment proof" the debtor only if they are not for fair value or if the assets received in a fair value exchange are then transferred to the shareholders or others without receiving fair value for them. Of course, granting secured credit might be regarded as a judgment-proofing strategy as between two existing creditors where one, but not the other, has received security after both of them have lent to the debtor unsecured.

30. LoPucki, *supra* note 1, at 30.

31. See 14 COLLIER, *supra* note 24, ¶ Intro.03.

32. See 11 U.S.C. § 522(d) (1994).

33. See *id.* (covering individual debtors only); see also 4 COLLIER, *supra* note 24, ¶¶ 522.02 to .11.

34. LoPucki, *supra* note 1, at 32.

35. See *supra* note 21 and accompanying text.

return each year with the other equity holders. As the owner of one-tenth of the equity, the investor would be entitled to only \$2 million (a 20% return). If, on the other hand, the investor could purchase all of the equity for \$10 million, and procure the remainder of his capital by borrowing \$90 million at 8%, his return on the same transaction (after interest) would be \$12.8 million (a 128% return). More leverage means not only more gains to the equity owners on success, but also fewer losses to the equity owners on failure. If one assumes a corporation with no debt, the equity owners lose \$100 million on its failure. The owners of a corporation with \$90 million in debt, on the other hand, lose only their \$10 million; the remaining \$90 million loss is borne by the creditors.

In theory, therefore, playing “without chips” (i.e., playing with a creditor’s money) both enlarges the equity holders’ possibility for gain and diminishes their possibility for loss. But this is a remarkable poker game; others play with me as though I have invested \$100 million in chips when I win, and treat me as though I have invested only \$10 million when I lose.

The poker metaphor reveals the problem with the hypothesis. No one will allow a person to play poker unless that person puts chips in the pot and thereby commits himself to pay if he loses. In the hypothetical leveraged corporation, the creditors who are asked to put up \$90 million of the chips will understand that their chips stand behind only \$10 million of capital and will appreciate that they will lose \$90 million if the business fails. Understanding that they are being made to take the risks that are traditionally assigned to the equity holders, but appreciating that they will not enjoy the gains of equity holders, the lenders will either refuse to make the loan or insist upon a share of the gains that looks much like the payment that would have to be made to an equity holder. Put another way, the lenders to such a highly leveraged business will behave like equity holders and will insist upon the control and payment that normally goes to equity holders, even though they are technically creditors. The changes wrought by the contract creditors (bringing about the end of a business or diminishing its leverage) will also protect the involuntary creditors.³⁶

B. *Financial Data on Corporate Judgment Proofing*

If economic theory is at odds with Professor LoPucki’s assertions, economic reality is even more so. Conceding the accuracy of his claims on the ease with which security interests can be granted and on the growth of asset securitization, I find little empirical evidence to support Professor LoPucki’s

36. I discuss the symbiotic relationship between contract creditors and involuntary creditors *infra* Section III.A. By insisting upon debtor behavior that will protect their own interests, contract creditors often require the debtor to take action (buying insurance or holding free assets) that will also protect the involuntary creditors’ interests.

hypothesis and much to challenge it. His evidence is fragmentary and idiosyncratic.³⁷ To test his hypothesis I have collected and analyzed asset, liability, and secured debt data on all companies in Standard & Poor's Compustat database.³⁸ Far from suggesting that the "major players are reducing their stakes,"³⁹ the data show that the major players' stakes have been essentially unchanged over the past fifteen years. Finally, I also consider the amount and kind of insurance that American companies purchased during that time. Since liability insurance covering a particular risk is a proxy for assets that could be used to satisfy persons injured by occurrence of a risk event, insurance is a substitute for assets that judgment creditors could otherwise take.

37. For example, Professor LoPucki distorts the data on bankruptcy, *see* LoPucki, *supra* note 1, at 18, by drawing inferences about judgment proofing from data compiled mostly from personal bankruptcies; his discussion of insurance, *see id.* at 71, is skewed by questionable assumptions; and his arguments about corporate liability avoidance, *see id.* at 3, are not borne out by empirical data on corporate assets as a percentage of liabilities. Much of Professor LoPucki's article is written in the subjunctive, and consists of statements about what "might," *e.g., id.* at 7, 12, 13, what "would," *e.g., id.* at 4, 9, 11, or what "could," *e.g., id.* at 5, 7, 8, happen. These statements are incapable of rigorous empirical verification or refutation. Moreover, where Professor LoPucki does undertake to support his argument with empirical data, these data provide questionable support for his thesis. For example, Professor LoPucki cites a report that approximately 60% of Texas attorneys do not carry malpractice insurance in support of the general claim that most individuals and businesses are judgment proof. *See id.* at 4 n.5.

38. The Compustat database is a compilation of public financial data for publicly traded companies. Compustat provides more than 300 annual and 100 quarterly data items taken from SEC filings and Standard & Poor's company contacts. Companies are not included if they do not meet a sales or trading requirement. For example, Compustat's 1997 data include 78% of the New York Stock Exchange (NYSE) listings on the University of Chicago's CRSP database, 78% of CRSP's AMEX listings, and 92% of CRSP's NASDAQ listings. Most of the listings that are not in the Compustat database are closed-end mutual funds. Of the 577 NYSE listings in CRSP that are not in Compustat, 336 are closed-end funds (including, *e.g.*, 61 Nuveen funds), 106 are Shares of Beneficial Interest (SBIs), 35 are American Depository Receipts (ADIs), 4 are Units, and 96 are other kinds of ordinary common shares.

The Compustat data items I used were: No. 6 Total Assets (current assets plus net property, plant and equipment, and other noncurrent assets including intangible assets, deferred items, and investments and advances); No. 24 Common Share Price (year-end); No. 25 Common Shares Outstanding (year-end); No. 181 Total Liabilities (current liabilities plus deferred taxes, other liabilities, long-term debt, and minority interest); and No. 241 Total Secured Debt (long-term debt secured by a mortgage, property, receivable, and stock or other assets). These data items were retrieved for companies for the years 1981-1995 inclusive. The data items were then used to calculate (1) Secured Debt as a Percentage of Assets (Total Secured Debt divided by Total Assets); (2) Assets as a Percentage of Liability (Total Assets divided by Total Liabilities); and (3) Market Capitalization (Common Share Price multiplied by Common Shares Outstanding). For Assets as a Percentage of Liability, if either data item was unavailable, then that company's data were not included. The data for 1995 consist of entries for firms with fiscal year-end months of June to December; data for firms with fiscal year-end months of January to May were not available.

For several reasons, I do not regard the omission of private companies from the Compustat database as significant. First, Professor LoPucki's claim concerns commercial businesses, most of which are public. *See* LoPucki, *supra* note 1, at 5 (referring to "large businesses" and "their competitors"). Second, most significant tort and statutory liabilities are caused by public companies such as Johns-Manville, A.H. Robins, Exxon, Amoco, and Union Carbide, to name a few. It is an unusual private firm that will have sufficient assets and a sufficiently wide distribution system to cause tort or other liabilities that will reach far enough beyond coverage of its assets or insurance to be a significant social problem.

39. LoPucki, *supra* note 1, at 3.

1. *Secured Debt to Assets*

Article 9 of the Uniform Commercial Code makes it easier and less expensive for a business debtor to grant an unassailable security interest to a creditor in most or all of its personal property than was formerly the case.⁴⁰ But Professor LoPucki claims more—specifically that debtors are granting more security than they were before Article 9 was enacted, thus leaving less for involuntary creditors.⁴¹ To test the hypothesis that more secured credit is being granted, I examined the secured credit of companies in the database. In 1981, there were more than 5000 companies in the database. By 1994, that number had grown to more than 7000. Nearly 6000 of those 7000 reported either that they had granted secured credit on their assets or that they had not.⁴² The remaining 1300 companies in the database did not report that they had granted secured credit, but they also did not report that they had not

40. *See id.* at 19.

41. *See id.* at 18.

42. The year-by-year data are as follows:

YEAR	NUMBER OF COMPANIES USED TO CALCULATE.	
	SECURED DEBT AS PERCENTAGE OF ASSETS	ASSETS AS A PERCENTAGE OF LIABILITY
1981	4198	5207
1982	4178	5189
1983	4487	5543
1984	4496	5606
1985	4553	5617
1986	4860	5924
1987	5024	6120
1988	4773	5870
1989	4617	5681
1990	4569	5610
1991	4680	5729
1992	4908	5977
1993	5393	6708
1994	5775	7074
1995	3946	4885

granted secured credit.⁴³

CHART 1. SECURED DEBT AS A PERCENTAGE OF ASSETS

Chart 1 shows the mean and median percentage of assets that are subject to security interest by year for American public companies. In 1981, the mean company had secured debt equal to 12% of its assets. The median company had even less secured credit, granting only four units of secured credit for each 100 units of assets. From 1981 to 1995, those percentages fluctuated slightly, but they generally declined. In 1995, the mean company had granted security on only 10% of its assets, and the secured debt of the median company was down to approximately 1% of assets.

Suspecting that smaller companies might differ from larger companies in their amount of secured debt, I examined the 200 largest companies (as measured by market capitalization) in the database and compared their outcomes with the 200 smallest. The largest companies granted insignificant amounts of secured debt. In 1981, the mean large company had granted secured debt on approximately 2.5% of all its assets; the median large company had granted security on less than 1% of its assets. Over time, these numbers decreased, so that by 1995 the median company among the largest 200 had granted security on less than 0.1% of its assets. The declining median

43. Exactly why some of these companies made no report is unclear. Based on a spot check, it is my hypothesis that most of the companies that reported neither the presence of secured credit nor its absence had in fact granted none. The SEC requires companies, as part of normal financial disclosure, to report the granting of security in their footnotes. See 17 C.F.R. § 210.4-08(b) (1997) ("Assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, shall be designated and the obligations collateralized briefly identified."). None of the excluded companies had done that, and I therefore assume that most (though probably not all of them) had not granted any significant secured credit.

shows that a decreasing number of companies are taking on significant secured debt; the declining mean shows that the amount of secured debt has also been decreasing.

Small companies granted more security, and their level of security was more variable. Their mean ranged from 14% (secured credit divided by assets) in 1981, up to a high of more than 16% in 1989, and then down to approximately 12.5% in 1995. The median numbers went through a similar range, from approximately 5% at the outset to approximately 1% in 1995.

If the mean and median are the relevant numbers, the message is clear: Companies grant only a limited amount of secured credit, and, over the fourteen years from 1981 through 1995, the amount of secured credit as a percentage of the assets of those companies has declined. Of course, the means and medians could be misleading. They might hide a large number of companies with no secured debt, and a smaller but significant number with large amounts of secured debt. To test that possibility, I looked at the percentage of companies in the database that had different levels of secured debt as a percentage of assets in six different years.

CHART 2. DISTRIBUTION OF SECURED DEBT AS A PERCENTAGE OF ASSETS

Chart 2⁴⁴ portrays the percentage in six separate years—1981, 1984, 1987, 1990, 1993, and 1995. In 1981, 25.7% of the companies had no secured debt, another 27.8% had secured debt equal to 5% or less of their assets, and

44. Chart 2 shows the distribution of the "Secured Debt as a Percentage of Assets" variable for all companies in the "Full Data Set." The lower axis is divided into ranges of "Secured Debt as a Percentage of Assets," and the data points for each range indicate the percentage of companies falling into that range each year.

an additional 12.8% had secured debt of 6% to 10%. As the years went on, the percentage of companies that had any significant secured debt steadily declined. By 1995, 39.8% of the companies in the database had no secured debt, 25.7% had from 1% to 5%, and 7.7% had from 6% to 10% of secured debt. Thus, by 1995, 73.2% of all the companies in the database that reported on this issue had secured debt that was less than 10% of their total assets. In all years, only a trivial number of companies granted security in more than half their assets.

If, as Professor LoPucki argues, major players are reducing their stakes by means of granting security interests, one would expect larger numbers of companies in every year to have granted security interests covering a larger percentage of their assets. Moreover, one would expect a trend contrary to the one that is disclosed, namely a rising percentage of assets covered by security, not a falling percentage. But not only does the percentage of assets that are subject to a security interest appear to be declining, it is also quite small in each year. By 1995, only 22.1% of all companies had granted security interests in more than 15% of their assets. Moreover, the trend over the fourteen-year period is contrary to Professor LoPucki's hypothesis: The number of companies with significant secured debt is declining, not rising. In short, corporate debtors are not beggaring potential tort claimants by granting security interests in their assets.

2. *Assets to Liabilities*

Granting secured debt is only one of the ways that a firm could immunize itself against claims of prospective tort claimants. Professor LoPucki correctly notes that disposing of assets has the same consequences for a prospective judgment holder as granting security would have.⁴⁵ An industrial firm might sell its machinery and lease it back. The creditor of the selling company would be unable to reach the leased asset upon the "lessee's" default. Under the Bankruptcy Act and the Uniform Commercial Code, those assets would ultimately go to the lessor, not to the creditors of the lessee.⁴⁶ Securitization has the same effect, with respect to intangibles, allowing a firm to dispose of its intangible assets (usually accounts receivable or the like) to a trustee.⁴⁷ The trustee issues beneficial interests in the trust and sells them to investors.⁴⁸ These interests entitle the investor to receive the payments from the account debtors that would normally go to the firm. This transaction, of course, is similar to granting a perfected security interest in one's accounts. In both a securitization and a sale-and-leaseback transaction, the asset is put beyond the

45. See LoPucki, *supra* note 1, at 25-26.

46. See 11 U.S.C. §§ 365, 541 (1994); U.C.C. § 2A-307 (1996).

47. See Schwarcz, *supra* note 28, at 135.

48. See *id.*

reach of the seller's creditors, who must satisfy themselves with the sale's proceeds.⁴⁹ Professor LoPucki recognizes that securitization has become much more widespread within the last ten years than was formerly the case, and he identifies it as one of the ways companies are judgment proofing themselves.⁵⁰

The asset-to-liability ratio directly measures the extent to which firms are impoverishing themselves by transferring assets to third parties through sale-and-leaseback transactions, securitization, payment of excessive dividends, or any other mode of disposition for less than face value. The percentage also measures the extent to which firms accomplish the same end by remaining undercapitalized from their founding, or rendering themselves undercapitalized by making losses. The data prove that the companies in the database are for the most part adequately capitalized; their asset-to-liability ratio does not decline over time.

CHART 3. ASSETS AS A PERCENTAGE OF LIABILITIES

49. Remember that the sale of an asset is not enough alone to judgment proof a debtor. If the sale is for fair value, the proceeds of the sale will replace the asset on the debtor's balance sheet and thus leave the debtor in exactly the same position after the sale as before. To use asset securitization, sales and leasebacks, or the like to judgment proof oneself requires a second step, namely the disposition of the net proceeds by dividends to shareholders or by other transfers for less than fair value.

50. See LoPucki, *supra* note 1, at 23-30. Similar but less significant dispositions can be fraudulent conveyances or gifts to family members or to others. For example, one can set up a trust in the Cook Islands and, at least theoretically, enjoy the benefits of the assets while keeping the assets beyond the reach of one's creditors. See *id.* at 32 n.142 (citing sources). I do not concern myself with those transactions. Typically, they involve (and I suspect always will involve) only individuals and not companies. But see Steven R. Strahler, *Personal Preservation: Developers Go Offshore To Save Skin*, CRAIN'S CHI. BUS., May 6, 1991, at 17 (discussing developers who have shifted assets into offshore trusts). Some guarantors of real estate debt are apparently using these techniques to avoid liability in business guarantees. See *id.* The techniques are relevant to this Essay only to the extent that they become widespread among business individuals who could cause significant tort liability, such as physicians.

Consider first the means and medians shown in Chart 3.⁵¹ In every year, the median company in the database had between \$1.67 and \$1.85 in assets for every dollar of liability. Note that the median percentages descend from 1983 through 1989 and then ascend from 1989 to 1994. This change may stem from the recession of 1990; losses that occurred in those years could easily account for the decline and later rise in solvency. In any case, there is no perceivable long-term trend. The medians for all data are remarkably constant, hovering near \$1.75.

The data for the smallest 200 companies in the database and for the largest 200 companies in the database are not distinctly different from the data for all firms. Large companies tended to be more stable between 1981 and 1995; their mean and median percentages declined slowly, from 188% in 1981 to 174% in 1995. The corresponding median values were 181% and 154%. In the small companies, on the other hand, median percentages for assets and liabilities fluctuated between 127% and 170%, and the means fluctuated between 300% and 850%.

51. Chart 3 shows the mean and median percentage values of the "Assets as a Percentage of Liability" for all companies each year. "Assets as a Percentage of Liability" for a given company is defined as the total assets of that company divided by the total liabilities of that company. The data are as follows:

YEAR	ASSETS AS A PERCENTAGE OF LIABILITY: ALL COMPANIES	
	MEAN	MEDIAN
1981	380.17	181.16
1982	357.25	179.02
1983	385.24	185.66
1984	407.85	181.62
1985	585.45	176.69
1986	553.12	175.95
1987	493.11	175.20
1988	442.71	172.63
1989	632.08	167.42
1990	593.63	167.43
1991	522.46	171.31
1992	543.93	175.02
1993	617.88	177.49
1994	512.58	177.78
1995	481.68	177.56

The only data that give any support to the suggestion that corporations are becoming more leveraged over time are the medians and means of the largest 200 firms, where one sees a small but perceptible decrease over time. But the median company still has more than \$1.50 of assets for every dollar of liability in every year, and the mean company still has more than \$1.70 of assets for every dollar of liability in every year. Since the net assets of the mean and median companies in the largest 200 companies more than doubled between 1981 and 1994, the modest decline in the ratio during that time is not real evidence of judgment proofing. Neither the small companies nor the combined data show any similar progressive decline in solvency.

Examining the actual distribution in Chart 4 for six of the years in this setting shows only a modest change in the distribution of companies' solvency.

CHART 4. DISTRIBUTION OF ASSETS AS A PERCENTAGE OF LIABILITIES⁵²

The majority of the companies in the sample have between \$1.00 and \$2.00 of assets for each dollar of liabilities. In 1981, there was a slightly larger representation in the \$1.50 to \$2.00 range, whereas between 1981 and 1995 there was a gradual shift so that there is now a larger number of companies that have a ratio of between \$1.00 and \$1.50. In the early years, from 1981 to 1986, there was a gradual shift to the left, toward lower asset ratios. Between

52. Chart 4 shows the distribution of the "Assets as a Percentage of Liabilities" for all companies in the "Full Data Set" for five years. The lower axis is divided into ranges of "Assets as a Percentage of Liabilities," and the data points for each range indicate the percentage of companies falling into that range each year. The "Full Data Set" used to generate this chart represents those companies in the Compustat Industrial Annual Files for the years 1981, 1984, 1987, 1990, 1993, and 1995 for which total liabilities and total assets were reported.

1990 and 1995, there has been a shift the other way, toward more assets for each dollar of liability.

In a final effort to tease any judgment proofers out of the data, I identified a number of industries—chemicals, pharmaceuticals, and hazardous waste management—whose manufacturing processes or products seem to have the largest possibility of causing catastrophic tort or other liability. The data are summarized in Chart 5.

CHART 5. ASSETS AS A PERCENTAGE OF
LIABILITIES—SELECTED INDUSTRIES

In general, the data show these apparently risky businesses to be as well capitalized as others and, in some cases, to be much better capitalized than the average company. For example, pharmaceutical companies had more than \$5.00 of assets for every dollar of debt in most of the years between 1981 and 1995. Like the data for all companies, and the data for small and large companies, the data on these selected and apparently risky businesses show no evidence of judgment proofing and, by some interpretation, show the opposite.

The message from all of the data across years and among industries and in businesses of different size is consistent: There is no pattern toward a lower asset-to-liability ratio. These data conflict with the claim that firms are practicing the most plausible mode of judgment proofing, the outright disposition of assets or the operation of thinly capitalized businesses.

Against these data—these direct measures of judgment proofing—Professor LoPucki offers only the barest inference from dividends in bankruptcy cases. Dividends to creditors in bankruptcy were lower in 1992 than in 1976 and

lower in 1976 than in 1926.⁵³ From this decline in bankruptcy dividends, Professor LoPucki apparently infers that firms are becoming more highly leveraged than before. Accepting the doubtful proposition that distributions at the end of a firm's bankruptcy are a measure of the leverage of that firm before bankruptcy,⁵⁴ Professor LoPucki's data still do not justify his inference. His data, at least for the later years, are drawn from all bankruptcies, yet the vast majority of bankruptcies are individual, nonbusiness bankruptcies. In 1980, about 87% of bankruptcies were nonbusiness bankruptcies; by 1996, that number had increased to more than 95%.⁵⁵ The great majority of bankruptcies—especially for individuals—are filed under Chapter 7;⁵⁶ in 1993, approximately 94% of Chapter 7 bankruptcies were filed by individuals.⁵⁷ Despite their small number, business bankruptcies represented the lion's share of the distributions in Chapter 7.⁵⁸ Because Professor LoPucki calculates his percentages on an undifferentiated mass of business and personal bankruptcies—where more than 90% of the cases are personal and where each personal bankruptcy carries the same weight as a much larger business case does—it is possible that both the rise in the percentage of “no-asset” cases (where there are no payments to general creditors) and the decline in payments

53. See LoPucki, *supra* note 1, at 18.

54. There are many reasons that the current distributions in bankruptcy compared with those of years ago are not a reliable measure of leverage. First, the comparative solvency of businesses exiting bankruptcy is a function of the courts' leniency to debtors and the speed of bankruptcy law. If, as currently is the case, companies are allowed to linger long in Chapter 11, the distribution to creditors at the end of such lingering death would be much lower than it would be under other regimes in which procedures ended earlier.

Second, rules on priority and administrative expenses can have a substantial impact on distribution to creditors. To the extent that administrative expenses for lawyers and operation of the business are expanded—as appears to be the case under the 1978 Bankruptcy Reform Act, 11 U.S.C. § 507 (1994)—there will be smaller distributions to existing creditors upon liquidation. This would be true even if one held constant the amount of leverage of the company at the time it entered bankruptcy.

Third, the amount of distributions to creditors at the end of a bankruptcy may also be a function of when, for various reasons, a bankruptcy is commenced. If, for example, companies found it in their interests to declare Chapter 11 early under one regime, but later under another, the distribution to creditors would be different under the two regimes even if the amount of leverage in firms generally were the same in both cases.

Against my direct and palpable measure of leverage, Professor LoPucki offers indirect, fragmentary, and problematic data. See LoPucki, *supra* note 1, at 52-53 (offering evidence of firms' leverage only through data from firms in bankruptcy); see also *infra* note 58.

55. See American Bankruptcy Institute, *Bankruptcy Statistics* (visited Oct. 6, 1997) <<http://www.abiworld.org/stats/statsfvant.html>>.

56. See *id.*

57. See Administrative Office of the U.S. Courts, *Bankruptcy Data* (visited Nov. 6, 1997) <http://bankrupt.com/Bankruptcy_Statistics/1980_to_1994_Statistics>.

58. Professor LoPucki cites a General Accounting Office (GAO) report that analyzes data from 1991-1992, but he does not mention that almost all of the bankruptcies analyzed in the report are individual bankruptcies. See LoPucki, *supra* note 1, at 18 n.69 (citing U.S. GEN. ACCOUNTING OFFICE, BANKRUPTCY ADMINISTRATION: CASE RECEIPTS PAID TO CREDITORS AND PROFESSIONALS 1 (1994)). So the overwhelming majority of bankruptcies Professor LoPucki discusses are bankruptcies filed by individuals, mostly poor individuals. In fact, the GAO report notes that while only 5% of the Chapter 7 cases were asset cases, business cases accounted for most of the recoveries by creditors: 77% of the dollars distributed to creditors in Chapter 7 cases came from business bankruptcies, and 83% of asset cases in which the recoveries were greater than \$500,000 were business bankruptcies. See U.S. GEN. ACCOUNTING OFFICE, *supra*, at 7, 34 tbl.11.2.

in asset cases (as a percentage of claims made) are attributable exclusively to changes in the personal bankruptcy cases. It is no secret that the inclusion of personal exemptions in the Bankruptcy Reform Act of 1978⁵⁹ and the concurrent enlargement of state law exemptions, and the further expansion of personal exemptions in the bankruptcy amendments of 1994⁶⁰ have facilitated personal bankruptcy without payment to any general creditor.⁶¹

3. Insurance

The amount of liability insurance carried by American firms may serve as an alternative measure of judgment proofing. Buying liability insurance is inconsistent with judgment proofing; the insurance stands in lieu of assets, and the insurance premium in lieu of their cost.

Because Professor LoPucki's claim is so broad—American companies are taking their chips off the table—one need not examine the activities in particular industries to challenge this thesis. Accordingly, I have collected liability insurance data for general liability of American commercial business, for medical malpractice liability, and for workers' compensation liability. Separately and together, these data show no significant changes between 1981 and 1995. Chart 6 plots the percentage increase of losses incurred in each year under "other liability" policies (i.e., business liability policies) issued to American firms and under workers' compensation and medical malpractice policies. These are the policies that will respond to liability for personal injury or property damage arising from the insured's negligence, commission of strict tort, breach of warranty, or the like.⁶²

59. Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 522).

60. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106; *see also* 4 COLLIER, *supra* note 24, ¶ 522.09.

61. Implicit in Professor LoPucki's thesis is the notion that social attitudes are changing to make the kinds of financial and legal structures utilized by persons wishing to avoid liability more acceptable. Yet, while he integrates this element into his argument in some places, in others he fails to do so. While focusing on the increased role of secured debt in his discussion of bankruptcy, Professor LoPucki never considers the *reasons* for the increased role of secured debt, such as an enormous increase in consumer debt in general. In fact, "[c]onsumer debt . . . has more than doubled in the past decade and is up 44% in the last three years alone." *Testimony of the American Bankruptcy Institute on Consumer Debt, Delinquencies and Personal Bankruptcies Before the Committee on Banking and Financial Services of the U.S. House of Representatives* (visited Oct. 6, 1997) <<http://www.abiworld.org/legis/testimony/12sep96.html>>. Another factor might well be the sharp increase in consumer bankruptcy filings themselves, which have shown an extremely strong correlation with consumer debt. *See id.* Total bankruptcy filings increased over 100% from 1980 to 1994, while the number of public companies filing for bankruptcy decreased 53% from 1985 to 1994. *See* Administrative Office of the U.S. Courts, *supra* note 57. So not only are Professor LoPucki's data flawed, but he fails to contextualize the data appropriately.

62. Insurance figures are from A.M. BEST CO., BEST'S AGGREGATES AND AVERAGES: PROPERTY-CASUALTY (1996); and A.M. BEST CO., BEST'S AGGREGATES AND AVERAGES: PROPERTY-CASUALTY (1990). Data items used were workers' compensation losses incurred, medical malpractice losses incurred, and other liability losses incurred. Gross Domestic Product (GDP) data are from U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES—1996, at 443 (1997).

CHART 6. GROWTH OF INSURED LOSSES INCURRED

Chart 6 shows that covered losses tracked the Gross Domestic Product (GDP) and, in fact, grew more rapidly than GDP between 1981 and 1995. If one assumes that the losses generated by American business are more or less proportional to business activity (as measured by GDP), the insurance coverage for those losses in every year since 1981 has exceeded the insurance coverage available for comparable losses in 1981. The chart shows the same to be true of insurance for medical malpractice and workers' compensation.

How do these data contradict Professor LoPucki's hypothesis? If, as he claims, businesses believe that they can render themselves judgment proof, it is a waste of money to purchase liability insurance. By hypothesis, a firm's liability insurance stands in the place of and protects its business assets. If a firm has no business assets or has only assets that creditors have already claimed, then it has no need for such insurance, and rational managers would cancel their coverage.⁶³ That has not happened; there has been greater insurance coverage in the 1990s than in the 1980s.

Because the data encompass all business risks and all liabilities, they do not answer the question whether the companies in various industries where there is high probability of tort injury have reduced their insurance coverage. Likewise, the data do not show exclusions from coverage. For example, most insurance companies have excluded asbestos injuries from their general liability policies written in recent years.⁶⁴ It is possible that the policies of 1995 had

63. Of course the creditors, particularly secured creditors, might insist upon insurance to preserve their collateral or to preserve the debtor's earning capacity. Doubtless some part of the insurance that I have observed was purchased at the insistence of secured creditors.

64. See Patrick J. Hagan et al., *Totalling Up the Costs of Asbestos Litigation: Guess Who Will Pay the Price?*, 9 TEMP. ENVTL. L. & TECH. J. 1, 15 (1990).

significant exclusions that were not present in 1981, and thus that the insurance written in 1981 for some risks was larger than that written in 1995, even though the aggregate covered losses are greater in the later year.

Even with those qualifications, the continued maintenance of significant liability insurance—at a level equal to or greater than the 1981 level—is an embarrassment to Professor LoPucki's thesis. Professor LoPucki's primary argument about insurance, however, envisions a world in which the liability-avoiding measures he outlines have already taken effect; that is, a world where liability is already dead.⁶⁵ Although I have argued above that this world is merely a fantasy, it is nevertheless worthwhile to examine Professor LoPucki's argument on its own terms.

Professor LoPucki begins by asserting that "much, if not most, liability is of an uninsurable nature" and that "purely accidental events cannot be deterred."⁶⁶ Both of these statements are questionable, the second highly so. If by "purely accidental" he means "absolutely unavoidable," then it is difficult to argue with his statement, but it has no applicability to most accidents, which are avoidable to some degree. If, on the other hand, Professor LoPucki means what most people mean when they say "accidental" (i.e., "unintentional"), then his statement is nonsense: Many unintentional events are avoidable and thus deterrable.⁶⁷

65. See LoPucki, *supra* note 1, at 71. Throughout his article, Professor LoPucki uses the term "liability" in two distinct senses. The first is the standard sense of a legal obligation or debt; the second, as in his title, is a more particular sense of an *enforceable* legal obligation or debt. Professor LoPucki is not arguing, after all, that the law will change in such a way that it will no longer be possible to bring tort claims, but merely that corporations will arrange their assets in such a way that it will be impossible to enforce them. His use of the word "liability" with two different meanings becomes confusing in his discussion of insurance, where, for example, he says that "[e]xperience' rating . . . encourages the debtor to avoid liability now so that future premiums will be lower." *Id.* at 73. Here, "avoid liability" seems to mean "be careful so that tort claims will not be brought," not "hide assets," which is clearly the meaning the phrase has when Professor LoPucki uses it earlier, in the statement "those businesses could avoid liability if they so chose." *Id.* at 5.

66. *Id.* at 72. There are, of course, some things that are uninsurable—asbestos is a good example—but I suspect that these uninsurable liabilities are less significant than one might imagine. For the most part, a business tort liability becomes "uninsured" as to a company with liability insurance only because it is explicitly excluded from the coverage. Policies are written to cover all losses arising from tort and the like and it is then a job of the insurance company's drafter to write exclusions that will protect it from things it does not wish to cover. In many cases, there are no applicable exclusions for the most serious injuries precisely because neither the insurer nor the insured could foresee them and therefore the insurer could not exclude them. For example, coverage for asbestos liability was not excepted from policies until the early 1980s. By that time the horse had already left the barn. Note as well that "not foreseeable" and "unavoidable" are two different things: The extent of the asbestos litigation was surely not foreseeable, but much of the damage was avoidable, since the asbestos companies knew for years that the substance was dangerous. See PAUL M. BRODEUR, *OUTRAGEOUS MISCONDUCT: THE ASBESTOS INDUSTRY ON TRIAL* 10-22 (1985).

67. Professor LoPucki does conclude that "liability-producing events are rarely either purely intended or purely accidental," LoPucki, *supra* note 1, at 73, but he then moves on to other elements of his argument, providing only abstract and highly tenuous support for his statement that "much, if not most, liability is of an uninsurable nature," *id.* at 72. Later, as evidence for his claim that there exists "a vast realm of uninsurable liability," *id.* at 75, Professor LoPucki lists intentional torts and "many new, apparently risky kinds of activities," *id.*, yet fails to provide a sound example of the latter. The sole examples he supplies—biotechnology companies—are in fact insurable, as LoPucki himself admits. See *id.*

Professor LoPucki further argues that liability insurance upsets the balance of efficient levels of risk and thus works against the liability system because it allows risk takers to engage in risky behavior and reimburses them when the behavior produces liability.⁶⁸ This statement, however, is only partly true. As Professor LoPucki himself admits, schedule rating and experience rating align the interests of insurer and insured—namely, the interest in avoiding liability-generating conduct.⁶⁹ But, Professor LoPucki continues, this situation holds only for voluntary insurance.⁷⁰ With judgment-proofing strategies in place, he argues, firms will tend only to buy insurance involuntarily.⁷¹

Professor LoPucki then proceeds to the core of his argument, which concerns a world in which all firms are judgment proof. He first argues:

As Chapter 11 is improved to make it more efficient, it will provide a more cost-effective substitute for insurance. As Chapter 11 cases become more common, the publicity individual cases receive can be expected to decline. Debtors will tend to find it cheaper and less stigmatizing to deal with their liability through Chapter 11 than through liability insurance.⁷²

This argument is, of course, as impossible to disprove as it is impossible to prove, for it involves not only an assumption of universal judgment proofing, but also an assumption that Chapter 11 will become cheaper and more efficient than it is now. Yet, it is as easy to imagine a world in which firms are judgment proof and Chapter 11 is more expensive and more stigmatizing than insurance as it is to imagine a world in which firms are judgment proof and Chapter 11 is less expensive and less stigmatizing than insurance. And

at 75 n.315. Since systematic intentional torts would be a public relations death knell for most corporations, they are irrelevant to his thesis.

68. See *id.* at 73.

69. See *id.*; see also Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 320 (1990) (arguing that schedule rating—in which the insurer inspects the insured's operations to adjust premiums—and experience rating—in which the insurer takes into account the liability record of the insured—allow insurers to offer insurance that is almost "perfectly responsive")

70. See LoPucki, *supra* note 1, at 76.

71. See *id.* Professor LoPucki recognizes that there are reasons other than liability avoidance to buy insurance; he lists the preference for insurance over Chapter 11, the contract requirements of other firms or individuals, avoidance of adverse publicity, and moral obligation. See *id.* For several other reasons for firms to buy insurance, see David Meyers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982). Meyers and Smith write

[F]or corporations with diffuse ownership[,] risk aversion by the owners apparently provides no incentive for the purchase of insurance We argue that the corporate demand derives from the ability of insurance contracts to (1) allocate risk to those of the firm's claimholders who have a comparative advantage in risk bearing, (2) lower expected transactions costs of bankruptcy, (3) provide real-service efficiencies in claims administration, (4) monitor the compliance of contractual provisions, (5) bond the firm's real investment decisions, (6) lower the corporation's expected tax liability, and (7) reduce regulatory constraints on firms

Id. at 293. To the extent that Professor LoPucki does not deal with these factors, they provide arguments against his position as well.

72. LoPucki, *supra* note 1, at 76.

Professor LoPucki gives no reasons that we should imagine the latter instead of the former.

Professor LoPucki's next argument—that bankruptcy might be preferable to insurance⁷³—is equally tenuous. Here he argues that a well-drafted contract can allow one party to the contract to go into bankruptcy instead of buying insurance, while still providing for the fulfillment of the contract.⁷⁴ This argument assumes that the insurance premium to be avoided by the contracting party will exceed the costs of bankruptcy. The direct cost of bankruptcy—of lawyers' and accountants' fees and time spent in court—can be considerable. Less palpable, but not necessarily smaller, are the indirect costs of bankruptcy in opportunities foregone because one must operate under court control, and at sufferance to every creditor with sufficient anger or economic stake to challenge an act as inappropriate under the Bankruptcy Code. Also onerous are the indirect costs of damage to one's reputation in the business community. I doubt there are many cases where these multiple costs of bankruptcy are less than the cost of insurance.

Even if the cost of insurance were greater than the cost of bankruptcy, it would still be contrary to the interest of most persons to choose the latter over the former. As I suggest below,⁷⁵ most businesses have multiple contract creditors. Those creditors, too, would be interested in the debtor's performance and might insist upon insurance to protect against the debtor's avoiding its liability to them while performing its executory obligations under § 365 of the Bankruptcy Code⁷⁶ for other creditors.

Remember finally that bankruptcy is a game played in court, a game which brings with it all of the uncertainties of any other court proceeding. A favorable outcome in bankruptcy depends upon many circumstances that are beyond the control of the contracting parties: Will a trustee be appointed? Will the creditors in the bankruptcy remove the management that had made the deal and replace it with management that has no allegiance to any particular contracting party? Will litigation bring other unforeseen calamities? In short, insurance is clean, predictable, and largely beyond the control of the contracting party. To trade that for the hope of performance by a bankrupt seems a poor bargain to me.

Professor LoPucki's final argument is that pervasive judgment proofing would lead to compulsory insurance, which would not solve the problem. He offers four reasons: (1) In Professor LoPucki's imagined world, insureds have no economic incentive to concern themselves with whether their insurers will pay claims, so an insured will pay little attention to insurer solvency and will

73. *See id.* at 77.

74. *See id.*

75. *See infra* notes 128-132 and accompanying text.

76. 11 U.S.C. § 365 (1994).

open the door for unscrupulous bankruptcy-prone insurers;⁷⁷ (2) it would be in the common interest of insureds and insurers to minimize coverage to the extent permitted by law;⁷⁸ (3) the incentive to provide accurate information on insurance applications would disappear because the insured would no longer care whether the insurer paid the loss, and it would not be possible for insurers to deny coverage for fraud in the insurance application;⁷⁹ and (4) the incentive to cooperate in processing claims also disappears, so insureds may be reluctant to cooperate.⁸⁰

These arguments are easy to overcome. Making required coverage relatively high and assessing penalties—in the form of higher premiums or even criminal sanctions—for fraud or failure to cooperate in the processing of claims would answer most of Professor LoPucki's concerns. Imposing stringent requirements for the privilege of writing such insurance policies would solve the remainder. Professor LoPucki's arguments concerning compulsory liability insurance focus almost solely on compulsory automobile liability insurance, and they extrapolate from conditions surrounding present-day automobile liability insurance to conditions that will obtain in LoPucki's imagined world of judgment-proof corporations.⁸¹ He argues that (1) since required coverage under compulsory insurance is presently often lower than necessary for full liability coverage, compulsory corporate liability insurance in the world where corporations are judgment proof would also be at levels too low to provide full liability coverage;⁸² (2) compulsory insurance has proved unenforceable with respect to automobile liability insurance, and it must therefore prove unenforceable with respect to corporate liability insurance;⁸³ and (3) insurance companies would be required to write insurance policies for high-risk enterprises at below-market rates, which would then force them to charge above-market rates for other enterprises, thus subsidizing the high-risk enterprises.⁸⁴

Disregarding for the moment that Professor LoPucki's conclusions do not even appear to follow from his premises, I will attempt to show why his conclusions are mistaken. Under his first point, Professor LoPucki states, "We can expect that a compulsory business liability insurance system would require

77. See LoPucki, *supra* note 1, at 80.

78. See *id.* at 81.

79. See *id.* at 82.

80. See *id.* at 80-83. Of course, unless the insurance companies were themselves judgment proof, they would have a strong motivation to adopt policing strategies to ensure cooperation and weed out fraud.

81. Here and elsewhere in his article, Professor LoPucki assumes without argument that a feature of today's world will persist into his judgment-proof world. And yet, when one posits an imaginary world, it seems a false step to assume that certain features of today's world must survive. Perhaps in a judgment-proof world mass torts will not exist. Perhaps there will be unicorns and dragons. Who can say?

82. See LoPucki, *supra* note 1, at 85.

83. See *id.* at 87.

84. See *id.* at 86.

insurance only to low policy limits.”⁸⁵ Yet the only evidence he supplies in support of this assertion is data on present-day hazardous waste and auto liability insurance.⁸⁶ There is no reason to suppose that present-day conditions must continue to obtain in Professor LoPucki’s judgment-proof world; in fact, there is considerable reason to suppose otherwise. It might very well be true (indeed, the presence of financial responsibility laws in some states, to which Professor LoPucki himself draws our attention,⁸⁷ suggests it is true) that liability limits are so low *because* most firms and many drivers are not presently judgment proof. If the average net assets for firms that produce or handle hazardous waste is \$1,000,000, liability insurance limits might well be set about \$1,000,000 below what would be required for full coverage of liability in most instances. This situation would clearly not be the case in the judgment-proof world that Professor LoPucki is asking us to imagine. In any case, Professor LoPucki offers no reasons why the present low liability coverage, which I assume for the sake of argument is often insufficient to cover losses generated by bad drivers,⁸⁸ would not be in and of itself a sufficient reason to make liability coverage higher under pervasive compulsory insurance, since defects in legislation are often remedied at a later stage.

Professor LoPucki offers similar evidence for his other two points, and similar objections can be made. He asserts that “[t]he problems of implementation of compulsory automobile liability insurance are likely to be repeated in the context of compulsory business liability insurance,”⁸⁹ but this need not be the case. Professor LoPucki seems here to be concerned with problems of enforcement and cross-subsidization. Since premiums are government controlled, compulsory automobile insurance is a losing proposition for insurance companies.⁹⁰ Not only is there no reason for compulsory corporate liability insurance premiums to be lower than a fair market price, there is actually sound reason that they should be higher than fairly priced, i.e., that they should be money-making propositions for insurance companies. Since compulsory insurance would, by hypothesis, be a substitute for tort liability brought on by corporate liability avoidance, mandating high premiums would provide some incentive for corporations not to make themselves judgment proof. The compulsory insurance system could be designed so that premiums are higher than fair market value, with insurance

85. *Id.* at 87.

86. *See id.* at 87 n.365.

87. *See id.* at 86.

88. In reality this is not the case. The average cost of a personal injury automobile accident is \$9487. *See* DEBORAH HENSLER, COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES 103 (1991). Presumably, personal injury costs dwarf property damage costs, but even assuming that they are roughly the same, the average cost of an auto accident is under \$20,000. Most states mandate liability coverage in excess of this amount.

89. LoPucki, *supra* note 1, at 86.

90. *See* Suzanne Yelen, *Withdrawal Restrictions in the Automobile Insurance Market*, 102 YALE L.J. 1431, 1431 (1993).

companies paying a direct federal tax (in some amount less than their profit from the unfair premiums) to support the increased government regulatory machinery that would be necessary to administer the compulsory insurance program. Firms with sufficient assets available for tort judgments might be excluded from the insurance requirement or get a rebate from their premiums. There need be no assigned-risk policies at all: Riskier enterprises would demand high premiums, and less risky ones, lower premiums. All this, of course, is hypothetical; it shows, however, that there are sound hypothetical responses to Professor LoPucki's hypothetical scenario.

Professor LoPucki states that there would be political issues connected with compulsory insurance.⁹¹ With this I agree. We differ, however, on what these issues would be. Professor LoPucki notes in this regard: "Conditioning business opportunity on insurance is somewhat analogous to conditioning the right to drive a car on insurance. Both are essential elements of individual autonomy in modern society, the denial of which [is] not easily accepted."⁹² He is clearly implying here that requiring insurance is tantamount to a denial of the right. In general, however, opening a business requires assets in some form. Assuming that there would be some class of businesses that would be so risky that the additional amount of capital required to buy compulsory insurance would deny some people the "right" to open such a business,⁹³ it is unclear that this would become a divisive political issue. It does not seem to bother too many people in today's society that many who would like to own their own businesses do not have the financial wherewithal to do so.

Professor LoPucki argues, finally, that it is impossible to enforce a compulsory automobile insurance scheme and that therefore one could not enforce a compulsory business insurance scheme.⁹⁴ It seems, however, that compulsory automobile insurance is easier to avoid than compulsory corporate liability insurance. There are far more drivers than businesses in this country, and, conversely, businesses are more prominent in their communities than individual drivers. Businesses, in other words, are easier to spot than individual drivers. A simple solution requiring that proof of insurance for the year be attached to income tax returns would probably solve the problem. The Treasury Department might, indeed, be the natural arm of government to look to for enforcement of compulsory liability insurance.

91. See LoPucki, *supra* note 1, at 85.

92. *Id.* at 86.

93. It is somewhat difficult to imagine how this could happen in the judgment-proof world. Presumably, there would still be start-up costs in such a world, judgment proofing would occur after the business had been set up but before it had begun generating liability by engaging in its particular enterprise. In the course of judgment proofing, the assets of the business would be sequestered from potential creditors. Would it not be possible to use some of these assets to buy insurance?

94. See LoPucki, *supra* note 1, at 86.

Professor LoPucki does admit that a compulsory insurance system could conceivably preserve liability,⁹⁵ but he is unwilling to entertain a fantasy world of compulsory insurance. This argument is surprising because a compulsory insurance world is a more orderly, more realistic, and altogether more pleasant fantasy than the world in which firms commit mass torts with impunity.

In sum, it is not likely that liability insurance will disappear. The data from 1981 to the present do not show any decline in the purchase of liability insurance; in fact, they show the reverse. For reasons that are discussed below,⁹⁶ it is doubtful that we will ever experience the fantasy world in which most commercial firms are judgment proof and their incentive to maintain insurance is accordingly diminished. Should that world come to pass, it is just as plausible as not that legislators would pass laws making it prohibitively expensive for firms to avoid buying liability insurance.

4. *Subsidiaries*

The data set out above do not show the financial status of corporate subsidiaries. Because the Compustat data are from consolidated balance sheets, a subsidiary's assets and liabilities are reported in those data as though they were the assets and liabilities of the parent company. Because there are only consolidated data, reports on insurance and secured debt also fail to give any reliable information about the financial status of wholly owned subsidiaries. To explain the use of subsidiaries as a judgment-proofing device, I propose first to set forth the reasons that corporations—particularly multinational corporations with considerable exposure to tort claims—conduct much of their business in subsidiaries. Second, I consider the deliberate, self-conscious steps necessary to use a subsidiary as a successful judgment-proofing device. Third, I discuss a handful of anecdotal tort cases involving subsidiaries.

Consider current use of subsidiaries and the reasons for their use. According to Professor LoPucki's thesis, firms that engage in risky activity should separately incorporate each risky endeavor and feed the profits back to the parent. An examination of twenty-two randomly selected firms from industries that might engage in this strategy (the petroleum, chemical, and pharmaceutical industries) shows no significant trend toward increasing the number of subsidiaries within corporate groups.⁹⁷ Between 1988 and 1995,

95. See *id.* at 83. He then observes that "it is clear that it would, in the process, transform the liability system almost beyond recognition." *Id.* at 88. Yet this would hardly be surprising because the liability system would have died first anyway. Professor LoPucki seems to be suggesting, in effect, that the transformation of the liability system under compulsory insurance is somehow an argument against compulsory insurance—but if this is true, it is equally an argument against his entire article.

96. See *infra* Part III.

97. The following subsidiary information is from Disclosure, Inc.'s January 1988 and December 1996 CD-ROMs:

twelve of the twenty-two companies had increased their number of subsidiaries, eight had decreased their number, and two were constant.

To understand some of the legitimate reasons for using subsidiaries, consider the case of Union Carbide. It has sixty-five subsidiaries, of which thirty-nine are incorporated abroad.⁹⁸ Consider why management might have chosen separately to incorporate various businesses even in circumstances in which it was not judgment proofing itself by undercapitalizing those subsidiaries.

When we consider the foreign subsidies, it is readily apparent that there are at least two good reasons for doing business in a foreign country through a subsidiary and not through the parent. First, local foreign law may require local incorporation or that law may offer tax or other incentives for a local

NAME	SUBSIDIARIES 1/88	SUBSIDIARIES 12/95	CHANG.
Abbott Laboratories	105	105	0
Adams Resources and Energy	0	12	12
Air Products and Chemicals	14	27	13
Amerada Hess	12	14	2
American Pacific	2	12	10
Amoco	57	70	13
Atlantic Crown Richfield	2	4	2
Biogen	10	7	-3
Bristol-Meyers Squibb	226	236	10
Carrington Labs	4	7	3
Chevron	45	27	-18
Crown Central Petroleum	21	20	-1
Dow Chemical	201	317	116
E.I. DuPont	7	64	57
Eli Lilly	113	189	76
Exxon	50	74	24
Global Marine	31	31	0
Merck	147	115	-32
Pharmacia-Upjohn	53	5	-48
Schering Plough	172	141	-31
Sun	456	183	-273
Warner Lambert	125	110	-15

98. See Disclosure, Inc. CD-ROM (Dec. 1996).

incorporation.⁹⁹ Even if there is no legal requirement, a large company may not wish to expose all of its assets and operations to the control of legislative, administrative, and executive agencies in a foreign country. Just as important, it may not wish to expose all of its assets to the courts of that country. Declining to expose all of a parent's assets to a foreign jurisdiction, however, is not the same as judgment proofing a subsidiary from liability arising in that country. A company such as Union Carbide, with a net worth of five billion dollars, may be quite willing to expose a subsidiary with tens or hundreds of millions of dollars net worth, but may be unwilling to expose its entire five billion to the vagaries of a foreign legislature or a foreign court.¹⁰⁰

Domestic subsidiaries may be necessary to comply with particular domestic law or to insulate the parent's operation from the control of a particular domestic agency. Consider, for example, Union Carbide's Benefit Capital Management. That subsidiary manages pension funds for Union Carbide and was established to sell pension management advice to other pension funds.¹⁰¹ As an advisor to third parties, it is licensed by the SEC and submits to that agency's jurisdiction. It would have been awkward, conceivably impossible, to comply with SEC requirements if the parent company were to engage in that activity through a division and not a subsidiary. To expose all of the acts of the parent company to SEC supervision and control would have been both unnecessary and inefficient.¹⁰²

Doubtless some subsidiaries are maintained by happenstance. For example, eleven of DuPont's current subsidiaries have the word "Conoco" in their title.¹⁰³ Presumably, these subsidiaries came to DuPont with its acquisition of the old Continental Oil Company.¹⁰⁴ Some of them may remain subsidiaries only because they were acquired in that fashion.

Finally, there may be managerial and organizational efficiencies in operating a particular business as a separately incorporated subsidiary and not

99. For a summary of incentives to incorporate subsidiaries in seven countries, see Yitzhak Hadari, *The Role of Tax Incentives in Attracting Foreign Investments in Selected Developing Countries and the Desirable Policy*, 24 INT'L LAW. 121 (1990). Some foreign laws restrict certain commercial activities to local corporations. See, e.g., MEX. CONST. tit. I, ch. I, art. 27 ("Only Mexicans by birth or by naturalization and Mexican companies have the right . . . to obtain concessions for the exploitation of mines or waters."). Moreover, the Foreign Sales Corporation (FSC) provisions of the Deficit Reduction Act of 1984 provide benefits that depend on incorporation in a foreign country. See I.R.C. § 922(a)(1) (1994).

100. By allowing tens of millions of dollars to remain subject to judgment, corporations following this strategy will be, by definition, not judgment proof.

101. See *Directory: Money Managers*, in CRAIN COMMERCIAL, INC. PENSIONS & INVESTMENTS 42, 42 (May 12, 1997).

102. Consider also the reasons for Exxon's separate incorporation of its shipping subsidiary that owned the Valdez. See Helen R. MacLeod, *Legal Separation Helps Exxon Win Insurance Lawsuit*, J. COM., June 14, 1996, at 8A (reporting that the Exxon Corporation won \$350 million from insurers because money paid to Exxon Shipping from an exclusive indemnity policy was not considered money paid to the Exxon Corporation, and hence did not count against the policy limit).

103. See National Register Pub. Co., *E.I. Du Pont De Nemours & Co.*, available in LEXIS, COMPNY Library, DCA File.

104. See Peter Behr, *Critics Hit Du Pont-Conoco Merger*, WASH. POST, Mar. 31, 1982, at D8.

as a division. Making a person the CEO of a subsidiary instead of a "division director" may enhance that person's status and enable the firm to acquire better executives more cheaply. There may also be organizational virtues in firmly segregating one business from an unrelated business and so more readily identifying and calculating its success and failure. I can only speculate on those reasons.

In short, corporations have motivations other than judgment proofing for maintaining subsidiaries. Corporate counsel of the oil and chemical companies with whom I have communicated denied that their companies ever set up subsidiaries with the intention of judgment proofing themselves.¹⁰⁵ While they acknowledge that they would assert their corporate separateness in certain circumstances—particularly where jurisdiction is asserted in the United States by a foreign plaintiff seeking a higher award than a plaintiff might be able to obtain abroad—they denied that any of their operating subsidiaries were undercapitalized and explained their existence with the reasons described above.

Turn now to the acts that a corporation must undertake to use a subsidiary as a judgment-proofing device. It is not enough merely to move the liability-generating activities into the subsidiary. If those activities require assets for their performance or if, as is likely, those same activities produce profits, additional steps must be taken. In the first case, the parent company would have to own the assets that generated the liability and lease them or otherwise make them available to the subsidiary without exposing them to the subsidiary's creditors. If substantial assets are left in the subsidiary—either from the parent's capitalization or from profits earned on the liability producing business—those assets will be available for tort claimants as well as others. Thus, the profits will have to be distributed upstream in the form of dividends, and any substantial assets acquired as capital (if those are required to produce income) somehow must be held outside the subsidiary or otherwise made unavailable to the subsidiary's creditors.

Finally, consider the anecdotal evidence concerning subsidiaries and affiliates in notorious tort cases. Remember Union Carbide's response to the Bhopal disaster.¹⁰⁶ The American parent, Union Carbide, owned 50.9% of Union Carbide India, Ltd. No Americans had worked at the Indian plant for more than two years prior to the accident,¹⁰⁷ and the Indian subsidiary was not undercapitalized by normal standards. On the other hand, the subsidiary did

105. See, e.g., Letter from Robert A. Butler, Chief Litig. Counsel, Union Carbide Corp. 1-2 (Sept. 2, 1997) (on file with the *Yale Law Journal*); Letter from John Seddelmeyer, Counsel, Exxon Corp. 1 (Jan. 23, 1998) (on file with the *Yale Law Journal*).

106. See Thomas J. Lueck, *Union Carbide Set for Damage Suits*, N.Y. TIMES, Dec. 7, 1984, at A10.

107. See Robert A. Butler, *Claims Against a Parent Corporation from the Perspective of In-House Counsel*, INT'L Q., Jan. 1989, at 126, 127. Keep in mind that a debtor's insolvency is not necessarily proof that its managers or shareholders "judgment proofed" the company prior to that insolvency. See my definition of "judgment proofing," *supra* note 2.

not have enough assets to pay the kind of judgment that might have resulted in an American court from liability to the several thousand claimants who had suffered death or injury as a result of the leak of poisonous gas from the Bhopal facility. The plaintiffs in that case pursued the parent in American courts on what they called a "multinational enterprise liability" theory.¹⁰⁸ The U.S. District Court for the Southern District of New York dismissed the American case on the grounds of *forum non conveniens*, but it conditioned the dismissal on Union Carbide's consent to the jurisdiction of the courts of India.¹⁰⁹ After the American case had been dismissed, the Indian high court, without trial, held that Union Carbide Corp. was "prima facie liable" and would have to pay "interim compensation" of \$192 million.¹¹⁰ Thereupon the case was settled; the parent paid the bulk of the settlement.¹¹¹

Oil spills furnish additional examples. The Amoco Cadiz was an oil tanker owned by a subsidiary of the parent company, Amoco International Oil Company. In the American litigation over the oil spill resulting from the Cadiz's grounding in France, the parent was found negligent in failing to repair and maintain the tanker properly and in failing properly to train the crew employed by its subsidiary.¹¹² The Exxon Valdez, meanwhile, was operated by a subsidiary of Exxon, Exxon Shipping Company. Promptly after the Valdez accident, the CEO of Exxon stated that the corporation would not assert its corporate separateness and that the parent would assume liability for damages that might arise as a result of the subsidiary's action.¹¹³ In that case, the parent might have had liability even if the corporate veil had not been

108. The plaintiffs pled: "The complex corporate structure of the multinational, with networks of subsidiaries and divisions, makes it exceedingly difficult or even impossible to pinpoint responsibility for the damage caused by the enterprise to discrete corporate units or individuals." Complaint, *In re Union Carbide Corp. Gas Plant Disaster at Bhopal, India* in December, 1984, 634 F. Supp. 842 (S.D.N.Y. 1986) (No. 85 Civ. 2696), cited in Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 333 (1996).

109. See *In re Union Carbide Corp.*, 634 F. Supp. at 867; cf. *Aguinda v. Texaco*, No. 93-Civ-7527 (VLB), 1994 U.S. Dist. LEXIS 18364, at *3 n.4 (S.D.N.Y. Dec. 17, 1994) (noting that "accept[ing] the jurisdiction of Ecuadoran courts [is] a potential prerequisite to dismissal of plaintiffs' damage claims on grounds of *forum non conveniens*").

110. See *Union Carbide Corp. v. Union of India*, 26/88 (Madhya Pradesh H.C. Apr. 4, 1988) (order of Seth, J.). See generally Tim Covell, *The Bhopal Disaster Litigation: It's Not Over Yet*, 16 N.C. J. INT'L L. & COM. REG. 279 (1991).

111. Union Carbide Corp. paid \$420 million of the \$470 million settlement. See *Charan Lal Sahu v. Union Carbide* (1989) 1 S.C.C. 674 (India); *Charan Lal Sahu v. Union Carbide* (1989) 2 S.C.C. 540 (India); *Charan Lal Sahu v. Union Carbide* (1989) 3 S.C.C. 38 (India).

112. See *In re Oil Spill by the Amoco Cadiz*, 954 F.2d 1279 (7th Cir. 1992).

113. See "Exxon Valdez" Oil Spill and Its Environmental and Maritime Implications: Hearing Before the Senate Comm. on Commerce, Science, and Transportation, 101st Cong. 47 (1989) (statement of L.G. Rawl, Chairman of the Board and Chief Executive Officer, Exxon Corp.) ("[Exxon] take[s] full responsibility. As we have done from the very beginning."). Even though Exxon Corporation initially denied criminal responsibility, see *Oil-Spill Indictment: Exxon Claims No Criminal Liability for Wrongs of Subsidiary*, A.B.A. J., July 1990, at 28, 28 (quoting an Exxon Corporation lawyer as saying, "After looking at the indictment, I have absolutely no idea of why my client was even named"), the corporation eventually accepted criminal responsibility, see Michael Weisskopf, *In Plea Bargain, Exxon Accepts Criminal Liability; \$100 Million Alaska Spill Fine Is Largest*, WASH. POST, Mar. 14, 1991, at A3.

pierced because its medical department had been involved in the return to duty of the captain, who was alleged (after his rehabilitation treatment) to have been drinking shortly before the accident, and because it was the owner of the cargo.¹¹⁴ Under Alaskan law, the owner of cargo would have shared liability for environmental pollution.¹¹⁵

Breast implant litigation provides a final example. Dow Corning Corp. is owned 50% by each of its parents, Dow Chemical and Corning, Inc. Dow Corning was established as a subsidiary of the two companies during World War II to produce products made of silicone—long before breast implants were any part of its business.¹¹⁶ By 1989, Dow Corning had sales of \$1.5 billion, ranking 254 in the Fortune 500 by sales, and assets of \$1.6 billion, ranking 218 in the Fortune 500 by assets.¹¹⁷ In 1984, Dow Corning had net income of \$91 million from sales of \$855 million, sufficient to rank it 355 in the Fortune 500.¹¹⁸ It could not be described as undercapitalized, much less judgment proof. In one breast implant case, Dow Chemical successfully asserted its corporate separateness,¹¹⁹ but in another the plaintiffs successfully reinstated Dow Chemical as a defendant on the theory that Dow itself had liability for providing toxicological testing services to Dow Corning.¹²⁰

Of course, these cases are only anecdotes. They are not a firm base upon which to build a systematic argument about judgment proofing through wholly owned subsidiaries. But they do give a map of the terrain that confronts a lawyer advising a large pharmaceutical, chemical, or oil company. And the terrain is not inviting for a firm that wishes to judgment proof itself by engaging in a risky business through a wholly owned subsidiary.¹²¹

114. See Emily Barker, *The Exxon Trial*, AM. LAW., Nov. 1994, at 68, 70.

115. See ALASKA STAT. § 46.03.758 (Michie 1996) (establishing strict liability for the "owner" of the cargo at the time the vessel was loaded).

116. See Joan E. Rigdon, *Corning Is Feeling the Heat in Breast Implant Debate*, WALL ST. J., Jan. 29, 1992, at B4.

117. See *The Fortune 500*, FORTUNE, Apr. 23, 1990, at 346, 356.

118. See *Dow Corning Corp. Announces Record '84 Sales and Profits*, PR. Newswire, Jan. 28, 1985, available in Westlaw, ALLNEWSPLUS Database.

119. See *In re Silicone Gel Breast Implant Prods. Liab. Litig.*, 837 F. Supp. 1128 (N.D. Ala. 1993) (holding that plaintiffs could not pierce the corporate veil); see also *Temporomandibular Joint Implant Recipients v. Dow Chem. Co. (In re Temporomandibular Joint Implants Prods. Liab. Litig.)*, 113 F.3d 1484 (8th Cir. 1997) (dismissing Dow Chemical as a defendant in a silicone jaw implants case).

120. See *Spitzfaden v. Dow Corning Corp.*, No. 92-2589, 1995 U.S. Dist. LEXIS 16787 (E.D. La. Nov. 8, 1995); see also *Lindsey v. Dow Chem. Co. (In re Dow Corning Corp.)*, 113 F.3d 565 (6th Cir. 1997) (consolidating breast implant cases against Dow Chemical).

121. Other notorious tort-induced bankruptcy cases show no evidence of successful judgment proofing through use of subsidiaries. See, e.g., *Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988), *Committee of Dalkon Shield Claimants v. A.H. Robins Co.*, 828 F.2d 239 (4th Cir. 1987), *Keene Corp. v. Coleman (In re Keene Corp.)*, 164 B.R. 844 (Bankr. S.D.N.Y. 1994). In each of those cases it appears that all of the assets of the parent company were put into the bankruptcy and that any immunity of the corporate parent was not successfully asserted.

III. WHY COMMERCIAL FIRMS WILL NOT BECOME JUDGMENT PROOF

The data and anecdotes set out above convince me that Professor LoPucki is wrong. The numbers show little secured credit, little leveraging, and much liability insurance. Nor are the trends in the direction he predicts: During the last fifteen years there has been no systematic increase in secured lending, no systematic reduction in free assets of American firms, and no systematic reduction in liability insurance. In all of the prominent tort cases, parents answered for their subsidiaries' sins. In short, I have uncovered no empirical evidence for the proposition that American firms, in general, have judgment proofed themselves or are judgment proofing themselves. But the data do not foreclose the possibility that Professor LoPucki's claims will turn out to be correct in the future. By examining the reasons that firms have not rendered themselves judgment proof, I propose to explain the data and to show why Professor LoPucki's predictions are as wrong as his statements about the present.

No single part of the American legal or economic structure explains why judgment proofing is not widespread. Indeed, I see at least nine related but discrete reasons for businesses to maintain substantial assets or insurance in lieu of assets. Some constraints—like state laws that mandate insurance—directly limit a firm's choices, and the very concerns that animate Professor LoPucki have surely motivated their creation. Others—such as concern about a company's public image and pressure from potential joint tortfeasors—operate more on the margins of corporate decisionmaking. The enterprises with which we are concerned are diverse; they range from oil producers to pharmaceutical companies to car manufacturers to medical providers. Each faces a different set of pressures—legal, practical, and economic—but I see no significant subset of enterprises that does not face important legal, practical, or economic barriers to judgment proofing.

Raised to its highest level of generality, Professor LoPucki's thesis is that equity holders can increase their wealth by taking on more liability (or, the same, by disposing of assets while holding liabilities constant). Surely Professor LoPucki is not challenging the iron law of corporate finance that made Franco Modigliani and Merton Miller¹²² famous—namely that a firm does not change its total value by splitting its cash flow into different streams (in this case, one for creditors and one for common stockholders). He must be making a lesser claim—namely that shareholders can enhance their value by taking some of the value of the firm from the debtholders while the debtholders are not watching. This would be possible if the debtholders were foolish or if the only debtholders were tort claimants who could not bargain.

122. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

But absent those possibilities, one would expect the debtholders to command their fair share—a share of the profits that would roughly offset the present cost of their prospective losses because of the added leverage of the firm.

So the rules of corporate finance present some serious—I think ultimately infeasible—obstacles to Professor LoPucki's hypothesis. The following section shows that corporate finance theory is likely to be an insurmountable obstacle for the LoPucki hypothesis, and the eight subsequent sections survey smaller, but still significant, hurdles.

A. *Contract Creditors*

If one ignores the tax benefit from the deductibility of interest and excludes firms with very high debt ratios, standard corporate finance theory states that a firm that has a certain percentage of debt and a different percentage of equity will have the same value as a firm whose ratios are reversed.¹²³ But that example obscures the important point for our purposes. We are not interested in the value of the entire firm, but in the relative distribution of value between debt and equity. As Professor LoPucki instinctively appreciates, the value of equity would rise as the amount of debt rises—at least if the cost per unit of debt could be held constant (i.e., if the interest rate and other costs do not rise as the amount of debt rises). The converse happens to the debt; as debt rises as a percentage of total capitalization, the present cost of the risk of financial distress increases, and the comparative value of the debt declines. At some point, the value of the debt probably declines exponentially as risk of distress becomes greater and greater.¹²⁴

Because debt imposes a fixed obligation to pay interest and principal, the risk of financial distress brought on by inability to meet that obligation increases as the share of debt increases. Creditors understand this and thus would insist upon a higher interest rate from highly leveraged firms to offset the present value of the risk of financial distress. In the words of Professors Brealey and Meyers:

The costs of bankruptcy come out of the shareholders' pockets. Creditors foresee the costs and foresee that *they* will pay them if

123. See RICHARD A. BREALEY & STEWART C. MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 447 (5th ed. 1996).

124. See *id.* at 461. Whether a firm in practice with some debt has greater value than one with all equity (because interest payments on debt are deductible and dividends are not in the current American income tax system) is subject to dispute among finance experts. See, e.g., Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261, 262 (1977) (noting that "[e]ven in a world in which interest payments are fully deductible in computing corporate income taxes, the value of the firm in equilibrium will still be independent of its capital structure"). Less controversial is the proposition that the value of the firm declines as the percentage of debt reaches some high level and thus itself undergoes an exponential decline in value. See BREALEY & MEYERS, *supra* note 123, at 485.

default occurs. For this reason they demand compensation in advance in the form of higher payoffs when the firm does *not* default. That is, they demand a higher promised interest rate. This reduces the possible payoffs to shareholders and reduces the present market value of their shares.¹²⁵

That, in a nutshell, demonstrates the fundamental flaw in Professor LoPucki's thesis. Contract creditors will appreciate the risk to them when firms make themselves judgment proof and will demand corresponding compensation.¹²⁶

But how does this principle apply to tort claimants who are at least nonadjusting (i.e., claimants who cannot adjust or bargain based on risk) and probably nonexistent? They can hardly demand a payment for their greater but still unperceived risk. To understand how tort claimants are protected, consider the firm and the relationship of its creditors—contract and tort. As I have explained,¹²⁷ the firms that concern us (and should concern Professor LoPucki) are those that might perpetrate mass torts and be subject to large statutory liability. To create that kind of liability, a firm must usually have assets in the form of mines, manufacturing facilities, distribution capacity, crude oil carriers, or the like. To commit large torts, one must do large business, and to do large business normally requires substantial assets.¹²⁸ If the firm has procured such assets through borrowing, it will have significant contract creditors. If the firm procures assets by the sale of equity, the firm will have a cushion of assets available for tort creditors. Thus the firms with which we are really concerned are those with substantial assets and corresponding contract debt.

Without intending to do so, the contract creditors' pursuit of their own interest also protects the interests of the nonadjusting creditors about whom Professor LoPucki is concerned. To see this, return to my hypothetical firm.

125. BREALEY & MEYERS, *supra* note 123, at 487.

126. The interest and aggressiveness of contract creditors vary widely. The creditors with the most to lose from financial failure are probably the managers of the business, for they will likely lose their jobs—either at once or through the Chapter 11 process. See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 675 (1993). Almost as vigilant are bond and venture trustees whose very existence is fulfilling their fiduciary duty to a particular set of creditors by monitoring the operations of the debtor. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 72 (1982). After them will be a variety of other creditors and financial intermediaries who may vary considerably in their ability and willingness to monitor the debtor.

127. See *supra* note 16 and accompanying text.

128. This observation is both theoretically probable and empirically verifiable. For example, Union Carbide had several billion dollars in assets at the time of the Bhopal disaster. See Bradford C. Mank, *Preventing Bhopal: "Dead Zones" and Toxic Death Risk Index Taxes*, 53 OHIO ST. L.J. 761, 795 (1992). Exxon, which continues to litigate the Valdez oil spill, is currently the third largest industrial company in the United States and has \$84 billion in assets. See Charles M. Camp, *Shreds of Exxon Evidence: Lawyers Wage War over Admissible Testimony*, DALLAS MORNING NEWS, Aug. 21, 1994, at 1H. Johns Manville had \$1.1 billion in net assets before declaring bankruptcy due to the asbestos litigation. See William D. Marbach et al., *An Asbestos Bankruptcy*, NEWSWEEK, Sept. 6, 1982, at 54. In only the last case were the company's assets insufficient to meet tort claims.

If, in our \$100 million enterprise, there were \$99 million of equity and \$1 million of debt—or the reverse, \$1 million of equity and \$99 million of debt—how would the creditors holding that debt behave differently? The former would be a highly capitalized company with little chance of failure and with high probability that it would be capable of paying off the \$1 million of debt notwithstanding sharp reverses. The opposite would be true of the latter. Assuming our 8% interest hypothesis, the former would have annual interest liability of only \$80,000; the latter's liability would approach \$800,000—an annual interest claim almost equal to its capital. One would expect the latter firm to have trouble meeting its interest and principal obligations any time it suffered losses for even a short period.

The holder of the \$99 million of debt would not be oblivious to these concerns. Creditors would appreciate the increased riskiness of the \$99 million loan and would behave differently from the creditors of the highly capitalized firm. A creditor asked to undertake \$99 million of debt in a company whose net worth is negative or barely positive might refuse to lend because the prospective firm was so thinly capitalized. If it agreed to make the loan, it would charge a much higher interest rate than in the first case. Moreover, the creditor might expect to enjoy the rights of an equity owner since it would find itself in the position of an equity owner in even a modest downturn of the company's business. Among an equity owner's rights are the right to control the business and to share in its profits. Thus, if our hypothetical creditor were willing to make the \$99 million loan, one would expect it to insist upon complex terms granting it rights to control the business decisions of the debtor. One might also expect it to insist upon a high interest rate and perhaps on a share of the profits in case the company were profitable (in the trade, an "equity kicker").¹²⁹

The vigilance of contract creditors can protect tort claimants in one of two ways. First, the refusal of contract creditors to lend may abort a risky business entirely. If so, the potential tort claims never arise and the potential victims are never injured. More likely, conditions that the prospective contract creditors will demand before lending to a judgment proof company may prove to be so costly that the debtor will choose to capitalize the company more fully to avoid those costs. In any case, the vigilance of the contract creditors protects the tort claimants and others.¹³⁰

129. If the contract creditors take too many steps toward equity status, they may be treated by the courts as equity holders rather than debtholders. See, e.g., *Matlins v. Sargent*, No. 86 CIV 0370 (MJL), 1991 WL 79219, at *2 (S.D.N.Y. May 7, 1991) ("The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business . . ."), *Martin v. Payton*, 158 N.E. 77, 79-80 (N.Y. 1927).

130. Consider a typical loan document clause that prohibits disposition of assets

Restriction on Disposition of Assets.

Subject to the provisions of Article Eight, the Company will not, otherwise than in the ordinary course of business, sell, lease, transfer or otherwise dispose of any substantial part of

Of course, the interests of the contract creditors and the nonadjusting tort creditors are not exactly aligned. Indeed, the contract creditors might take security and thus protect themselves to the detriment of later tort claimants.¹³¹ Why do we not observe this? The creditor may fear that the assets—even with a value equal to the amount of the debt while the concern is operating—will be inadequate to satisfy their claims on default. For

its properties and assets, including (but without limitation), any manufacturing plant or substantially all properties and assets constituting the business of a division, branch or other unit operation.

AMERICAN BAR FOUND., COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS, 1965, MODEL DEBENTURE INDENTURE PROVISIONS, ALL REGISTERED ISSUES, 1967, AND CERTAIN NEGOTIABLE PROVISIONS WHICH MAY BE INCLUDED IN A PARTICULAR INCORPORATING INDENTURE 427 (1971). Also consider a typical clause for limitation of debt:

Limitation on Debt of the Company and Subsidiaries.

Neither the Company nor any Subsidiary will incur or otherwise become liable in respect of any Debt other than

(1) in the case of the Company,

(a) unsecured Current Debt incurred in the ordinary course of business as a result of borrowing; provided, that there has been a period of [x] consecutive days within the period of [y] consecutive months immediately preceding the date of the incurring or renewal of such Debt during which the Company has been free from Current Debt resulting from borrowing (excluding prepayments, fixed sinking fund payments or other payments required to be made with respect to Debt incurred as Funded Debt),

(b) unsecured Senior Funded Debt; provided that the Company shall not incur any such Debt if, immediately after giving effect to the incurring of such Debt and the receipt and application of the proceeds thereof, (i) the aggregate principal amount of Consolidated Senior Funded Debt would exceed [z]% of the aggregate amount of Consolidated Net Tangible Assets; or (ii) the aggregate principal amount of Consolidated Funded Debt would exceed [a]% of the aggregate amount of Consolidated Net Tangible Assets,

(c) Subordinated Debt; provided, however, that the Company shall not incur any such Debt if, immediately after giving effect to the incurring of such Debt and the receipt and application of the proceeds thereof, the aggregate principal amount of Consolidated Funded Debt would exceed [b]% of the aggregate amount of Consolidated Net Tangible Assets, and

(d) unsecured Senior Funded Debt incurred for the purpose of (and substantially concurrently with the) refunding of any Senior Funded Debt and Subordinated Debt incurred for the purpose of (and substantially concurrently with the) refunding of any Senior Funded Debt or Subordinated Debt; provided that the Senior Funded Debt or Subordinated Debt being refunded was permitted by this Indenture;

(2) in the case of any Subsidiary, Debt owing to the Company or to a [Wholly-Owned] Subsidiary;

(3) in the case of the Company and any Subsidiary,

(a) Debt for taxes, assessments and governmental charges or levies and claims for labor, materials and supplies (as and to the extent permitted to remain unpaid and undischarged by § 10-4),

(b) secured Debt as and to the extent permitted to be secured by § 10-10,

(c) Debt represented by dividends declared but not paid, subject, however, in the case of the Company, to the provisions of § 10-12, and

(d) unsecured Current Debt incurred in the ordinary course of business and not as a result of borrowing or in respect of obligations of others.

Id. at 398-399. Kahan and Tuckman report that covenants in sales of assets appear in private debt issues in 85% of investment grade issues and 95% of junk grade issues, while limitations on debt appear in 100% of private debt issues and 91% of public ones. See Marcel Kahan & Bud Tuckman, Private vs. Public Lending: Evidence from Covenants (Harvard Law Sch. Program in Law and Econ. Paper No. 151, Feb. 1995) (unpublished manuscript, on file with author).

131. The contract creditors of a subsidiary could achieve the same end by receiving a guaranty of its indebtedness from the parent.

example, inventory purchased for \$100 million may turn out to be worth only \$10 or \$20 million on the default of the business when inventory has to be scrapped or sold at low prices to others. In addition, the agency cost imposed on the debtor by the security interest in the form of restrictions on the operation of the debtor's business may be large enough to dissuade the debtor from secured borrowing.¹³² Even with security, the creditor may still regard itself as the equity holder and therefore insist upon control over the behavior of the debtor and even upon a share of the profits. These are at least plausible explanations for the absence of large numbers of liability-producing companies whose available assets are subject to secured creditors' claims.

In unusual circumstances, a liability-generating company can be set up even though it has neither significant assets nor contract debt. The model for this transaction is a taxi company whose only fixed asset is a single taxicab and whose principal value derives from the owner's service in driving the taxicab. Beyond such small-scale service providers,¹³³ such businesses are surely rare. Moreover, where such firms can generate liability without the presence of contract creditors to control their behavior, other actors (such as potential joint tortfeasors and government licensing agencies) may limit judgment proofing.

B. *Subsidiaries*

In Subsection II.B.4, I argued that subsidiaries are not widely used as judgment-proofing devices. Why not? Surely corporations create subsidiaries to insulate themselves and other subsidiaries from some liabilities.¹³⁴ Why, then, do firms not use their subsidiaries to reduce their liability to zero? There are at least seven reasons.

First, some of the reasons that the parent will not judgment proof itself apply equally to its subsidiaries. Concerns about both public perception and the government's use of its discretionary power apply equally to judgment proofing directly and to judgment proofing by means of a subsidiary.

132. For a general discussion of the reasons that secured debt is not as widespread as one might predict, see Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV L REV 625, 668-83 (1997). See also Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO L J 1 (1997) [hereinafter Mann, *Small-Business Lending*]; Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997).

133. Other examples include surgeons and an occasional sole proprietor such as a contractor.

134. Professor LoPucki is, of course, correct when he notes that "[c]orporations in general and subsidiaries in particular limit liabilities." LoPucki, *supra* note 1, at 21 nn.78-79. I draw a distinction between judgment proofing and more conventional limitation of liability to some level above zero, but below infinity. I concede that subsidiaries, like many of the devices discussed in this Essay, can be and are used to judgment proof in some cases. I argue only that the device is not widely used for this purpose and that there is good reason why only a limited number of outliers do use subsidiaries as a judgment-proofing device.

Second, using subsidiaries can be costly. The mere establishment of a wholly owned subsidiary does not judgment proof a parent from liability. If the parent's assets must be put into the subsidiary to do its business, then those assets are at risk, and if the subsidiary is successful, its earnings must be removed from the subsidiary to maintain its judgment-proof status. Like its parent, the subsidiary will not be able to borrow substantial sums and yet remain judgment proof, for contract creditors will require protection for themselves, as described in the previous section. Thus, to put substantial assets into the subsidiary the parent must ensure that the subsidiary obtains assets free and clear, contract creditors receive appropriate payments, or that the parent guaranties the contract creditors' liability. Depending upon the particular circumstances and how the judgment proofing is to be achieved, the cost of these assurances may be substantial and may outweigh the apparent benefits.

Third, a parent may be liable for its own involvement in the subsidiary's actionable behavior, thus making their corporate separation irrelevant. Recall the cases of the Amoco Cadiz,¹³⁵ the Exxon Valdez,¹³⁶ Dow Chemical,¹³⁷ and Union Carbide.¹³⁸ In all four cases, plaintiffs argued that the parent was liable, not because the corporate veil should be lifted, but because of the parent's own actions. If a parent is inevitably involved with the acts of a subsidiary in perpetrating mass torts and if, therefore, a plausible claim can be routinely made for direct liability against the parent, judgment proofing by establishing a subsidiary is impossible and the costs of attempted judgment proofing will be wasted. Based upon the available evidence, it is impossible to tell how often a plaintiff can mount a plausible case against the parent, but there are at least several prominent and clear examples where the claim has been successfully made.¹³⁹

135. See *In re Oil Spill by the Amoco Cadiz*, 954 F.2d 1279 (7th Cir. 1992); see also *supra* note 112 and accompanying text.

136. See *In re Exxon Valdez*, 767 F. Supp. 1509 (D. Alaska 1991); see also *supra* notes 113-115 and accompanying text.

137. See *In re Silicone Breast Implants Prod. Liab. Litig.*, 887 F. Supp. 1455 (N.D. Ala. 1995); see also *supra* notes 116-120 and accompanying text.

138. See *In re Union Carbide Corp. Gas Plant Disaster at Bhopal, India in December, 1984*, 634 F. Supp. 842 (S.D.N.Y. 1986); see also *supra* notes 106-111 and accompanying text.

139. There are other cases in which courts have found parents directly liable for their subsidiaries' torts. See, e.g., *Gardner v. Federated Dep't Stores, Inc.*, 907 F.2d 1348 (2d Cir. 1990) (holding the parent liable for torts of its subsidiary's personnel); *Anglo Eastern Bulkships Ltd. v. Ameron Inc.*, 556 F. Supp. 1198, 1202-03 (S.D.N.Y. 1982) (finding a parent liable for defects in its representations of subsidiary's products). Courts also attribute liability in cases where the parent and subsidiary share a common corporate group. See, e.g., *Dunn Appraisal Co. v. Honeywell Info. Sys., Inc.*, 687 F.2d 877, 881 (6th Cir. 1982) (finding a parent liable when the plaintiff did not realize there were two different companies); *Erickson v. Curtis Ins. Co.*, 432 N.W.2d 199 (Minn. App. 1988) (finding that the parent of the lessee of a parking ramp owes a duty to the lessee's customer); *Fiscus v. Atlantic Richfield Co.*, 742 P.2d 198 (Wyo. 1987) (holding that it is sufficient to claim that the parent owned and supplied defective machinery used by the subsidiary). For a general discussion of direct parental liability, see PHILLIP I. BLUMBERG, *LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 14 (1987).

Fourth, courts retain the power to pierce the corporate veil. One suspects that piercing the corporate veil is easy to threaten but hard to do. But consider our case: By hypothesis, the subsidiary is wholly owned and is being used as a judgment-proofing device. To achieve judgment proofing, a parent must do more than set up a properly capitalized subsidiary. The parent must routinely drain the subsidiary of its assets while satisfying the subsidiary's contract creditors. Yet these are the very acts by which courts justify piercing the corporate veil. For example, in *Eastridge Development Co. v. Halpert Associates*,¹⁴⁰ a parent acquired a subsidiary, cancelled its insurance, and channeled the revenues directly to the parent. When the parent learned of a tort claim against the subsidiary for actions that had been taken before the parent's acquisition, the parent sold off assets to itself and to other insiders and collected all of the accounts receivable. The court pierced the corporate veil.¹⁴¹

The argument that computerized recordkeeping will make it easier for corporate parents to observe required corporate formalities¹⁴² does not blunt the claim in cases like *Eastridge*. Even when the parent keeps proper records and observes appropriate corporate formalities, a wholly owned and thinly capitalized subsidiary that transmits its profits upstream and is subject to control by its parent is a likely object of a successful veil-piercing argument.¹⁴³ In summary, the cases on piercing the corporate veil with respect to parents and wholly owned subsidiaries should give pause to a corporate lawyer advising a parent considering an attempt to judgment proof itself through creation of a subsidiary.¹⁴⁴ Although the tests for veil piercing are hardly precise, their factors coincide more or less with the acts a parent

140. 853 F.2d 772 (10th Cir. 1988).

141. See *id.* at 780.

142. See LoPucki, *supra* note 1, at 47 (making this argument).

143. In *United States v. Jon-T Chemicals, Inc.*, 768 F.2d 686 (5th Cir. 1985), the court listed the following factors, among others, as relevant in determining when to pierce the corporate veil: common directors and officers, consolidated financial statements, the parent's financing of the subsidiary, the parent's arranging the incorporation of the subsidiary, grossly inadequate capital, the parent's payment of salaries and other expenses of the subsidiary, and the subsidiary's having no business except that given to it by the parent. See *id.* at 691-92.

144. Courts also sometimes impose enterprise liability if it is difficult to attribute liability to a single corporate entity in a complex corporate group. See PHILLIP I. BLUMBERG, LAW OF CORPORATE GROUPS: STATUTORY LAW—SPECIFIC 993 (1992) ("[L]egislatures, agencies, and courts are increasingly turning to enterprise principles for a more effective resolution of legal problems involving corporate groups. In a growing number of areas, entity law is clearly eroding, and [there is an] increasing acceptance of enterprise principles . . ."); BLUMBERG, *supra* note 139, § 8 ("Tort law principles that have become increasingly accepted strongly support the recognition of enterprise liability in place of traditional entity law"). Barry R. Furrow, *Enterprise Liability and Health Care Reform: Managing Care and Managing Risk*, 39 ST. LOUIS U. L.J. 77, 80 (1994) (describing the increasing use of enterprise liability in health care). While Professor LoPucki is concerned that corporate entity law is killing liability, another commentator feels that corporate entity law is being killed by, among other things, expanding enterprise liability. See Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW U. L. REV. 148, 148 (1992).

would have to take to insulate itself from liability generated by a subsidiary.¹⁴⁵

Fifth, *Accounting Research Bulletin No. 51*,¹⁴⁶ which concerns Consolidated Financial Statements, makes judgment proofing through a subsidiary less attractive. That rule, published by the Financial Accounting Standards Board (FASB), requires that the financial statements of "all companies in which a parent has a controlling financial interest . . . shall be consolidated."¹⁴⁷ Of course, the consolidation rule requires only that the parent show the subsidiary's liability on its balance sheet as its own—not that it become liable to the subsidiary's creditors. Nevertheless, inclusion of the subsidiary's liability on the parent's balance sheet may have adverse consequences for the parent. For example, the parent itself may fall into default under the terms of its own borrowing if its ratio of assets to liabilities—shown on its consolidated balance sheet—falls below a certain number. Thus, a parent's bringing a subsidiary's liability to its balance sheet might open the parent to suits, foreclosure, or the like from its own creditors when the covenants in its own loan agreements are broken.¹⁴⁸

145. The tests for piercing the veil also coincide with the traditional justifications for tort liability, i.e., deterrence, retribution, etc. Subsidiaries that obey proper corporate formalities and operate in their own self-interest will not sacrifice themselves for their parents. When a subsidiary operates against its own interest and in the interest of the parent (e.g., the subsidiary makes above market-rate lease, licensing or other payments to the parent), that is good evidence that the subsidiary is controlled by the parent or that the subsidiary is an instrumentality or alter ego of the parent, two factors most often associated (97% and 95%, respectively) with court decisions that pierce the veil. See Robert Thompson, *Piercing the Corporate Veil*, 76 CORNELL L. REV. 1036, 1064 (1991). Undercapitalization is also a significant factor in veil-piercing cases. An empirical study of veil-piercing cases found that courts pierced the veil in 40% of the 1583 cases examined. See *id.* at 1048. There were 120 cases in which the courts found undercapitalization; they pierced the veil in 88 (73%) of those cases. See *id.* at 1064.

For specific cases piercing the corporate veil or refusing the parent summary judgment against a veil-piercing attempt, see *Slottow v. American Casualty Co.*, 10 F.3d 1355 (9th Cir. 1993), which found undercapitalization alone adequate to justify piercing the corporate veil under California law; *In re Oil Spill by the Amoco Cadiz*, 954 F.2d 1279, 1303 (7th Cir. 1992), which found Amoco liable for its subsidiary's oil spill (the parent was "so highly integrated each of the subsidiaries was a mere instrumentality of the parent corporation"); *In re Silicone Gel Breast Implants Prod. Liab. Litig.*, 887 F. Supp. 1447 (N.D. Ala. 1995), which denied summary judgment for the parent-defendant because a jury could find that the subsidiary was the alter ego of the parent; *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962), which pierced the veil to reach stockholders of taxicab companies; *Montgomery Health Care Facility, Inc. v. Ballard*, 565 So. 2d 221 (Ala. 1990), which held the parent of a nursing home liable for the nursing home's negligence when the parent controlled the operations of the nursing home; *Green v. Champion Insurance Co.*, 577 So. 2d 249 (La. App. 1991), which found that an insurance company and related entities were a "single business enterprise," thereby allowing creditors to reach assets of affiliated entities; and *Brandimarti v. Caterpillar Tractor Co.*, 527 A.2d 134 (Pa. Super. Ct. 1987), which held the parent liable when its subsidiary used the trade name of the parent on a harmful product, even though the parent was not involved in the manufacture, distribution, or sale of the product. See also STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* §§ 2.08, 2.22 (1991) (discussing Delaware and Massachusetts as two jurisdictions that have traditionally made it difficult to pierce the veil but are now making it easier).

146. FINANCIAL ACCOUNTING STANDARDS BD., ACCOUNTING RESEARCH BULLETIN NO. 51 (1959).

147. *Id.* ¶ 3.

148. Note that the 1987 amendment to *Accounting Research Bulletin No. 51* strengthened the rule by removing two exceptions to the consolidation requirement. Formerly, a parent was obliged to consolidate neither "non-homogenous" operations nor those involved in a foreign location. The 1987 amendment removed those exceptions and required consolidation even of non-homogenous and foreign subsidiaries.

Sixth, fraudulent conveyance law provides a potential obstacle. Presumably, firms engage in risky businesses because those businesses offer correspondingly high rates of return. Businesses that manufacture cigarettes or pharmaceuticals, for example, may offer not only high potential liability, but also high potential profit. To keep a profitable subsidiary judgment proof requires that profits be distributed routinely to the parent as dividends so that the earnings are not available to tort and other claimants. The distribution of those dividends may be a fraudulent conveyance. The most direct analogy is a lesser-included case—where a wholly owned subsidiary guaranties the liability of its parent. Some commentators and a few cases suggest that a subsidiary's guarantying of a parent's or sister's liability is itself a fraudulent conveyance.¹⁴⁹ The guaranty engenders no value for the subsidiary unless, of course, the parent and the subsidiary are engaged in a joint business operation from which the subsidiary also benefits.¹⁵⁰ When the payment is

Paragraphs 2 and 3 of *Accounting Research Bulletin No. 51* were amended to read

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary).

3. All majority-owned subsidiaries—all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest—shall be consolidated except those described in the last sentence of paragraph 2

FINANCIAL ACCOUNTING STANDARDS BD., FINANCIAL ACCOUNTING SERIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94, at 5 (1987).

149. Guaranties and other transfers will be void if either: (1) the transferor was (or was thereby rendered) insolvent and received no fair consideration; or (2) there was an intent to hinder, delay, or defraud creditors. See *Voest-Alpine Trading USA Corp. v. Vantage Steel Corp.*, 919 F.2d 206, 214 (3d Cir. 1990) (finding actual and constructive intent to defraud in a transfer of assets from one wholly owned corporation to another); *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981) (vacating the lower court's finding of no fraudulent conveyance in a transfer of assets where the lower court did not properly consider issues of fair consideration and insolvency of the transferor); *Gough v. Titus (In re Christian & Porter Aluminum Co.)*, 584 F.2d 326, 337 (9th Cir. 1978) (holding that a transfer to a third party not made for fair consideration is a fraudulent conveyance); *Central Nat'l Bank v. Coleman (In re B-F Bldg. Corp.)*, 312 F.2d 691 (6th Cir. 1963) (holding the guaranty of a sister's debt to be a transfer without fair consideration); *Edward Hines W. Pine Co. v. First Nat'l Bank*, 61 F.2d 503 (7th Cir. 1932) (holding that an insolvent company that made an assignment to pay its president's sister's debt intended to hinder, delay, and defraud creditors). See generally Kenneth J. Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy*, 60 AM. BANKR. L.J. 109 (1986).

150. See *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 201 (7th Cir. 1988) (holding that although it is dangerous when a parent "causes one of its subsidiaries to guarantee another's (or the parent's own) debts . . . a guarantee of an affiliate's debt is enforceable provided that the guarantor derives some benefit, even if indirect, from the guarantee" (citations omitted)); *Klein v. Tabatchnick*, 610 F.2d 1042, 1047 (2d Cir. 1979) (holding that the transaction's benefit to the debtor "need not be direct" and "may come indirectly through benefit to a third person"); *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368 (D.N.J. 1984) (holding that a guaranty by a solvent corporation was not a fraudulent conveyance and noting that indirect benefit may provide the necessary fair consideration); *Manufacturers & Traders Trust Co. v. Goldman (In re Ollag Constr. Equip. Corp.)*, 446 F. Supp. 586, 591 (W.D.N.Y. 1978) (stating that key factors involved in determining whether a subsidiary's guaranty of a parent's liability, or vice versa, is in furtherance of the corporate purpose and thus valid are "the closeness of business relationship between the

made upstream as a dividend and without any promise or prospect of a quid pro quo from the parent to the subsidiary, the potential for fraudulent conveyance is even more obvious. Moreover, the prospects for a successful claim of fraudulent conveyance increase in direct proportion to the self-consciousness of the parent's act. If intentional judgment proofing is disclosed (typically through a memorandum in the parent's file or the testimony of a disaffected former employee) as the purpose for the establishment of the subsidiary and the upstreaming of its revenues, one could even make the case for an intentional fraudulent conveyance.¹⁵¹

Seventh, state and federal statutes that explicitly decline to recognize corporate separateness of parties might thwart judgment proofing through subsidiaries. The most notable of these is the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),¹⁵² which provides for the liability of not only actual polluters, but also owners, operators, or arrangers in certain circumstances.¹⁵³ For example, in *United States v. TIC Investment Corp.*,¹⁵⁴ the court found that the parent was liable as an "arranger" where it had some control over the subsidiary's "arrangement for disposal."¹⁵⁵ Similarly, some states' environmental laws disregard corporate separateness by requiring insurance or bond to protect judgment creditors not

corporations, any commonality of shareholders, officers and directors, the reasons for guarantying another's debts or for granting a security interest to secure such indebtedness, and the beneficial results expected to be derived therefrom"); *id.* (finding the transaction in furtherance of a corporate purpose yet void on the basis of the insolvency of the transferor).

151. In *Arnold v. Commissioner*, 67 T.C.M. (CCH) 2351 (1994), the Tax Court found a constructive dividend in the bargain element of a sale and leaseback between parent and subsidiary corporations, and held that when neither corporation benefited from the arrangement, the transfer upstream was purely for the benefit of the CEO and the 100% owner of the parent. The court also found that the parent's failure to report capital gains on a portion of proceeds from the leveraged buyout of the subsidiary amounted to tax fraud. *See id.* at 2357-58. In *Marquis Products, Inc. v. Conquest Carpet Mills, Inc. (In re Marquis Products, Inc.)*, 150 B.R. 487 (Bankr. D. Me. 1993), the court held that a subsidiary's guaranty of a loan to the parent was a fraudulent conveyance because the thinly capitalized subsidiary had made itself insolvent by transferring its assets upstream. *Cf. Carl, supra* note 149, at 118 (describing an upstream guaranty by a subsidiary).

152. 42 U.S.C. §§ 9601-9675 (1994).

153. *See, e.g., Schiavone v. Pearce*, 79 F.3d 248, 255 (2d Cir. 1996) ("[D]irect operator liability for parent corporations is both compatible with the statutory language and consistent with CERCLA's broad remedial scheme."); *United States v. Nicolet, Inc.*, 712 F. Supp. 1193, 1203 (E.D. Pa. 1989) ("[A] corporation which holds stock in another corporation (e.g., a subsidiary) and actively participates in its management can be held liable for cleanup costs incurred as a result of that corporation's disposal."). *See also* PHILLIP I. BLUMBERG, LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW OF GENERAL APPLICATION § 18 (1989); Peter S. Menell, *Legal Advising on Corporate Structure in the New Era of Environmental Liability*, 1990 COLUM. BUS. L. REV. 399, 410-11 ("[T]he unsettled nature of the law with regard to the liability of parent corporations for the environmental harms of their subsidiaries . . . suggests that risk-insulating approaches to minimizing environmental liabilities cannot provide the guarantees that they once offered."); Lynda J. Oswald & Cindy A. Schipani, *CERCLA and the "Erosion" of Traditional Corporate Law Doctrine*, 86 NW. U. L. REV. 259 (1992).

154. 68 F.3d 1082 (8th Cir. 1995).

155. *Id.* at 1091-92.

only from acts of a particular party, but also from acts of any related party.¹⁵⁶

C. *Fraudulent Conveyance Law*

The dividend that a judgment-proofing subsidiary might pay to its shareholder is only one form of payment that might be subject to fraudulent conveyance law. Distributions to the parent's own shareholders might also be suspect. Of course, fraudulent conveyance laws will not restrict the granting of secured credit or asset securitization. As Professor LoPucki notes, any asset-securitization sale for "reasonable equivalent value" will not be voidable under section 4 of the Uniform Fraudulent Transfer Act.¹⁵⁷ As noted above,¹⁵⁸ however, to the extent that an asset securitization sale or any other transfer of corporate assets is for reasonably equivalent value, the corporation has not succeeded in hiding any assets: It still has the proceeds of the sale as assets.

To conclude that the vagueness of the rules on fraudulent conveyance renders them inconsequential would be a mistake. For example, the fraudulent conveyance laws were used successfully against shareholders and lenders in

156. See, e.g., CONN. GEN. STAT. § 22a-178 (1997) (making a landowner and a person causing air pollution jointly and severally liable); FLA. STAT. ANN. § 403.141 (West Supp. 1996) (providing joint and several liability for air and water pollution); MICH. STAT. ANN. § 324.20126 to 324.20126a (Law Co-op 1996) (providing joint and several liability for personal injury arising from release of hazardous substances); N.C. GEN. STAT. § 143-215.94DD (1996) (providing joint and several liability for environmental damage arising from offshore oil and gas activities); TENN. CODE ANN. § 68-212-107(2)(4) (1996) (authorizing joint and several liability for persons involved in the handling of hazardous waste). See generally PHILLIP I. BLUMBERG & KURT A. STRASSER, *LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATE STATUTORY LAW* (1995).

A purchaser of corporate assets may be liable as a successor if the purchase is a de facto merger, if there is continuity with the purchased corporation, or if the transaction is a fraudulent transaction structured to evade liability. See *B.F. Goodrich v. Betkoski*, 99 F.3d 505, 519 (2d Cir. 1996) (applying successor liability in a CERCLA case because otherwise "a predecessor could benefit from the illegal disposal of hazardous substances and later evade responsibility for remediation simply by changing the form in which it does business"); *Chicago Truck Drivers Union Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48 (7th Cir. 1995) (holding that a pension fund that could not recover from a debtor in bankruptcy may recover from the successor corporation); *United States v. Mexico Feed & Seed Co.*, 980 F.2d 478, 487 (8th Cir. 1992) (holding that "[b]ecause corporate successors are within CERCLA's ambit of liability, CERCLA must also incorporate the traditional doctrines developed to prevent corporate successors from adroitly clipping off the hook"); *Minnesota Mining & Mfg. Co. v. Eco Chem., Inc.*, 757 F.2d 1256, 1264-65 (Fed. Cir. 1985) (holding a defendant corporation liable as a successor when it had been created from all the assets and personnel of a patent-infringing corporation); *Gould, Inc. v. A & M Battery & Tire Serv.*, 950 F. Supp. 653 (M.D. Pa. 1997) (holding that the purchaser of a corporation's assets was a successor on a continuity-of-enterprise theory of successor liability and was liable under CERCLA); *Schmoll v. Acands, Inc.*, 703 F. Supp. 868, 874 (D. Or. 1988) (holding the successor corporation liable because there was "no just reason to respect the integrity" of the transactions in a corporate group reorganization that was "designed with the improper purpose of escaping asbestos-related liabilities"). See generally PHILLIP I. BLUMBERG, *LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW* § 13.05 (1987) (dealing with implications of successor corporation liability for the imposition of intergroup tort liability).

157. See LoPucki, *supra* note 1, at 27 (citing UNIF. FRAUDULENT TRANSFER CODE § 4A, 7A U.L.A. 652 (1985) (stating that if there exists no actual intent to defraud, receipt of "reasonably equivalent value" bars a fraudulent conveyance claim)).

158. See *supra* note 49.

several of the leveraged buyouts of the 1980s.¹⁵⁹ Threat of their use doubtless forestalled or required changes in other leveraged buyouts during that time. Moreover, these rules have been applied in many cases against debtors who have attempted to avoid their liability by buying Florida homesteads and the like.¹⁶⁰ Although most of these cases involve individual debtors, the principles articulated in them threaten any analogous conveyance of corporate assets.

In addition, fraudulent conveyance laws' vagueness may give them a larger prophylactic effect upon firms that would otherwise distribute their assets than would clear and certain laws. Philip Morris and RJR Nabisco, both facing monumental potential liabilities for smoking-related illnesses, have not spun off their food subsidiaries.¹⁶¹ Whether fraudulent conveyance law would prohibit those spinoffs is debatable, but I doubt that many lawyers would give an unequivocal opinion that the distribution of a tobacco company's food assets to shareholders is not a fraudulent conveyance.¹⁶² Given such

159. See, e.g., *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986); *Moody v. Pacific Credit Inc.*, 127 B.R. 958 (Bankr. W.D. Pa. 1991); *In re O'Day Corp.*, 126 B.R. 370 (Bankr. D. Mass. 1991); *Weibolt Stores v. Schottenstein*, 94 B.R. 488 (Bankr. N.D. Ill. 1988).

160. See, e.g., *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574 (2d Cir. 1983) (holding an attempted purchase of a Florida homestead fraudulent under bankruptcy law); *United States v. Werner*, 857 F. Supp. 286 (S.D.N.Y. 1994) (finding assets secreted in a Liechtenstein trust reachable by a federal income tax lien); *Kapila v. Coevino (In re Coevino)*, 187 B.R. 773 (Bankr. S.D. Fla. 1995) (judging an attempt to remove assets from the reach of creditors by investing them in a Florida annuity to be a fraudulent conveyance and deeming an attempt to do so by paying off a Florida mortgage inequitable); *In re Coplan*, 156 B.R. 88 (Bankr. M.D. Fla. 1993) (finding a Florida homestead exemption invalid where the debtors moved to Florida and bought a homestead on the eve of bankruptcy); *In re Butcher*, 62 B.R. 162 (Bankr. E.D. Tenn. 1986) (denying an attempt to assert the Florida homestead exemption in bankruptcy).

161. As Professor LoPucki points out, some minor players in the tobacco industry had spun off their assets even before he wrote. For example, Kimberly Clark spun off its cigarette paper manufacturing business. See LoPucki, *supra* note 1, at 65 n.275. On October 15, 1997, B.A.T. Industries, PLC, announced its intention to distribute its tobacco business to its shareholders and to merge the remainder of its business with Zurich Insurance Company. See Suein L. Hwang & Milo Geyelin, *B.A.T. May Kick Tobacco Habit, Despite Some Legal Insulation*, WALL ST. J., Oct. 15, 1997, at B8. A quote in a contemporaneous article from one of B.A.T.'s New York lawyers suggests that B.A.T. had asked its lawyers about the legal consequences of this distribution. See *id.* Of course, the tobacco divisions of B.A.T., R. J. Reynolds, or Philip Morris are so richly endowed with assets that they would not be regarded as judgment proof by any standard measure. See *id.*

162. The corporate fraudulent conveyance analogues are state corporate law restrictions on the payment of dividends. For example, title 8, section 170 of the Delaware Code states that directors may declare dividends

either (1) out of its surplus, as defined in and computed in accordance with §§ 154 and 244 of this title, or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. If the capital of the corporation, computed in accordance with §§ 154 and 244 of this title, shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.

DEL. CODE ANN. tit. 8, § 170 (1996); see also *Wittenberg v. Federal Mining & Smelting Co.*, 133 A. 48 (Del. Ch. 1926) (holding that corporations cannot declare dividends except out of profits and that the

uncertainty, firms will see judgment proofing not as an ace under the table but as a dangerous wildcard.

D. *Bargains by Prospective Creditors and Joint Tortfeasors*

When a patient dies in surgery and the plaintiff's heirs or estate sues for wrongful death, the surgeon will rarely be the only defendant; at a minimum, the plaintiff is likely to name the anesthesiologist and the hospital. The peripheral joint tortfeasors are unlikely to be as guilty of malpractice committed in the operating room as the surgeon, but if the surgeon has no assets, the peripheral parties will be targets. Such joint tortfeasors understand their vulnerability, and they are likely to insist that every potential joint tortfeasor have insurance or sufficient assets to meet his or her responsibility.¹⁶³

Not only will potential joint tortfeasors object to being pushed into the front ranks when the plaintiffs start shooting, but they also will be concerned for their own claims for contribution against other joint tortfeasors. The physician's judgment proofing protects him not only from the plaintiff in the original suit, but also from recovery by the joint tortfeasors' insurers of a pro rata share of the judgment. For these reasons, one would expect hospitals, physicians, and their insurers to require that all persons have insurance or to provide that an umbrella organization, such as the hospital or Health Management Organization (HMO), buy insurance that covers all.¹⁶⁴

This response by potential joint tortfeasors is not limited to the medical malpractice field. Some auditors now refuse to audit certain companies for fear that the auditors themselves will be exposed to liability if those companies fail.¹⁶⁵ Presumably the same is true in other circumstances in which experience shows that a particular kind of tort is likely to arise from the

invested capital shall be kept intact), *aff'd*, 138 A. 347 (Del. 1927)

163. Or they will be sure that they themselves have sufficient liability insurance to cover potential tort claims. See Mary Ellen P. Dooley, *An Implied Right of Contribution Under Rule 106-5: An Essential Element of Attaining the Goals of the Securities Exchange Act of 1934*, 61 *FORDHAM L. REV.* 185 (1993) (making this point in the context of secured transactions).

164. This is all the more so because hospitals are subject to vicarious liability for the malpractice of doctors using their facilities—even if those doctors are in fact independent contractors. See Kenneth S. Abraham & Paul C. Weiler, *Enterprise Medical Liability and the Evolution of the American Health Care System*, 108 *HARV. L. REV.* 381, 388 (1994); see also *id.* at 381 (arguing that “making hospitals liable for all malpractice by their affiliated physicians, would better serve the goals of tort law than does the current individual liability regime”). In fact, most hospitals require their doctors to carry malpractice insurance. See William M. Sage et al., *Enterprise Liability for Medical Malpractice and Health Care Quality Improvement*, 20 *AM. J.L. & MED.* 1, 24 n.133 (1994). While there is no requirement of malpractice insurance in the HMO Act, 42 U.S.C.A. § 300e (West Supp. 1997), many HMOs also require insurance. *see, e.g.*, Sage et al., *supra*, at 17. Diana Joseph Bearden and Bryan J. Maedgen urge HMOs to require medical malpractice insurance of their doctors. See Diana Joseph Bearden & Bryan J. Maedgen, *Emerging Theories of Liability in the Managed Health Care Industry*, 47 *BAYLOR L. REV.* 285, 356 (1995).

165. See Elizabeth MacDonald, *More Accounting Firms Are Dumping Risky Clients*, *WALL ST. J.*, Apr 25, 1997, at A2.

participation of several firms.¹⁶⁶ For example, one would expect an airplane manufacturer and the manufacturer of engines for that airplane to bargain over such issues. In this context, as in the medical malpractice context, each actor sees itself as a potential joint tortfeasor and, if it is insured or has sufficient assets, as a potential creditor of the other joint tortfeasors. These prospective joint tortfeasors are a proxy for our victim, the tort creditor. Speaking for themselves, they will demand assets or insurance that will indirectly benefit any tort victim.

E. *Bargains by Potential Judgment Creditors*

For the most part, tort and similar claimants are unknown before the tortious act and, by hypothesis, they cannot protect themselves by bargaining with the tortfeasor. But in a few cases prospective judgment creditors have agents who, at least in gross, foresee their claims. Routinely, unions bargain for pension, health, and life insurance benefits that will pay, if at all, in the distant future. To a limited extent, the Pension Benefit Guaranty Corporation (PBGC), as the ultimate insurer of pension liability, acts as a proxy for prospective claimants.¹⁶⁷ Both unions and the PBGC will scrutinize the solvency of the potential debtor and ask that funds be set aside for other agreements made to provide pensions and other benefits. Like the joint tortfeasor, these agents act as proxies for future creditors.

F. *Loss of Assets*

Some of the most traditional and ancient judgment-proofing activities have inherent risks that minimize their effectiveness.¹⁶⁸ An individual's classic mode of judgment proofing himself is to convey property to a spouse or child. This transaction is likely to be a fraudulent conveyance, but with luck one might escape a fraudulent conveyance claim. Yet there is no evidence that physicians and wealthy sole proprietors are conveying their property to their spouses at any greater rate than in the past. Why? I suspect that there is a natural limit on these transactions: The transferor fears that the transferee will

166. "With joint and several liability, firms must also consider the potential liability they may face for other joint tortfeasors who become insolvent." Note, "Common Sense" Legislation: The Birth of Neoclassical Tort Reform, 109 HARV. L. REV. 1765, 1778 (1996).

167. The creation of the PBGC is mandated by the Employee Retirement Income Security Act (ERISA) §§ 4001-4068, 29 U.S.C. §§ 1301-1368 (1994). The PBGC guarantees vested benefits, see 29 U.S.C. § 1322, and has the power to terminate financially troubled plans, see 29 U.S.C. § 1341. In both of these capacities, the PBGC provides potential aid to prospective tort claimants.

168. See, e.g., Karen Blumenthal, *Simmons, Daughters Facing Court Battle*, WALL ST. J., May 16, 1997, at B11 (reporting on the difficulties that can arise from secreting one's assets in trusts with one's children as the beneficiaries).

not keep the explicit or implicit promise to retransfer the assets or to allow the transferor to enjoy them.

Any time a potential debtor puts its assets beyond the reach of creditors with the expectation of continuing to enjoy them or of later getting them back, there is the persistent threat that the transferee will prove unfaithful or incapable. For most, I suspect that the discounted annual cost of that brooding threat exceeds the cost of malpractice insurance premiums or of other alternatives.

G. *Requirements Set by Law*

A direct barrier to judgment proofing is legislation,¹⁶⁹ such as workers' compensation laws that require the purchase of insurance or the maintenance of proven net worth. Annually, thousands of U.S. workers are killed on the job, and tens of thousands are injured.¹⁷⁰ Most of these losses are covered by workers' compensation insurance, which every state legally mandates.¹⁷¹ Measured by the number of potential claims, workers' compensation may be the single largest barrier to judgment proofing.¹⁷²

In addition to workers' compensation, many states require persons engaged in certain enterprises to carry liability insurance. For example, New York City regulations require taxicabs to carry at least \$150,000 of liability insurance; moreover, the medallions that are required to operate taxicabs in New York City, which are worth about \$200,000 each, cannot be renewed if there is an outstanding claim against the cabs that operate under them.¹⁷³ Similar regulations in Chicago require taxicabs to carry \$350,000 of liability insurance.¹⁷⁴

169. Examples of federal laws that provide for liability claims and carry insurance, financial responsibility, or other requirements inconsistent with judgment proofing are the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), which provides that property involved in a release of hazardous substances is subject to a federal lien in an amount equal to the costs of removal or remedial action, 42 U.S.C. § 9607(l) (1994), and the Oil Pollution Act of 1990, which requires "evidence of financial responsibility sufficient to meet the maximum amount of liability to which the responsible party could be subjected," 33 U.S.C. § 2716(a) (1994).

170. See William Serrin, *The Wages of Work*, NATION, Jan. 28, 1991, at 80.

171. See U.S. CHAMBER OF COMMERCE, 1995 ANALYSIS OF WORKERS' COMPENSATION LAWS 3 (1995).

172. In 1991, workers' compensation accounted for 14.9% of total loss compensation and was second only to health insurance as a compensatory mechanism. See HENSLER ET AL., *supra* note 16, at 108.

173. Telephone Interview with Vincent Andreassi, Assistant Gen. Counsel, New York City Taxi and Limousine Comm'n (Oct. 1, 1996). New York State requires liability insurance of \$25,000 for one person, and \$50,000 for more than one. This would be available, for example, to cover pain and suffering. In addition, the city requires cabs to carry \$100,000 in no-fault liability insurance that would cover medical expenses and lost wages. Finally, up to \$400,000 would be available to tort claimants from the value of the medallions. Of course, medallions may well be subject to a security interest and, if so, a smaller portion of the value would be available. *Id.*

174. Telephone Interview with Paula Becker, Deputy Comm'r, Chicago Public Vehicles Dep't (July 3, 1997). Some states do, however, require less insurance, in *Baker & Drake, Inc. v. Public Service Commission (In re Baker & Drake, Inc.)*, 35 F.3d 1348 (9th Cir. 1994), for example, a cab company had

Certain other businesses that deal with the public are required in most states to carry insurance covering their liability to the public or are required to prove their financial capacity to meet this liability.¹⁷⁵ In effect, these laws act directly on behalf of potential creditors (the injured workers in workers' compensation cases, and the injured members of the public, in other cases) who themselves become "involuntary creditors." They are a self-conscious bar to judgment proofing.

to declare bankruptcy due to personal injury lawsuits; in reorganization, the company tried to make its drivers independent contractors, but this was found to be a statutory violation. *Cf. Teamsters Local No. 310 v. Ingram (In re Tucson Yellow Cab Co.)*, 789 F.2d 701, 703 (9th Cir. 1986) (reporting that \$100,000 of mandated insurance coverage was not enough to cover a personal injury law suit brought against the cab company, which declared bankruptcy).

175. Most states require pest control professionals to carry liability insurance or, in some cases, other proof of financial responsibility. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 8691-8692 (West 1995); COLO. REV. STAT. § 35-10-106 (1993); DEL. CODE ANN. tit. 3, § 1208 (1996); FLA. STAT. ANN. ch. 487.046 (Harrison 1995); GA. CODE ANN. § 2-7-103 (1990); HAW. REV. STAT. ANN. § 460J-3 (Michie 1995); IOWA CODE ANN. § 206.13 (West 1994); KAN. STAT. ANN. § 2-2448 (1991); MD. CODE ANN., AGRIC. § 5-207 (Supp. 1996); MASS. ANN. LAWS ch. 132B, § 10 (Law Co-op. Supp. 1997). Several states require health care providers to carry liability insurance or other proof of financial responsibility. *See, e.g.*, COLO. REV. STAT. § 12-32-102 (1996) (podiatrists); *id.* § 12-40-126 (optometrists); *id.* § 13-64-301 (1997) (every physician, dentist, or health care institution); CONN. GEN. STAT. § 20-11b (1997) (physicians); *id.* § 20-18b (osteopaths); *id.* § 20-28b (chiropractors); *id.* § 20-39a (natureopaths); KAN. STAT. ANN. § 40-3402 (1996) (health care providers); *id.* § 65-2005 (1992) (podiatrists); PA. STAT. ANN. tit. 63, § 625.508 (1996) (chiropractors); WIS. STAT. ANN. § 448.075 (West Supp. 1997) (podiatrists). Many states require private investigators and security guard or bodyguard services to carry liability insurance or other proof of financial responsibility. *See, e.g.*, ARIZ. REV. STAT. ANN. § 32-2613 (West 1992); ARK. CODE ANN. § 17-40-308 (Michie 1995); GA. CODE ANN. § 43-38-6 (1994); KAN. STAT. ANN. § 75-7b11 (1989); MD. CODE ANN., BUS. OCC. & PROF. §§ 13-604, 19-504 (Supp. 1996); N.C. GEN. STAT. § 74C-10 (1989). Several states require the following businesses to carry liability insurance or other proof of financial responsibility: fire sprinkler or alarm installers, *see, e.g.*, KAN. STAT. ANN. § 198B.595 (1996); LA. REV. STAT. ANN. § 37:2156.2, 37:2167 (West 1988 & Supp. 1997); N.C. GEN. STAT. § 74D-9 (1992); S.C. CODE ANN. §§ 23-45-70, 40-79-80 (Law Co-op. Supp. 1996); asbestos removal contractors, *see, e.g.*, ARK. CODE ANN. § 20-27-1006 (Michie Supp. 1993); TEX. REV. CIV. STAT. ANN. art. 4477-3a (West 1998); handlers or owners of dangerous animals, *see, e.g.*, GA. CODE ANN. § 27-5-4 (1994); PA. STAT. ANN. tit. 3, § 459-503-A (West 1995); R.I. GEN. LAWS § 4-13.1-3 (1987); electricians, plumbers, or contractors, *see, e.g.*, HAW. REV. STAT. § 444-11.1 (Supp. 1996); LA. REV. STAT. ANN. § 37:2167 (West 1988 & Supp. 1997); MD. CODE ANN., BUS. OCC. & PROF. § 12-501 (1995); MD. CODE ANN., BUS. REG. § 8-302 (1996); MINN. STAT. § 326.40 (1996); N.D. CENT. CODE § 43-07-04 (1995); S.D. CODIFIED LAWS § 36-16-20 (Michie 1997); gasoline dealers, *see, e.g.*, KAN. STAT. ANN. § 234.120 (1996); LA. REV. STAT. ANN. § 40:1847 (West 1997); S.C. CODE ANN. § 39-43-60 (Law Co-op. 1996); foster homes, day-care centers, or nursery schools, *see, e.g.*, CAL. HEALTH & SAFETY CODE § 1597.531 (West 1996); ME. REV. STAT. ANN. tit. 22, § 8402 (West 1996); TEX. HUM. RES. CODE ANN. § 42.049 (West 1997); WIS. STAT. ANN. § 48.627 (West 1997); motor carriers, *see, e.g.*, KAN. STAT. ANN. § 66-1, 128 (1996); *id.* § 281.655; MINN. STAT. ANN. § 221.035 (West 1992); carnivals and circuses, *see, e.g.*, MASS. GEN. LAWS ANN. ch. 140, § 181 (West 1991); WYO. STAT. ANN. § 33-6-101 (Michie 1996); guides, outfitters, or commercial whitewater rafting companies, *see, e.g.*, COLO. REV. STAT. § 33-32-105 (1996); ME. REV. STAT. ANN. tit. 12 § 7365 (West 1996); WYO. STAT. ANN. § 23-2-413 (Michie 1996). This list is not nearly exhaustive; insurance requirements in some states are highly particularized and sometimes surprising. For example, Michigan has an insurance requirement for electric sign specialists, *see* MICH. STAT. ANN. § 18.204(3j) (Law Co-op. 1996); Oklahoma requires alternative fuels technicians to carry liability insurance, *see* OKLA. STAT. ANN. tit. 74, § 130.16 (West 1995); New Jersey requires acupuncture researchers to carry liability insurance, *see* N.J. STAT. ANN. § 45:9B-8 (West 1991); Texas requires liability insurance of testers and inspectors of ranch scales, *see* TEX. AGRIC. CODE ANN. § 13.353 (West 1995); New York requires appearance enhancement professionals such as hair stylists to carry liability insurance, *see* N.Y. GEN. BUS. LAW § 405 (McKinney 1996); and Maryland requires liability insurance of organizers of beach bingo games, *see* MD. CODE ANN., CRIMES & PUNISHMENTS art. 27, § 259A (1996).

H. *Government Reaction*

Even when the legislature does not require insurance or prohibit transfers, the potential for government action may have an effect upon the behavior of firms that would otherwise judgment proof themselves. For example, large and prominent companies such as Exxon, General Electric, General Motors, and all of the other Fortune 500 companies repeatedly petition federal, state, and local governments for permits, licenses, authorizations, and the like. Some of the most prominent, such as General Electric and Boeing, have large contracts with agencies of the federal government and even turn to the federal government for help in international sales competitions or, in the case of the oil companies, against foreign regimes that threaten to nationalize their assets. For a company, like Boeing, that is dependent on government contracts, failure to pay a claim against a subsidiary could result in a federal determination that the company is not financially responsible or even in its debarment from government contract work. Either would be catastrophic.

To the extent that companies judgment proof themselves and, having done so, fail to pay what are perceived to be just tort liabilities, they would not only disqualify themselves from other government contracts, but would also anger the political friends on whom they rely for friendly discretion. Consider the political reaction that might have followed from Exxon's assertion of limited liability arising from the fact that the Exxon Valdez was owned by a subsidiary or from a comparable attempt by Manville or Robins to escape their tort liability. A firm that becomes a public pariah by judgment proofing increases costs and risks the impairment of rights and favors from federal, state, and local government.

I. *Consumer Reaction*

Regulation among consumers is similarly important for companies that sell to the public under their corporate names. Companies like Exxon, Johnson & Johnson, General Motors, and General Electric spend millions of dollars developing and maintaining images as responsible, reliable companies that produce safe and efficacious products.¹⁷⁶ For Johnson & Johnson to deny liability when there is a Tylenol scare or for Exxon to deny liability for an oil

176. American companies with public image programs spent, on average, more than \$1.5 million each on these programs in 1980. See Thomas F. Garbett, *When To Advertise Your Company*, HARV. BUS. REV., Mar.-Apr. 1982, at 100, 101. Professor LoPucki apparently contemplates the possibility that all companies will avoid an adverse consumer reaction by simultaneously becoming judgment proof hand in hand. Given our antitrust law and the culture of sharp competition among various American companies, I see little reason to assume that General Motors would join with General Electric, much less with Chrysler, to undertake an act that would be widely criticized in the press, by the courts, and probably by elected officials as well.

spill would undermine their status with the public and would forfeit the millions of dollars that they have spent to burnish their names.

IV. CONCLUSION

The specter of widespread judgment proofing by commercial firms is mere fantasy. The data from the Compustat database show that public companies grant much more modest levels of security than would be necessary to render themselves judgment proof. The same data show that most companies have free assets that greatly exceed their liabilities and that their asset-to-liability ratios have changed only modestly over the last fifteen years. The data also show that these public companies carry substantial amounts of liability insurance—apparently the same or greater insurance coverage than fifteen years ago. While these data do not disprove the possibility of judgment proofing by an occasional company, they refute the proposition that judgment proofing is widespread among American commercial firms.

The many barriers to judgment proofing discussed in Part III suggest that the absence of judgment proofing is unlikely to change. Among the barriers is the resistance of contract creditors, which redounds not only to their benefit but also to the benefit of involuntary creditors such as tort claimants. Many laws, such as workers' compensation laws, stand directly in the way, and a close examination of a subsidiary's legal and economic relation to its parent shows that this theoretical avenue to judgment proofing is difficult and abstract.

Although my data are taken exclusively from public companies, I believe that data from private companies would be no different.¹⁷⁷ Almost all of the barriers in Part III to judgment proofing apply equally to public and private firms. And even if the judgment-proofing devices identified by Professor LoPucki were used more frequently by private than by public firms, their use would present a substantially smaller social problem, for a company's liability-producing capacity is proportional to its size. In addition, contract creditors and other guardians of corporate solvency may be even more watchful of private than of public companies.

In summary, corporate judgment proofing is not a significant social problem today, and it is unlikely to become one. Liability lives.

177. For data showing that the smallest businesses do not use secured credit to judgment proof themselves, see Mann, *Small-Business Lending*, *supra* note 132, at 24.