Piercing the Corporate Veil: Some Misfits between Theory and Practice

Tomer Fellach, Moran Ofir and Uriel Procaccia[1]

Very Preliminary Draft

Abstract

Corporate limited liability and its flip side, piercing of the corporate veil, are both devices to allocate the risk of insolvency between firm owners and creditors. In this paper, we make the claim that the risk ought to be allocated to the constituency whose costs in bearing it are lower, regardless of the question whether a premium was actually paid by the owners to the creditors for their consent to bear the risk and regardless of equity considerations. In the theoretical part, we scan various types of owners-creditors pairs with the objective of defining the optimal risk allocation device to fit their relationship. In the empirical part, we analyze all the legal cases litigated in the Israeli courts between 2011 and 2016 where plaintiffs sought to pierce the corporate veil. We reveal that in most cases the courts manage to intuitively identify efficient solutions, but since they fail to grasp the theoretical foundations of piercing they are also prone to commit frequent errors. We show that given these erroneous outcomes the law of piercing remains, as Judge Cardozo once remarked, "enveloped in the mists of metaphor". We conclude by offering a list of recommendations.

[1] Fellach is a fourth year student at the Hebrew University Law School; Ofir is an Assistant Professor at the Harry Radziner School of Law, The Interdisciplinary Center (IDC) Herzliya. Procaccia is the Wachtell, Lipton, Rosen and Katz Professor Emeritus of Corporate Law at the Hebrew University and a Research Professor at the Tel Aviv University Law School.

Introduction

Since the late 19th Century the concept of the corporation is intimately intertwined with the doctrine of limited liability[2]. This is rather surprising, since limited liability ostensibly empowers corporate shareholders to externalize the expected costs of insolvency to their creditors. Most Common Law jurisdiction crafted a remedy designed to re-internalize those external costs to the firm owners, known as the doctrine of "piercing the corporate veil". Lamentably, this doctrine, in spite of its prevalent use, remained "enveloped in the mist of metaphor", as Judge Benjamin Cardozo famously stated almost a century ago[3].

What is then the theoretical justification of limited liability and what ought to be the limits for its reign, given the choice to opt out of it by piercing the corporate veil? In the discussion that follows we build on the pioneering work of Frank Easterbrook and Daniel Fischer ("EF"), who convincingly demonstrated why the creditors of public corporations should be bound by the constraints of limited liability[4]. We show why the EF contribution, illuminating as it is, merely kick-starts the discussion, but falls short of resolving its multiple puzzles and in particular fails to extract the doctrine of piercing the corporate veil out of its metaphoric haze.

[2] The explicit doctrine of limited liability was first introduced in the U.S in 1811 in a New York statute, a statute that was later emulated by other American jurisdictions. In the 1860's most European states recognized the privilege of corporations to shield their owners from the reach of the corporate creditors; in the U.K. the concept was enacted into law in the Companies Acts of 1855 and 1862, but the doctrine was only debated in serious and reaffirmed in the decision of the House of Lords in *Salomon v. A. Salomon and Co*., [1897] A.C. 22.

[3] *Berkey v. Third Avenue Ry*. 244 N.Y. 84 155 N.E. 58 (1926). Judge Cardozo's complaint is echoed by modern commentators over and over again. For example, David Millon, writing in 2007, opined that "Creditors of insolvent corporations often ask courts to "pierce the corporate veil" and hold shareholders personally liable for a corporate obligation. Veil piercing is the most heavily litigated issue in corporate law, yet legal doctrine in this area is notoriously incoherent. Courts typically base their decisions on conclusory references to criteria of doubtful relevance. Results are unpredictable." See David Millon, *Piercing the Corporate Veil, Financial Responsibility and the Limits of Limited Liability*, 56 Emory L.J. 305 (2007). Some more impatient commentators, having despaired of seeing the light through the doctrine's maze suggested to simply dump it as a burdensome nuisance: Steven Bainbridge, *Abolishing Veil Piercing*, 26 Iowa J. Comp. L. 479 (2001).

[4] See Frank Easterbrook and Daniel Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985). Until our work should be published, it will be the 35th anniversary of the EF contribution and hence we dedicate this Essay to their groundbreaking treatment of the subject. Of course, the literature is filled with additional attempts. besides EF's to shed some light on the complexities of the doctrines. See, for instance, as an inconclusive list, Paul Halpern, Michael Trebilcock and Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law,* 30 U. of Toronto L. J. 147 (1980); David Leebron, *Limited Liability, Tort Victims and Creditors*, 91 Col. L. Rev. 1565 (1991).

A line of American and foreign scholars, wary of the repeated attempts to draw the line between limited liability and pierced corporate veils by means of theoretical reflections, resorted to empirical studies, designed to record the actual judicial choice between the two competing doctrines[5]. By- and- large those studies revealed surprising results, ranging from the counter-intuitive to the downright infuriating.

In this short Essay we wish to enrich the EF contribution by introducing into the discussion several parameters that were left out in the EF paper. This part of the Essay is contained in Chapter One that follows. In Chapter Two we report an empirical study we conducted of all piercing cases in a small jurisdiction (Israel) over a time span of six years. The study is largely informed by the theoretical insights we developed in Chapter One. The results of this study are better aligned with sound theoretical predictions, compared to the results obtained and reported in the United States. In our view, the most palpable explanation for this difference is not that American and other foreign judges are less qualified to embrace efficient outcomes than Israeli judges. Rather, the gap occurred simply because the disappointing results were occasioned by poorly designed studies. It is interesting indeed to see how American data might be transformed if the cases were to be mined for a more relevant information, or, as an easier alternative, how the Israeli results would have looked like if our study were to follow the American pattern. Chapter Three summarizes and offers a list of recommendations for reform.

1. Theory

Limited -liability, just like *un*limited liability, are nothing but a pair of defaults. Unless otherwise provided, the default rule for corporations is limited liability, but this rule can, and often is, contracted around, such as is the common practice when closely-held companies seek credit from a lending institution[6]. Similarly, natural persons are

[5] A critical reference to these studies is contained in the beginning of Chapter Two *infra*.

[6] The practice of contracting around limited liability has not escaped the attention of several commentators. See, for example, R.J. Mofsky and R. Tollinson, *Piercing the Veil of Limited Liability*, 4 J. of Corporate Law 351 (1979) who argue, *inter alia*, that given the contractual choice to choose the liability regime, the statutory default has only a relatively small significance. Others contend that the default, although prevalent, is more portentous because not all creditors are equally equipped to exercise opting out and hence contracting around limited liability may result in unsavory social distributions. See Judith Freedman, *Limited Liability: Large Company Theory and Small Firms* 63 Modern L. Rev. 317, 388 et seq. (2000).

governed by the opposite default, of *un*limited liability, but this too can be contracted around such as where credit is granted on a non-recourse basis[7]. Why are corporations and natural persons governed by opposite defaults? The EF paper provides a clear rationale for limited liability for the special case of publicly traded companies. Since their paper is the foundational starting point of our own contribution we summarize in short its main points.

The EF paper is based on the assumption that "good" defaults mimic the contract that the parties would have voluntarily crafted, if they could negotiate at arm's length in an ideal environment with full information and zero transaction costs. Herein "the parties" are the firm owners and its creditors and the subject of negotiation is the allocation of the expected burden of corporate insolvency. EF argue that without limited liability the company's owners (the shareholders) would be burdened by the need to monitor the solvency level of the company in which they choose to invest, as well as the solvency of alternative investment vehicles, to minimize the risk that they be aboard a sinking ship in the abyss of insolvency. They would also be pressured to confine their investment portfolio to few companies (ideally to only one), to minimize the probability that one of these companies should go bust, but such a strategy would severely compromise the ability of the shareholders to diversify away risk.

The threat of insolvency is assumed to be milder for the other side of the agreement, which in the case of public corporations is represented by vocational lenders or by well mediated holders of publicly disseminated corporate debt. Those corporate creditors diversify their firm- specific risk over a large number of debtors and compensate for future insolvencies by marking up the cost of capital to the borrowers. Consequently the maximum premium that the owners would be willing to pay (and actually pay, in most cases, in the form of higher interest rates) for transferring the risk to the creditors, would be less than the minimum premium that the creditors would be willing to accept (and actually do accept in most cases). Since this is the contract which would be ironed

[7] A famous example concerns the practice of many financial institutions to finance home mortgages on a non-recourse basis prior to the devastating mortgage meltdown of 2008. For many borrowers this arrangement shielded everything they owned except their homes from the reach of the lending institutions. The recipients of these loans, especially those who were not particularly indigent, could well be thought of as "limited liability natural persons".

out (and normally contracted for in actual fact) this should also be the default rule, even without explicit contracting.

We note in passing that the same default should apply even in the rare cases where no premium is actually paid by the owners of listed corporations to the vocational creditors, because limited liability looms as a Pareto-superior form of risk allocation in comparison to its alternative (*un*limited liability) and hence would be contracted for in any event by rational parties in the ideal contracting environment of full information and zero transaction costs. For example, if the cost of *un*limited liability to the owners is 100 and the cost of limited liability to the creditors is only 50 and the parties for some reason do not contract for limited liability, their omission is blatantly inefficient and a Pareto –superior outcome could be achieved by reversing the regime. It is equally immaterial, in our view, whether or not the actual choice of regime could accurately be priced at the time of contracting; the only material question is which constituency can shoulder the risk of insolvency more comfortably, even if the contract terms did not reflect this relative comfort.[8]

The thing to observe, in any event, is that the rationale suggested by EF is limited in scope, since it only applies to the allocation of risk between the public shareholders of large corporations and their typical lenders. We turn now to discuss the application of this rationale to other kinds of lenders and to other types of owners. We start with other kinds of lenders.

1.1 Creditors

Side by side with the lending institutions envisaged by EF, one could think of series of bondholders who acquired their holdings in public securities markets. Although each individual member of the group typically lacks the ability or the motivation to monitor the debtor corporation or to haggle over the terms of the loan, the investors as a group are mediated by professional intermediaries who craft for them a sophisticated contract of investment (the "indenture of trust") which normally contains safeguards against

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[8] In this respect we differ sharply from some commentators that seem to consider the accuracy of pricing to have some normative consequences. See Andrey Pavlov and Susan Wachter**,** *Robbing the Bank: Non-Recourse Lending and Asset Pricing*, 28 J. of Real Estate Finance and Economics 147 (2004).

insolvency ("covenants")[9] and prices the cost of capital in conformity with its estimated level of risk. Indeed, we did not find in our data base even one case of a successful attempt to pierce the corporate veil initiated against the public shareholders of a listed entity by either financial institutions (the case discussed in the EF paper) or by an indenture trustee acting on behalf of the bondholders. These two are the easy cases. It is much more difficult to resolve the case of a different kind of creditors.

As an umbrella term for these creditors we think of claimants who did not gain their position in the wake of arm's length negotiations. They are usually termed "involuntary creditors" because they mainly consist of tort claimants, and perhaps some other categories of creditors whose claims are non-contractual, as, e.g. the tax authorities or parties suing under the doctrine of unjust enrichment. What singles out involuntary claimants from their contractual counterparts is the fact that their claims were not generated in the process of mutual negotiations, and hence they were not in a position to charge a premium as compensation for the added risk, as appears to be the case if the credit is extended by financial institutions. Since their added risk is uncompensated for, the specter of inefficient externalities is of some concern. This kind of concern moved some critics to suggest a wholesale abolition of limited liability as a shield against the claims of involuntary creditors[10]. There is a germ of truth in these views, but much more has to be clarified.

Let us start with a terminological observation that seems to have alluded former scholars. In our view the term "involuntary creditors" ought to comprise not only tort claimants and their ilk but also contractual claimants, who in spite of the formal pact between them and the debtor corporation, did not have a realistic chance to factor their added risk into the transaction. In particular we think of two types of contractual, but powerless claimants. The first type is small retail consumers. Think for example of a buyer of a relatively cheap widget discovering that the widget is malfunctioning and hence worthless. One has to be a fanatic free-marketeer to repose sufficient trust in efficient markets as a compensatory tool for such losses. The second category of formally contractual claimants that ought to be treated like tort creditors is junior

[9] In the United States, the Trust Indenture Act of 1939 mandates that all debt offerings in excess of $10 dollars be issued under such as a trust of indenture.
[10] See, for example, Henry Hansmann and Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L. J. 1879 (1990).

employees who find to their chagrin that the employer fell short of honoring its obligations… and perhaps there are additional groups of parties who lack a sufficient bargaining power to participate in molding the terms of their agreement with the debtor corporation. We treat all these "involuntary creditors", broadly defined, as one group and differentiate them from "voluntary creditors", those who used their bargaining power to participate with their creditors in shaping the resulting credit transaction as a "composite good" which contains both the allocation of risk and its terms.

We normally endorse the view that involuntary creditors seeking to pierce the corporate veil ought to be treated more generously by the courts than voluntary creditors; but it does not follow that the involuntary nature of their claims should be regarded as a *sufficient* condition for piercing, nor is our rationale grounded solely in the non-payment of a risk premium. Our skepticism stems from two different reasons. First, not all involuntary creditors are made of a single cloth. Consider, for example, the case of arrears in tax payments. The fisc is without a doubt an "involuntary creditor", not only in the expansive sense outlined above, but also in the strict sense of not having engaged in pervious negotiations with the defaulting corporation. But should the fisc and all other involuntary creditors have an equal claim to the shareholders' money? If we let the lost tax receipts lie where they fall, i.e. if we deny piercing, the loss is spread among the entire population; if we allow piercing, the loss is loaded on a much smaller set of players, the corporate shareholders. Assuming the concavity of the typical taxpayers' utility function (the so-called diminishing marginal utility of money) a transfer payment from the shareholders to the government is bound to reduce aggregate utility. Assuming away wrongdoing by corporate owners, it seems that allowing the government to pierce the veil might reduce aggregate utility, in spite of the involuntary nature of the unpaid tax obligations.

The second reason why lack of contractual consent might not provide a sufficient reason for piercing is this: As stated above, limited liability should govern the relationship between the two sets of players, if the expected cost of limited liability to the creditors is less than the cost of *un*limited liability to the owners. Now consider the case of an isolated industrial plant that emits dangerous fumes in the process of its production.

The law provides a delictual remedy on a no-fault basis[11] to passers-by who inhale the offensive fumes. The plant could reduce the pollution or eliminate it altogether, but only at a high cost. The owners of the plant wish to avoid the high cost of eliminating the pollution, but they fear personal liability if passers-by are injured and then choose to reach into their personal assets. On the other hand the potential victims could avoid the damage at relative ease by choosing alternative routes and hence would be willing to accept a relatively modest premium for their consent to limited liability. If the two parties were to negotiate the liability regime in ideal circumstances, limited liability would be chosen.

1.2 Debtors

Piercing the corporate veil is not an all- or- nothing proposition. In several jurisdictions the veil might be pierced against certain classes of shareholders but not against others. In this section we delineate a number of policy considerations that are pertinent to special kinds of debtors.

The most likely kind of debtors who are universally considered as easy prey for the piercing remedy are fraudulent owners, those who attempted to utilize the corporate shield as a means of defrauding their lenders. Indeed, one commentator (Professor Peter Ho) dubbed these dishonest parties "the elephant in the room", and implied that fraud is the governing principle in all, or almost all piercing cases[12]. The implication behind this argument is that courts are likely to give vent to their moral outrage against crooks, and hence are prone to "roast" them alive, while other explanations for the piercing practice pale in comparison.

This is not our theory, or at least not entirely so; in our view "fraud" need not be, for piercing purposes, as morally repugnant as it is imagined by Professor Ho, and it ought to be treated as a unified concept with what is normally thought of as "constructive fraud", i.e. a wide array of practices that are not intentionally reprehensible, but

[11] The example holds better if the relevant tort is assumed to rest on a strict liability basis. This is because if it were to be based on negligence, it could be contended, at least by those who embrace the Hand formula, that if the cost of eliminating the polluting effect is greater than the expected damage, no liability should ensue.

[12] See Peter Ho, *Veil Piercing*, 89 Tex. L. Rev. 81 (2010).

nevertheless ought to be treated as such. Suppose, once again, that owners and creditors confer in an ideal environment with full information and zero transaction costs, and haggle over the liability regime. Let us consider first the case of actual fraud. In the ideal environment the intention to defraud becomes common knowledge, and it is on the basis of this shared information that the expected risk of corporate insolvency is being contractually allocated. Clearly then, no premium offered by the crooks to the honest lenders could convince the latter to accept the risk, and hence a regime of *un*limited liability is likely to emerge. Our emphasis is not on the turpitude of the borrowers but on the infeasibility of the transaction. Viewed from this vantage point an expanded definition of "fraud" is called for. Two fact situations come immediately to mind.

Suppose, for example, that a given company faces severe liquidity problems and a set of angry creditors, but instead of cutting its losses (such as, for instance, by seeking protection under Chapter 11 of the Bankruptcy Code) it continues to assume fresh obligations and uses the newly raised capital to satisfy older debts, all the way to a deeper abyss of insolvency. Is this a "fraudulent" practice? In a strict sense it is not, because the ultimate motivation of the company and its incumbents could well be to salvage an ailing firm and resuscitate it back to life. Nonetheless in several jurisdictions around the globe the practice is called "fraudulent trading" which is another name for "constructive fraud". The most prevalent sanction for this kind of constructive fraud is to impose the corporate obligations on its directors and officers in their personal capacity[13]. Formally speaking, this remedy is not exactly "piercing", because the debts are imputed to the stewards of the company rather than to its shareholders. But in our view fraudulent trading ought to be treated just like actual fraud. Just as in the case of actual (rather than constructive) fraud, if the facts were laid on the table at the time of choosing the liability regime, there would be no compensating price that could lure the creditors into accepting a limited liability regime. Hence, we classify actual fraud and constructive fraud as two interchangeable birds of feather.

[13] In the United Kingdom the rule was legislated as section s.213 of the Insolvency Act, 1986 and applied, *inter alia,* in *R. v. Grantham* [1984] QB 675. British law has inspired many other Common Law countries. See, e.g. section 588G of the Australian Corporation Act or section 373 of the Israeli Companies Ordinance. In the United States fraudulent trading is currently not recognized as a separate category but several of its features are sanctioned by the Bankruptcy Code as a form of unlawful preference of creditors.

There is a strong argument for adding another fact scenario, in addition to fraudulent trading, to the same category, i.e. various instances of "thin capitalization". Common Law countries, unlike most of their European counterparts, do not impose a minimum capital requirement as a condition for incorporation. There is nothing blatantly illegal about starting a corporation with negligible equity investment. But if the owners of such an indigent company were to display its empty coffers to the inquisitive eyes of its prospective creditors when the two constituencies choose their liability regime, it is highly unlikely that the creditors would consent, at any premium level, to forego their privilege to dip into the personal assets of the shareholders in the eventuality of corporate insolvency. To sum up this point, we are inclined to consider the three cases of actual fraud, constructive fraud and inadequate capitalization as sufficiently analogous and treat them as a single class in shaping the normative contours of the piercing jurisprudence. The suggested unified approach to corporations that cannot display a realistic prospect of servicing their debt obligations will help clarify the otherwise foggy terrain of corporate piercing[14].

Perhaps the most important class of owners that deserve special attention is the group of shareholders of a closely held firm, especially of the smaller variety. There is nothing new in proposals to rethink limited liability of small firms[15]. The problem with these proposals is not in their conclusions, which are by and large reasonable. The rub is in their flawed reasoning. The most common argument for abolishing limited liability for closely held firms is grounded on the observation that their owners often treat the corporate entity as their *alter ego*: For instance they fail to keep separate bank accounts or they retain the same money managers for their corporate and personal book keeping. The obvious question is "So what?" But even if there is a lack of a quick answer to that question, there is a more convincing reason to pierce the veil against small private companies.

[14] Unfortunately, cases of thin capitalization do not form, in American jurisprudence, a sufficient rationale for piercing. See, for instance, Jonathan Macey and Joshua Mitts, *Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil*, 100 Cornell L. Rev. 99 (2014).

[15] Perhaps the first to suggest a thorough rethinking of limited liability for small companies was Bernard Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 Law and Contemporary Problems 473 (1953). For the same proposition in more recent times see Thomas Cheng, *An Economic Analysis of Limited Shareholder Liability in Contractual Claims*, 11 Berkeley Bus. L. J. 112 (2014).

The reason is that the expected cost of both owners and creditors associated with either liability regime is vastly different than it is in the case of public corporations. The owners of small closely held companies are largely exempt from the insurmountable burden that would be imposed on the public shareholders of a traded entity if the chosen regime were to be *un*limited liability. First, because their monitoring costs are likely to be negligible: The financial standing of their company is well-known to them without spending a penny, and so is also, at least in most cases, the financial stability of their co-shareholders. They are not likely to inspect the financial fortunes of other firms because the option of giving up their holdings in their current company and trading it for alternative investment opportunities is normally out of range for most of them. Secondly, in most cases their wealth is bound to be concentrated in a sole business (their own) and hence they do not even consider hedging their risk by holding a diversified portfolio.

While the expected cost of *un*limited liability for owners of closely held corporations is dramatically reduced, the cost of advancing credit to such corporations under limited liability is meaningfully greater: in the case of public corporations the severe disclosure requirements imposed by the securities legislation enables corporate creditors to price the risk associated with the loan with acceptable accuracy. But since the disclosure requirements do not apply to close corporations, the financial standing of these companies is hidden behind a thick wall of a-symmetric information, where the owners are well aware of the company's finances but the lenders are not. As is the case in other situations of a-symmetric information a "market for lemons" is likely to emerge and consequently efficient transactions are likely to collapse[16]. Creditors might wish to charge a high premium to compensate for trading in a market for lemons, but borrowers might be hesitant to comply. Hence in a hypothetical market with full information and zero transaction costs the parties are likely to opt for *un*limited liability; and in actual fact, this is exactly what we observe in the real world.

A more speculative question relates to controlling shareholders in public corporations. In a way, controlling shareholders share some relevant features in common with shareholders of closely-held companies. Like the latter, they are presumed to be

[16] George Akerlof, *The Market of "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Quarterly J. of Econ., 488 (1970).

thoroughly familiar with the financial standing of the corporation they control even without spending, at the margin, considerable monitoring costs. Prior to having committed themselves into making a massive investment in the corporation they control, they may be presumed to have scanned the market for alternative investment opportunities and having done so and gained a voice in the corporation, many of them are no longer keen on making an exit and reinvesting elsewhere. Also the possibility to hedge their holdings in a diversified portfolio is not always observable in the case of heavy investors as it is in the case of retail players who wish to have a large selection of securities in their portfolios.

Having said all of that, piercing the veil against controlling shareholders in public corporations have to be approached with extreme caution. This is not only because the lenders to public corporations are not confronted, as is the case with lenders of closely-held firms, with a market for lemons, but also because the lenders could, and normally do, charge a premium for the added expected risk inherent in choosing a limited liability regime, and a large portion of this premium was already paid by the controlling shareholders or their predecessors. In such cases all externalities to the creditors have already been re-internalized, and hence the case for piercing, although by no means eliminated, is considerably enfeebled.

The final category of shareholders we wish to set our sights on are corporate shareholders. Corporations hold shares in other corporations either as minority shareholders or as major block holders that often control their as far as subsidiaries. Very little attention has been given to the former case in the context of piercing, and in our view it is all for the better. The question whether piercing should be encouraged against corporate *controlling* shareholders, on the other hand, was widely debated in the literature. Those who advocate this differential approach may conceivably advance several reasons for their view. On the intuitive level one may feel less compassion for corporations who do not have the capacity to "suffer" from adverse judgements against them, than for natural flesh –and- blood humans, and hence may feel less remorseful to prescribe a harsher attitude to corporations. We observe that even if this intuition is not uncommon it is nevertheless hard to justify, since corporate wealth may consist a large portion of human shareholders' assets. Other commentators may have stronger claims. Some of them observe that companies belonging to the same corporate group, in spite of the fact that each one of their number is a separate legal person, often strive to maximize the value of the entire group, even if it comes at the expense of sacrificing the business goals of individual companies within the group. The argument is that if the companies within the group consider their destinies as inseparable from their affiliates', the legal regime should follow suit[17].

On the other side of the divide some commentators stress the cogent argument that each corporate member within the group may have a separate set of creditors, who are presumed to have priced their loans on the basis of their individual borrower's financial standing, and hence it would not be reasonable to treat the various entities within the group, in spite of their having differential solvency levels, as if they were a single enterprise. In addition, blurring the boundaries among the members of the group weakens each company's incentive to act as a distinct profit center, which might prove to be a suboptimal strategy for them all[18].

Now none of the arguments outlined above have a direct bearing on the theory we propose, because they are oblivious to the relative costs of owners and creditors in choosing the optimal regime. But perhaps there is an indirect connection; in unraveling it we come to the conclusion that corporate shareholders ought to be treated like human shareholders.

Suppose counter-factually that we were persuaded that corporate groups interpret their objective as maximizing aggregate values for the whole enterprise and hence the theory of enterprise liability ought to prevail. In that case it would have been exorbitantly costly for the lenders to estimate the risk of lending to any corporation within the group, and hence the lenders could not consent to be bound by a regime of limited liability save for a high premium. The controlling shareholders of the debtor corporation, on the other hand, would be more willing to assume the risk, because the financial standing of their controlled corporations are presumed to be available to them without having to expend monitoring costs. In such a situation the highest premium payable by the debtor

[17] This rather prevalent view was forcefully advocated by Phillip Blumberg in his book The Law of Corporate Groups (1985) and was echoed, both before and after him by numerous commentators. See, e.g., Jonathan Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. Chi. L. Rev. 589 (1975).
[18] See, for example, Richard Posner, *The Rights of Creditors in Affiliated Corporations*, 43 U. Chi. L. Rev. 499 (1976).

company to the lenders would fall short of meeting the minimum requirements of the latter, and a regime of *un*limited liability would emerge.

The whole set of theoretical claims made above can be condensed into the following five by four table. Types of creditors are listed vertically and types of owners are listed horizontally. If a pair-wise comparison yields the recommendation of limited liability we represent it by the letters LL. If piercing the veil ought to be seriously considered its representation is PV. If none of these recommendations is blatantly clear we leave the relevant cell blank.

Top down- **creditors**; Across- **debtor**;	Public shareholders in listed companies	Controlling shareholders in listed companies	Shareholders of closely held firms	Parent corporations	Cases of fraud
Financial institutions	LL	LL	LL		PV
Private creditors	LL		PV		PV
Non voluntary creditors	LL	PV	PV		PV
Government claims	LL	LL	LL		PV

2. Empirical Analysis

2.1. Empirical Scholarship

The first serious pioneer in looking at the facts was Professor Robert Thompson, in a canonic study published in 1991[19]. Thompson surveyed some 1600 American cases and came up with surprising results. In particular, three of his results stand in stark contrast to the theoretical predictions outlined above. First, Thompson found that American

[19] Robert Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991).

courts pierce the corporate veil in contract cases much more willingly than they do in tort cases. In an ideal world the opposite result should have been found because tort claimants have never been in a position to charge a premium for the expected cost of insolvency, and hence limited liability imposes on them an arguably unjustified external cost. Second, according to Thompson's data situations of thin capitalization play an insignificant role in shifting the risk from creditors to owners. This too is rather counter-intuitive, because in an hypothetical contract between the two sets of claimants, owners and creditors, most creditors would not have been willing to accept the expected risk of insolvency if the borrowing firm is perceived to be slouching dangerously close to the brink of bankruptcy; indeed, if a real, rather than an hypothetical contract is made between a lender and a financially unstable firm, such as most one-person companies and other small closely held companies are, lenders insist on receiving the owners' personal guarantee as a precondition for the extension of credit. Thirdly, Thompson's data show that American courts are slanted in favor of government claims relative to claims lodged by the private sector, in spite of the fact that the public fisc is the ideal risk-bearer and arguably also the cheapest.

Following Thompson's findings a proliferation of other researchers have followed suit, including in a number of non-American jurisdictions. Most of these studies echoed, to a larger or lesser extent, Thompson's results and thus provide, taken together, an important first step for predicting judicial responses to the piercing problem in the jurisdictions under observation. With this said, these studies suffer, in our view, from a serious methodological problem. The method used in these studies was simply to record the number of cases where some characteristics of the creditors' claim (such as, for instance, whether it sounded in contract or in tort) were associated with forensic success. But looking at differentiated characteristics, without controlling for other factors that might impact the judicial result, is simply not an acceptable methodology for the determination of a causal relationship. As Professor Peter Ho has justly observed, such a differentiated approach is liable to miss, on occasion, "the elephant in the room", to use his own expression[20]. In Ho's view, this "elephant" was the evidence of fraudulent behavior on part of the owners, which he thought provided the main rationale of all piercing cases, and thus this element held the dominant key for removing

[20] Peter Ho, *Veil Piercing*, 89 Tex. L. Rev. 81 (2010).

the "mist of metaphor" from the subject. Ho identified correctly the need for controlling relevant factors, but unfortunately fell into his own trap by simply counting cases and partitioning them according to the presence of fraud.

A major step forward was offered by Professor John Matheson from the University of Minnesota. By using multi-variable econometric analysis and controlling for the relevant factors he managed to avoid the methodological pitfalls of Thompson and his followers, and established some credible causal relationships that go a long way for clarifying the picture. His results, however, give a serious cause for concern from the normative point of view. His first study[21] focused on piercing attempts within groups of companies; he found that courts are likely, in this setting, to pierce the veil more frequently in contract cases than in tort cases (at a ratio of three to one), that piercing attempts by corporate creditors were twice as successful as similar attempts by individual creditors and that altogether the rate of success in piercing cases was rather low within groups of companies. His second study[22] transcended the relatively narrow domain of litigation concerning groups of companies. It confirmed his previous result regarding the relative reluctance of courts to pierce the veil in groups of companies cases; it also confirmed the greater willingness of courts to pierce the veil in contract cases than in tort cases, although not as dramatically as in the groups of companies study. In addition Matheson's second study found support for the proposition that piercing attempts were less successful if the plaintiff-creditors based their claims of numerous grounds relative to basing them on a single or on fewer arguments.

Given the normatively disappointing results obtained by Matheson as well as by Thompson and his followers, we set our sights on the empirical landscape in our own jurisdiction, Israel. We conjectured that the American results do not necessarily reflect a universal judicial attitude to the limited liability versus the piercing dilemma and hoped to discover more satisfying results in Israel. Our hopes were only partially fulfilled. Although we found that the empirical evidence in Israel is quite different from the evidence in the United States, we also found that our own courts had their fair share

[21] John Matheson, *The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context*, 87 N.C. L. Rev.1091 (2009).

[22] John Matheson*, Why Courts Pierce: An Empirical Study of Piercing the Corporate Veil***,** 7 Berkeley Bus. L.J. 1 (2010).

of inexplicable attitude to the piercing problem given the theoretical predictions outlined above. We turn now to describe our own empirical study.

2.2 Data

We first launched a descriptive statistical analysis much after the method used by Thompson in the United States, with full recognition that these results show very little as far as we wish to deduce from them causal relationships. We coded all the piercing cases litigated in Israel in all legal tribunals during a five year span from 2011 to 2016. The number of these cases was slightly above 200, but after filtering out a number of cases that raised methodological problems (for instance, the facts were not clearly stated) we settled for N=185.

We first note, in Table 1 below, the various explanatory variables under consideration:

Table 1: Explanatory Variables

Variable	**Description**
Region	Identifies whether the court hearing the case is located in Tel Aviv/ Jerusalem/ Haifa/ north of Israel/ center of Israel/ south of Israel/ national court
Court Level	Identifies whether the court hearing the case was a district court/ appellate court/ supreme court/regional labor court/ national labor court
Appeal	Identifies whether the case is an appeal on a court decision or is the first adjudication
When the case was initiated	In what year the case was initiated
Adjudication Year	Identifies the year of the court's adjudication
Sole Claim	Identifies whether the piercing claim is a sole one or is a part or multiple claims case
Industry	Identifies the industry to which the corporation belongs
Closely-held/Family Owned corporation	Identifies whether the corporation is a closely-held/ family owned corporation or other type of corporation

Corporate Group	Identifies whether the piercing is in parent-subsidiary context or to individual owners
Financial Distress	Identifies whether the defendant corporation was in financial distress
Voluntary/not voluntary claim	Identifies whether the creditors are voluntary or non-voluntary
Cause of action	Identifies whether the underlying cause of action is a contract, labor, tax, consumer, financial or a general claim

2.3 Descriptive Statistics

Before analyzing the details of veil piercing, we summarize in Table 2 the overall percentages of successful/unsuccessful claims.

Table 2: Piercing Results in All Cases

Category	**Total No' of Cases**	**Pierce**	**No Pierce**	**% Piercing**
All Cases	185	80	105	43.24%

The data yielded a significant chi square test $\chi^2(1)=3.378 > \chi^2(1,0.1)=2.705$ $p<0.05$.

Initially, we were somewhat surprised to see the relatively high percentage of successful claims, given the accepted wisdom that piercing is a rather rare exception to limited liability. We surmise that plaintiffs who have a weak piercing claim do not even attempt to raise it, and hence the numbers relate to plaintiffs who are armored with a strong case in the first place.

We were concerned that the piercing statistics might fluctuate widely from year to year, thus indicating a lack of a fixed pattern in court adjudications. As Table 3 indicated, judicial attitude to piercing claims seems to be surprisingly steady.

Table 3: Piercing Rates over Time

Year	Total No' of Cases	Pierce	No Pierce	% Piercing
2016	20	9	11	45%
2015	39	17	22	43.59%
2014	44	18	26	40.91%
2013	35	15	20	42.86%
2012	28	13	15	46.43%
2011	19	8	11	42.11%

The data yielded a significant chi square test $\chi^2(5)=0.468< \chi^2(5,0.05)=11.07$ $p<0.05$.

We were also taken aback initially to observe, as Table 4 indicates, that labor court judges are more close-fisted than judges of courts of general jurisdiction in granting the piercing remedy. However, a close reading of the labor court cases denying the remedy indicates, it is probably a reflection of the plaintiff-employees to "load" a piercing claim to their other alleged grievances even where piercing does not seem appropriate in the circumstances.

Table 4: Piercing by Court Level

Court	Total No' of Cases	Pierce	No Pierce	% Piercing
District Court	59	31	28	52.54%
Appellate Court	23	13	10	56.52%
Supreme Court	2	2	0	100%

Regional Labor Court	94	32	62	34.04%
National Labor Court	7	2	5	28.57%

The data yielded a significant chi square test $\chi^2(4)=87.52 > \chi^2(4,0.01)=13.276$ $p<0.01$.

Of course, the Supreme Court 100% record of granting the remedy indicates very little given the paucity of cases where it had an opportunity to dwell on the subject.

We did find some variance in the judges' inclination to grant the remedy depending on the region of adjudication. It appears that this result is consistent with the allegation that the law of piercing is "enveloped in the mist of metaphor" which gives free reign to judges to use their discretion in an unprincipled manner. Table 5 summarizes these haphazard results.

Table 5: Piercing by Region

Region	Total No’ of Cases	Pierce	No Pierce	% Piercing
North	8	2	6	25%
Jerusalem	18	12	6	66.67%
Tel Aviv	80	38	42	47.50%
Center	20	5	15	25%
South	10	4	6	40%
Haifa	40	16	24	40%
National	9	4	5	44.44%

The data yielded a significant chi square test $\chi^2(6)=29.022 > \chi^2(6,0.01)=16.811$ $p<0.01$.

Table 6 offers some credence to our conjecture that plaintiffs who "load' a piercing claim on a variety of other arguments, conceivably more convincing than the piercing claim, are more likely to be denied the remedy.

Table 6: Piercing as a sole claim or as one of multiple claims

	Total No' of Cases	Pierce	No Pierce	% Piercing
Sole Claim	88	50	38	56.82%
Multiple Claims	97	30	67	30.98%

The data yielded a significant chi square test $\chi^2(1)=7.741 > \chi^2(1,0.01)=6.63$. $p<0.01$

Table 7, on a standalone basis (i.e. without controlling for other variables) seems on its face rather counter-intuitive. It shows that if the plaintiff can prove that the corporation was in financial distress the plaintiff is *less* likely, rather than *more* likely, to prevail in his or her attempt to pierce the veil. It is counter-intuitive because financially distressed firms pose an *ex ante* greater threat of insolvency and hence a diminished willingness on the part of creditors to assume the expected cost of that eventuality.

Table 7: Piercing when the plaintiff show indications of the corporation's financial distress

	Total No' of Cases	Pierce	No Pierce	% Piercing
The plaintiff showed indications for financial distress	70	13	57	18.57%
The plaintiff didn't show indications for financial distress	115	67	48	58.26%

The data yielded a significant chi square test $\chi^2(1)=19.292 > \chi^2(1,0.01)=6.63$ $p<0.01$.

Fortunately, this table illustrates the shortcomings of descriptive statistics. As we show below, when we use advanced econometric multi-variable analysis the results of Table 7 are reversed and it appears, as one expects on the basis of the theoretical predictions, that if we control for the other variables financial distress is indeed a strong argument for piercing the veil.

Table 8 supports the proposition that smaller companies, including one man corporations and small family businesses are more likely to lose the battle compared to more robust companies. We note in passing that with one single exception the veil has always been pierced against private companies, and hence by using the expression "more robust" we do not allude to public corporations.

Table 8: Piercing by type of corporation

	Total No' of Cases	**Pierce**	**No Pierce**	**% Piercing**
Smaller private companies	50	32	18	64%
Larger private companies	135	48	87	35.56%

The data yielded a significant chi square test $\chi^2(1)=11.331 > \chi^2(1,0.01)=6.63$ $p<0.01$.

The next table, Table 9, is focused on attempts to pierce the corporate veil of a company that forms a chain within a corporate group. It shows that if the defendant is a parent corporation within the group it is likelier to lose the battle compared to an individual, i.e. a natural person who is sued for piercing.

Table 9: Piercing in corporate groups

	Total No' of Cases	Pierce	No Pierce	% Piercing
Piercing in parent-subsidiary context	24	16	8	66.67%
Piercing to Individual owners	161	64	97	39.75%

The data yielded a significant chi square test $\chi^2(1)=12.977 > \chi^2(1,0.01)=6.63$ $p<0.01$.

This feature of the law of piercing probably reflects the die-hard belief that artificial legal persons do not "suffer" as much as natural persons if they are charged with the obligations of the failing corporation.

The next table, Table 10, reflects a clear difference between "our" results and those obtained in the United States. As the table demonstrates, Israeli courts are more likely to pierce the veil if the plaintiff is a non-voluntary creditor as, indeed, we ought to expect given the predictions of the theory. As stated above, by the term "non-voluntary creditors" we lumped together creditors who never entered into a contractual relationship with the company, such as tort creditors, and other creditors who did enter such a relationship but the circumstances of the case made it impossible for them to either charge a premium for shouldering the expected cost of insolvency or to shape the contract in tandem with their own preferences. Examples of these creditors are small retail consumers or junior company employees.

Table 10: Piercing by type of creditor

	Total No' of Cases	Pierce	No Pierce	% Piercing
Voluntary creditors	51	19	32	37.25%
Non-voluntary creditors	134	61	73	45.52%

The data yielded a significant chi square test $\chi^2(1)=0.95 < \chi^2(1,0.05)=3.841$ $p<0.01$.

2.4 Econometric Analysis

As explained above, all these descriptive statistics, although they have their own meaning and value, cannot predict causal relationships, i.e. the impact of any single variable on the inclination of the court to pierce the veil, holding all the other variables constant. In the classical regression model, the dependent variable can take any value on the real line. In our case, the dependent variable is a discrete binary outcome of the court decision to either pierce the corporate veil or not. In other words, y is a binary variable that takes only two values: 0 when the court decides not to pierce the corporate veil and 1 if the veil is pierced. The linear probability model (LPM) is simple to estimate and use, but has some drawbacks in dealing with binary dependent variables. LPM's limitations can be overcome by using a more sophisticated binary response model[23]. The binary response model we use is of the form:

$$P(y=1|x) = G(\beta_0 + \beta_1 x_1 + \cdots + \beta_k x_k) = G(\beta_0 + \boldsymbol{x\beta})$$

Where y is the court's decision to pierce the veil and x is the full set of explanatory variables, i.e. court information, plaintiff information, type of case, type of corporation and type of creditor. G is a function taking on values strictly between zero and one for all real numbers z:

$$0 \leq G(z) \leq 1$$

For the function G, it is possible to use two nonlinear functions used in the vast majority of applications- logit and probit. In the *logit model*, G is the logistic function:

$$G(z) = \frac{\exp(z)}{1+\exp(z)}$$

[23] Wooldridge, Jeffrey M., *Introductory Econometrics: A Modern Approach,* 4^{th} Edition, South-Western Cengage Learning, 2009.

$G(z)$ is between zero and one for all real numbers z. This is the cumulative distribution function for a standard logistic random variable.

In the *probit model*, G is the standard normal cumulative distribution function, which again ensures that the regression equation is strictly between zero and one for all parameter values and for X_J. In our paper we use the *probit model* for its underlying assumption of normal distribution. Table 11 summarizes the results of our inquiry.

Table 11: Regression analysis

Variable	**(1)**	**(2)**	**(3)**
Non-voluntary creditors	1.872*** (0.447)	1.847*** (0.448)	
Financial distress	1.553*** (0.345)	1.414*** (0.296)	1.358*** (0.296)
Closely-held corporation	0.259 (0.327)	0.262 (0.327)	0.479 (0.241)
Corporate group	0.941** (0.392)	0.977** (0.389)	0.907** (0.383)
Appeal	0.124 (0.834)	0.716 (0.834)	0.113 (0.85)
Sole claim	-0.315 (0.393)		
Court level fixed effect		+	+
Submitting Year fixed effect		+	+
Adjudication Year fixed effect		+	+
Industry fixed effect		+	+
Region fixed effect		+	+
Underlying cause of action fixed effect			+***
Constant	-1.37 (1.736)	-1.442 (1.393)	3.722*** (1.369)
N	179	179	175
Pseudo R^2	0.341	0.339	0.362

***Significant at the 1 percent level ** Significant at the 5 percent level *Significant at the 10 percent level.

3. Conclusions and Recommendations

As Table 11 indicates, we found just two variables that predict the piercing result with strong statistical significance, the identity of the plaintiffs as non-voluntary creditors (broadly defined) and the overall profile of the debtor-company as being in financial distress. Both of these results seem to fit the theory, although one could argue that the numbers ought to have been more conspicuously slanted in the same direction. In addition we found statistically significant results indicating the greater willingness of courts to pierce the veil within corporate groups compared to the general case. There is nothing in theory that justifies this particular result and hence we believe that it ought to be revised.

All other results lack statistical significance. We deplore this result as far as it reflects a neutral attitude to small private companies. Limited liability in their case seems to be inappropriate as is evidenced by the prevailing practice of creditors to insist on personal guarantees if they are positioned to demand it. As a general rule parties are not drawn to make inefficient contracts and the fact that personal guarantee is routinely made when it is practicable to do so is at least *prima facie* evidence of its efficiency.

It is interesting to note that our results sharply deviate from the results obtained in the United States. This perceived difference attests to the fact that although the theory seems to be valid universally, judges in different jurisdictions do not necessarily apply it along similar lines. We interpret this observation as a natural corollary to the widely held belief that the law of piercing is hidden behind a "mist of metaphor" and hence its puzzles ought to be cracked by the arbiter's "chancellor's foot". Undisciplined discretion cannot affect equal justice to similar cases and it is indeed undisciplined because the underlying theory is too often ignored.