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## The Death of Liability

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# Articles

## The Death of Liability

Lynn M. LoPucki<sup>†</sup>

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*Think of the liability system as a poker game. Each person, corporation, or other entity in the economy is a player. Players risk their chips, that is, their wealth, by tossing them into the pot, that is, investing them in liability-generating economic activity. Chips contributed to the pot are at risk of loss; the system can take them to satisfy liability. Chips withheld are not at risk.*

*This poker game has an odd twist to it. Withholding chips does not reduce significantly the amounts players can win or players' likelihood of winning. Even players who don't put any chips in the pot—that is, players who are judgment proof—can keep playing the game and are eligible to win.*

*Why do players put chips in the pot? No rule requires them to do so. There are social, cultural, and economic pressures. But mostly, they do so for convenience. A wealthy player who wants that wealth available for use, but not in the pot to be lost through liability, must build arcane legal structures and document them through extensive record keeping.*

*In recent years, computer technology has dramatically reduced the cost of record generation and, consequently, the cost of keeping chips out of the pot. Major players are reducing their stakes. By doing so, they are breaking down the social norms and cultural barriers that prevent further reductions. The process is feeding on itself. Soon no one will have significant chips in the pot. When that happens the fundamental nature of the game will change. Liability will die.*

Law is a system for controlling human behavior. In contemporary society, governments enforce law by essentially two mechanisms: incarceration and liability. These roughly correspond to the two spheres of the legal system: the criminal and the civil. In the criminal sphere, the wrongdoer is threatened with imprisonment; in the civil sphere, the wrongdoer is threatened with deprivation of wealth.<sup>1</sup> Liability is crucial because it is one of only two principal means by which governments enforce law.<sup>2</sup>

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1. Within both spheres, social shaming is a significant element of the sanction. It is less so in the civil sphere, and, as will be discussed in this Article, is declining in respects important to the subject at hand.

There is some crossover between the two spheres of the system. The criminal law imposes fines and enforces them only by proceeding against the defendant's property. See, e.g., *Williams v. Illinois*, 399 U.S. 235, 241–44 (1970) (holding that incarceration of indigent person beyond statutory limit because of failure to pay fine denies equal protection). The civil law relies on the threat of incarceration for contempt of court in some aspects of the collection process. See, e.g., CAL. CIV. PROC. CODE § 482.080 (West Supp. 1996) (providing for orders directing debtors to transfer property to levying officer and inclusion in such orders of notice that failure to comply may subject defendant to arrest and punishment for contempt of court).

2. The distinction I make here between liability and incarceration as law enforcement mechanisms closely parallels the distinction made by Guido Calabresi and Douglas Melamed between "liability rules" and "property rules." See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092–93 (1972). Calabresi and Melamed refer to rules enforceable by criminal law or equitable remedy, ultimately backed by the threat of incarceration, as "property rules." *Id.* at 1126 ("In other words, we impose criminal sanctions as a means of deterring future attempts to convert property rules into liability rules"). see also Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1031 (1995); Louis Kaplow & Steven Shavell, *Do Liability Rules Facilitate Bargaining? A Reply*

The liability system enforces liability through the entry and forcible collection of judgments for the payment of money. Although liability is most closely associated with products liability and other tort actions, money judgments are also the means for enforcing contracts, civil rights, labor and employment law, environmental regulations, federal tax law, intellectual property law, most kinds of property rights,<sup>3</sup> and just about every other kind of law on the books. Without liability, the American legal system would be radically different.

The liability system currently is mired in controversy over who should be liable, for what conduct, and for how much money. Yet this grand debate may be over the arrangement of the deck chairs on the Titanic. To hold a defendant liable is to enter a money judgment against the defendant. Unless that judgment can be enforced, liability is merely symbolic.

The system by which money judgments are enforced is beginning to fail. The immediate cause is the deployment of legal structures that render potential defendants judgment proof.<sup>4</sup> The liability system has long accepted that those who do not have the financial ability to pay judgments do not pay them. The system employs a complex web of social, economic, and legal constructs to determine who can or cannot pay. Those constructs can be, and are, manipulated by potential defendants to create judgment-proof structures. Many of the constructs are so deep-rooted in culture that they are virtually impossible to change. Included among them are secured credit, shareholder limited liability, national sovereignty, and the ownership of property.

These constructs have existed in their current form for a considerable period. Their strategic manipulation has long been regarded as a problem for the liability system. Probably most individuals and businesses are either judgment proof,<sup>5</sup> or capable of rendering themselves so between

to *Ayres and Talley*, 105 YALE L.J. 221, 221–22 (1995) (describing “liability rule” as one under which “the injurer is free to harm the victim” and describing rule allowing victims injunctions as example of “property rule”).

3. Most property rights are in fact enforced through liability; neither criminal incarceration nor equitable order is available to the plaintiff. The defendant who negligently destroys the plaintiff’s property in an automobile accident or an industrial accident does not go to jail; the sole sanction is likely to be a judgment for money damages. When an invasion of property rights is deliberate, the system may sanction by criminal law or equitable order, but does not necessarily do so. The defendant who deliberately infringes a patent, holds over as a tenant, or refuses to surrender possession of collateral after default may eventually be ordered to cease violating the property rights of the plaintiff, but liability is likely to be the only sanction for violations committed prior to the order. *See, e.g.*, Calabresi & Melamed, *supra* note 2, at 1093 (recognizing that property interest in one’s house is protected by liability rules).

4. A debtor is judgment proof when the debtor has no wealth or holds its wealth in forms not subject to legal process for collection. That is, judgments against the debtor are uncollectible.

5. *See* PETER CANE, *ATYAH’S ACCIDENTS, COMPENSATION AND THE LAW* 183–87 (1993) (discussing difficulty of collecting tort judgments from individual defendants); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 707 (“We expect that agents apprehended for fraud usually will be judgment proof, because the firm’s value (and thus the agent’s wealth and ability to satisfy the optimal damage award) declines dramatically when the fraud is revealed.”); Thomas G. Bousquet, *It’s Time for Mandatory Malpractice Insurance*, TEX. LAW., Dec. 6, 1993, at 17 (asserting that approximately 60% of attorneys in private practice in Texas have no

commencement of a civil action against them and the entry of judgment. The system has nevertheless been able to function passably well. In most industries, liability insurance has been readily available at modest cost, leaving system participants with only modest incentives to adopt judgment-proof structures. Transaction costs, public relations considerations, and social norms have kept the largest businesses from judgment proofing themselves. Although those businesses could avoid liability if they so chose, they find it more cost effective to pay.<sup>6</sup>

In recent years, the introduction of computer technology has dramatically altered the equation by reducing the costs of recordkeeping. Judgment-proofing strategies have become cheaper and easier to execute.<sup>7</sup> Some large businesses now employ them and market forces are driving their competitors to do the same. The social norms that prohibit their use among reputable businesses have begun to erode. As this Article will show, the process may well be irreversible.

The method by which I explore this approaching change is a combination of systems analysis and strategic analysis. Systems analysis is an established discipline that has been applied to law only recently.<sup>8</sup> The analyst begins by identifying a law-related system<sup>9</sup> for analysis—here, the system for awarding and enforcing money judgments. The analyst treats the *system* as goal-seeking, and infers its goals from observations of its operation.<sup>10</sup> For example, the goals I attribute to the system for enforcement of money judgments are to determine what wealth judgment creditors should be able to reach and then to assist them in reaching it. This anthropomorphization of systems may be disconcerting to some readers, but its necessity is a fundamental postulate of systems analysis. Given the manner in which law-related systems evolve, the

professional liability insurance and that vast majority of those uninsured attorneys "either do not have the assets or the inclination (or both) to compensate clients whom they damage")

6. See, e.g., *infra* Subsection II.B.2.

7. See, e.g., Edward J. Kane, *Interaction of Financial and Regulatory Innovation*, 78 AM ECON REV 328, 331 (1988) ("Advances in electronic and financial-contracting technology have played a major role by creating unregulated or less-regulated 'loophole' substitutes for tightly regulated traditional products and ways of doing business."); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization Evolution. Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1370-71 (1991) (listing new technology as one of several forces contributing to tremendous growth in asset securitization)

8. For examples of the use of systems analysis in law, see LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH (1995); Todd R. Benson, *Taking Security in China: Approaching U.S. Practices?*, 21 YALE J. INT'L L. 183, 209-27 (1996); Lynn M. LoPucki, *Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577 (1995); Lynn M. LoPucki & George Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT'L L.J. 267 (1994); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 350-52 (1993)

9. A law-related system is a system in which law plays a role, usually along with social norms and physical subsystems such as police, courts, and jails. For a general discussion of the problem of identifying and isolating a "system" for study, see GERALD M. WEINBERG, AN INTRODUCTION TO GENERAL SYSTEMS THINKING 144-50 (1975).

10. For a discussion of the difficulties of inferring the goals of a system from observations of its operations, see *id.* at 87-122.

intentions are more accurately attributable to the system than to particular participants in system design, such as legislators.

Strategic analysis is a developing technique for facilitating the application of systems analysis to law-related systems. The essence of the technique is to view classes of participants in a law-related system—for example, secured creditors, debtors, and judgment holders—as goal-seeking. To the extent possible, the analyst attributes goals based on empirical observation of participants' actions.<sup>11</sup> The analyst identifies incentives generated by the law-related system for participants, the strategies by which the participants do or might achieve their objectives, and finally, the constraints on the use of those strategies.<sup>12</sup> The principal incentive considered in this Article is the avoidance of liability. The principal strategies are those by which potentially liable entities can render themselves judgment proof.

Strategies are changes in conduct by a system participant made with the intention to improve the participant's treatment by the system. System designers, such as legislators, judges, and influential commentators, intend to foster some strategic action by system participants. For example, they design the system to reward diligent recordkeeping in order to promote diligent recordkeeping. But participants in a system often devise strategies not contemplated, or at least not intended, by the system designers. Strategies of the former type will be referred to as "system-intended"; those of the latter as "system-unintended."<sup>13</sup> When the analyst discovers system-unintended strategies, the analyst considers what strategies the *system* can employ to prevent their continued use.

From such an analysis, this Article concludes that currently effective judgment-proofing strategies are fully capable of defeating the liability system. The remaining barriers that constrain use of these strategies—principally expense and cultural resistance—are in decline. The system has available to it a number of radical strategic responses by which some commentators think liability might be saved. They include abolishing shareholder limited liability, granting involuntary creditors priority over secured creditors such as mortgage holders, and extending liability to all who trade with those who have liability.

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11. By contrast, law and economics attributes goals by postulating that all participants in an economic system are utility maximizers.

12. See LYNN M. LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS (2d ed. 1991) [hereinafter LOPUCKI, STRATEGIES FOR CREDITORS] (identifying strategies used by or available to creditors before and during bankruptcy cases); Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498 (1996) [hereinafter LoPucki, *The Law in Lawyers' Heads*] (discussing legal strategy and strategic analysis as method for analysis of law-related systems); Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1 (1986) (analyzing mass tort problem by examining strategies available to actors in system).

13. See LoPucki, *The Law in Lawyers' Heads*, *supra* note 12, at 1522–24 (discussing this terminology).

Even if these responses are implemented, they are unlikely to rescue the liability system. Strategies are available by which participants could continue to render themselves judgment proof. The ultimate causes of this system failure are that: (1) the system is unwilling to bar those without wealth from engaging in liability-producing activity; and (2) the system lacks an effective conceptual framework for attributing wealth to those engaged in liability-producing activity. Mandating a modest level of financial responsibility for everyone engaged in liability-generating activity<sup>14</sup> might preserve the liability system, but only as a ghost of its former self.

Finally, it should be noted that only tort and statutorily imposed liability are at risk of death. 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. The result is a system in which shareholders of closely held companies have limited liability to their tort creditors, but unlimited liability to their bank lenders.<sup>15</sup> To return to the poker metaphor, tort liability is confined to the chips in the pot, while contract liability reaches into the players' pockets and may even tap their friends and family.

The argument proceeds in four parts. Part I describes nine basic principles on which the liability system is constructed, and which serve as the foundation for judgment-proof structures. Part I also explores the difficulty of altering each principle, should such alteration be considered a desirable means of undermining judgment-proofing strategies. Part II describes the four basic types of structures that permit a business or person to engage in liability-generating economic activity without vulnerability to money judgments. Part III identifies the economic, social, and cultural constraints on the use of judgment-proofing strategies and demonstrates how those constraints have been undermined by computer technology. Part IV describes some radical changes the system might make in response to judgment proofing and the strategies that potential debtors could employ to nullify each. While predictions regarding these future events are necessarily somewhat speculative, it would appear that changes in technology that have already occurred probably make it impossible to maintain the liability system in anything like its current form.

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14. See Richard A. Posner, *The Rights of Creditors of Affiliate Corporations*, 43 U. CHI L. REV. 499, 520 (1976) (proposing that every corporation engaged in dangerous activity should be required to post bond equal to highest reasonable estimate of its probable tort liability)

15. As it currently operates, this system can be deceptive. Contracting parties rely on their right to sue, only to learn that their debtor is judgment proof and others, who appeared to have taken the same risks, protected themselves in other ways. Once judgment proofing becomes the norm, the system likely will be less deceptive; contracting parties will know that they have no recourse except that provided in their contract.



## I. LIABILITY SYSTEM PRINCIPLES

The operation of a law-related system typically requires cooperation among a large number of people. To achieve that cooperation, systems operate according to basic principles that are few in number and remain stable over time. Participants in the systems may or may not be conscious of the principles they follow.<sup>16</sup> Sometimes the principles will be expressed in maxims, adages, or black letter rules of law.<sup>17</sup> But just as often they are so deeply embedded in the systems and the minds of participants that they go virtually unnoticed.<sup>18</sup> The principles do not necessarily govern every circumstance, but exceptions must be few enough and sufficiently intuitive that they will not confuse participants or inhibit system operation.

Changes in such basic principles are difficult to make. The principles usually reflect deeply held values. The principles may coordinate elements of the system so that any change in them leads by a sort of domino effect to the necessity for other changes. Alteration of principles central to participants' understanding of the system may confuse the participants and slow or muddle system operations. Changes in the basic principles underlying a law-related system occur, but seldom quickly. Often the change is accompanied by legal fictions that provide participants with a stable conceptual framework in which to understand the system even while the reality of system operation is in flux. For reasons I have explained elsewhere, these basic principles exist largely independently of the written law and may be resistant to change through formal legal process.<sup>19</sup>

The nine principles described here provide not only the foundations for strategies that render debtors judgment proof, but also the foundations of the system itself. Changes in these principles could render those strategies ineffective. But because of the system trauma involved in making such basic changes, the system will tolerate considerable amounts of system-unintended strategic activity before making changes.<sup>20</sup>

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16. See, e.g., Gary L. Blasi, *What Lawyers Know: Lawyering Expertise, Cognitive Science, and the Functions of Theory*, 45 J. LEGAL EDUC. 313, 384 (1995) ("The most fundamental 'superschemas' in the culture, by whatever name, are so pervasive and intrinsic to the conventions of thought that we are quite unaware of them. For this reason, the 'paradigms' in every field are generally described as they become history.").

17. Examples include the rule that shareholders are not liable for the debts of a corporation and the rule that one who does not have title to property cannot give title to it. The latter is usually referred to as the rule of *nemo dat qui non habet*. BLACK'S LAW DICTIONARY 1037 (6th ed. 1990) ("He who hath not cannot give.").

18. Examples of such deeply embedded principles include the principle that all property is owned by some person or entity and the principle that rights that are not property cannot be taken for debt, even though they might be valuable and transferable. Examples of such "nonproperty" include a celebrity's right to exploit his or her own image and various kinds of revocable government licenses. See LOPUCKI & WARREN, *supra* note 8, at 243-50.

19. See LoPucki, *The Law in Lawyers' Heads*, *supra* note 12.

20. See *id.* at 1533-41 (defining system-unintended strategy as strategy that designers of system do not intend to promote).

### A. *Enforcement Only Against Property*

Courts will enforce a judgment for civil liability against specific property of the debtor, but not against the person of the debtor. That is, the sheriff will take property of the debtor and sell it to satisfy the judgment, but the sheriff will not arrest or incarcerate the nonpaying debtor. Threatening to seize and incarcerate nonpaying debtors probably would be an effective means for the system to coerce the payment of liability. But to incarcerate debtors without first identifying specific property that each could apply against the debt risks the incarceration of some persons who cannot pay.<sup>21</sup> Though some vestiges of older practices remain,<sup>22</sup> imprisonment for debt offends deeply held American values.<sup>23</sup>

### B. *Property of the Debtor*

The holder of a judgment is entitled to proceed only against property owned by the debtor. Efforts to enforce against natural persons other than the debtor historically focused on debtors' spouses. By the end of the nineteenth century, the women's movement had established a clear norm in favor of the separate ownership of property by a spouse.<sup>24</sup> One effect has been to solidify the concept of separate ownership by children, other relatives, and even closest friends. It is now clear that one member of a household or close social group

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21. The law of some states does permit the court to order a debtor to surrender specific property and authorizes imprisonment of the debtor for contempt of court if the debtor does not comply. See *infra* note 165 and accompanying text. Unless specific property has been identified, the debtor might not have the present ability to comply and, therefore, use of the contempt power would be inappropriate. See *infra* note 166 and accompanying text.

22. The movement to eliminate imprisonment for debt had its roots in colonial times, and by the early 1900s, many states already had taken steps to eliminate "debtors' prisons." PETER J. COLEMAN, *DEBTORS AND CREDITORS IN AMERICA* 249-68 (1974). In some states, the abolition does not reach all types of debt for which one might be imprisoned. See, e.g., OR. CONST. art. I, § 19 ("There shall be no imprisonment for debt, except in case of fraud or absconding debtors."). Compare WIS. CONST. art. I, § 16 ("No person shall be imprisoned for debt arising out of or founded on a contract, express or implied"), with WIS. STAT. ANN. § 898.01-31 (West 1983); *id.* § 898.01 (providing procedures for release of persons "confined in jail on an execution issued on a judgment recovered in an action founded on a tort"). Some jurisdictions provide for both the imprisonment of debtors and their subsequent release once the court is satisfied that they have surrendered their property. See, e.g., N.J. STAT. ANN. § 2A:20-1 (West Supp. 1995) ("Any person, in actual confinement for debt or damages in any jail of this state, who is willing to deliver up to his creditor or creditors all his estate, both real and personal, toward their payment, may bring an action, in a summary manner, for his discharge under this chapter, in the superior court."); Paul Marcotte, *Debtor's Prison?: Court Jails N.J. Man Until He Discloses Assets, Posts Bond*, A.B.A. J., Feb. 1990, at 28 (reporting refusal of bankruptcy judge to intervene to free debtor jailed by state court on "body execution").

23. Cf. ALEXANDER M. BICKEL & BENNO C. SCHMIDT, JR., *THE OLIVER WENDELL HOLMES DEVISE HISTORY OF THE SUPREME COURT OF THE UNITED STATES* 820-907 (1984) (discussing Supreme Court's development of rule prohibiting "peonage," or debt slavery).

24. "[P]rompted by a desire to protect a wife's property from her husband's creditors, as well as to give her legal autonomy," all common law property states enacted Married Women's Property Acts between 1839 and the end of the nineteenth century. JESSE DUKEMINIER & JAMES E. KRIER, *PROPERTY* 368 (3d ed. 1993).

may own property of unlimited value while another owns nothing and is therefore judgment proof. The same is true of artificial entities recognized by law. A judgment against one corporation ordinarily cannot be enforced against its parent, wholly owned subsidiary, sister corporation, or shareholder.<sup>25</sup>

### C. *Transferability of Property*

To the extent that property is unencumbered and therefore vulnerable to liability, the owner can sell it or use it to make payment to a favorite creditor. Such a transfer is effective instantly to defeat enforcement against the property.<sup>26</sup> Reversal of an initially effective transfer is sometimes possible, but the right to reversal is riddled with exceptions and the procedures for reversal are sufficiently burdensome that reversals are relatively rare.<sup>27</sup> The reason for imposing such heavy burdens on those who would upset transfers is to protect transferees. Until a transferee can rely on a transfer, title to the property is clouded by possible claims for reversal.

### D. *Exemption*

The legislatures of each of the fifty states have enacted laws exempting specified property from procedures to enforce a judgment for money damages.<sup>28</sup> In most states, the exempted property is limited to specific categories and moderate dollar values. But some states deliberately exempt property of substantial dollar value and most states recognize at least one category of property that is exempt without limitation as to value. For example, in Florida and Texas, debtors are able to exempt homesteads worth millions

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25. The holder of a judgment may, however, enforce it against property formerly owned by the debtor that the debtor has fraudulently transferred to a third party. *See* UNIF. FRAUDULENT TRANSFER ACT § 7, 7A U.L.A. 660 (1984) (outlining creditors' remedies for fraudulently conveyed property).

26. To illustrate, assume that an unsecured creditor obtains a judgment against the debtor, obtains a writ of execution from the clerk of the court, and is about to levy. The debtor can defeat that levy by transferring his property to a competing creditor in satisfaction of the competing creditor's bona fide debt. The transfer is not fraudulent because the law deems it to be for "value." *See* UNIF. FRAUDULENT TRANSFER ACT §§ 3(a), 4(a)(2), 5(a), 7A U.L.A. 650-57 (1984). If the transfer is as security, the secured creditor need only file a financing statement in the public records to perfect it before the levy occurs and the transfer will defeat the levy. *See* U.C.C. § 9-301(4) (1994). The progress an unsecured creditor makes through years of litigation can be defeated by acts that the debtor and favorite creditor can perform in a few minutes.

27. One ground for reversal might be that the transfer is avoidable in bankruptcy as a preference. But to avoid the transfer on that ground, the judgment creditor may face the formidable task of forcing the debtor into bankruptcy by the preference deadline, winning the preference litigation, and then collecting the resulting judgment of avoidance, which is itself an unsecured debt. *See* LOPUCKI, STRATEGIES FOR CREDITORS, *supra* note 12, at §§ 2.8-2.9. Strategies exist by which sophisticated debtors and their favorite creditors can insulate their transaction against later preference avoidance. *See id.* §§ 2.4.1, 2.16.3.

28. *See* 7 COLLIER ON BANKRUPTCY (Lawrence P. King ed., 15th ed. 1995) (setting forth text of exemption laws of all 50 states).

of dollars from the enforcement of nearly all judgments for civil liability.<sup>29</sup> The laws authorizing such exemptions reflect long-standing, politically vibrant beliefs that debtors' personal lives should not be disrupted because the debtors have failed to pay their debts. Political efforts at the national level to rein in the states with the most liberal exemption laws have been unsuccessful.<sup>30</sup>

### E. *Subordination*

A judgment for civil liability is merely an unsecured debt. The holders of valid security interests, liens, and bankruptcy priorities are entitled to absolute priority over unsecured debts. That is, the value of collateral is considered a fund available to pay creditors. The fund is applied first to the claims of secured creditors until they have been paid in full. Unsecured creditors can recover from the collateral only to the extent of the value, if any, in excess of the amounts owed to secured creditors. If the amount of the secured debts equals or exceeds the value of the collateral, unsecured creditors recover nothing. To illustrate the principle of subordination, assume that a debtor owns only a single, nonexempt asset worth \$100,000. The debtor paid \$80,000 of the purchase price of the asset with the proceeds of a mortgage taken for that purpose and paid the remaining \$20,000 from savings. Later, a court enters a judgment against the debtor for tort damages in an amount exceeding the debtor's insurance coverage by \$400,000. The judgment creditor can enforce the judgment against the asset, but the mortgage creditor is entitled to the first \$80,000 of proceeds. The judgment creditor receives the balance of the proceeds, \$20,000, just five cents on the dollar. Among the many arguments used to justify this striking result, two are particularly powerful. The first is that without priority, mortgage and other secured lending would be unavailable.<sup>31</sup> Lenders would withdraw from the market because the mere entry of judgments such as the one in this illustration would virtually extinguish their interests. The second is that the priority of the secured lender does not harm the later judgment creditor; without the value furnished by the secured lender the debtor would not own the property at all.<sup>32</sup>

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29. See FLA. CONST. art. X, § 4; TEX. PROP. CODE ANN. §§ 41 001–002 (West Supp 1995), see also Larry Rohter, *Rich Debtors Finding Shelter Under a Populist Florida Law*, N Y TIMES, July 25, 1993, § 1, at 1 (discussing purchase by debtors of multimillion dollar homes in Florida)

30. See *infra* notes 135–36 and accompanying text.

31. See, e.g., Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 941–46 (1985) (claiming that lenders will not lend without security).

32. In this passage I have attempted to present the argument for the principle of subordination in its strongest terms. Elsewhere I have argued that involuntary creditors should have priority over secured creditors. See Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA L. REV. 1887, 1908–16 (1994)

## F. *Discharge on Demand*

Debtors are entitled to discharge their debts at any time by filing a bankruptcy case.<sup>33</sup> The justification for this seemingly liberal rule is that discharge does not harm creditors because it is accompanied by application of all property the system can reach to the debtor's debts. In the context of the bankruptcy of a large, insolvent company that continues to operate, the principle effectively means that all debts are discharged,<sup>34</sup> but the creditors become the owners of the company.

In the case of a natural person, the principle is altered in two significant respects. First, the property applied does not include the debtor's future earnings from personal services or the debtor's exempt property.<sup>35</sup> This reservation of future earnings exclusively and inalienably to the debtor is the "fresh start" that has been a driving tradition of American bankruptcy law. The system provides a fresh start at least partly because of the difficulty of denying it. Debtors who could neither pay nor discharge their debts might adopt a judgment-proof lifestyle, adopt a new identity, or join the underground economy. Both debtor and creditor might spend considerable efforts on a struggle that yielded less for the creditor than it cost the system in the aggregate. Furthermore, certain debts, including debts incurred through fraud or for willful and malicious torts, are excepted from discharge.<sup>36</sup>

## G. *Productive Use*

During enforcement, bankruptcy courts always stand ready to permit and provide for the continued productive use of the debtor's property. Thus a business that files for protection under Chapter 11 of the Bankruptcy Code can continue to operate under the protection of the bankruptcy court.<sup>37</sup> The rule maximizes the value available for distribution to the creditors.<sup>38</sup>

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33. The typical statement of this principle restricts its benefit to "honest" debtors. The restriction is largely rhetorical. See LoPucki, *The Law in Lawyers' Heads*, *supra* note 12, at 1552 (explaining how bankruptcy procedures enable most dishonest debtors to qualify for discharge).

34. See 11 U.S.C. § 1141 (1994) (stating that confirmation of reorganization plan "discharges the debtor from any debt that arose before the date of such confirmation" and providing no exception for debts incurred through fraud or even criminal wrongdoing).

35. See *id.* §§ 541(a)(6), 552(b); see also ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 220, 246 (3d ed. 1996) (explaining operation of Bankruptcy Code).

36. See 11 U.S.C. § 523(a).

37. See *id.* § 1108 ("Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business.").

38. See Warren, *supra* note 8, at 350-52 (describing policy behind productive use as preservation of value of business or assets).

## H. *Enforcement Only After Judgment*

Except in exigent circumstances, obligations for civil liability are enforced only after entry of a judgment. Enforcement prior to the entry of judgment is discouraged because the plaintiff might not be entitled to a judgment at all and early enforcement might harm the debtor. The state legislatures have enacted exceptions to this principle, authorizing prejudgment attachment and garnishment in those rare cases where a plaintiff can prove that the defendant is deliberately in the process of becoming judgment proof.<sup>39</sup> The Supreme Court has generally upheld the laws creating these exceptions,<sup>40</sup> but the exceptions are narrow and rarely used.<sup>41</sup>

## I. *Territoriality*

As an initial matter, a judgment can be enforced only within the territorial jurisdiction of the court that entered it. To enforce against property in another jurisdiction, the holder must establish its judgment in that jurisdiction. The “full faith and credit” clause of the United States Constitution assures that a judgment of one state will be enforced in the courts of another; the principle merely requires formal proof of the existence and validity of the judgment. Foreign countries, however, may require that the underlying cause of action be relitigated. The United States is not yet party to any treaties for the enforcement of judgments.<sup>42</sup>

From the foregoing discussion, it should be apparent that these nine principles are sufficiently basic that the system is unlikely to change them merely because they enable some debtors to defeat liability through judgment-proofing strategies.<sup>43</sup> Yet, as the next Part will show, adherence to these principles renders the liability system itself vulnerable to defeat.<sup>44</sup>

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39. See, e.g., FLA. STAT. ANN. §§ 76.04–05 (West Supp 1995) (stating grounds for attachment), TEX. CIV. PRAC. & REM. CODE ANN. § 61.001 (West 1986) (same)

40. See *Connecticut v. Doehr*, 501 U.S. 1, 16 (1991) (“Our cases have recognized [that a properly supported claim showing planned activities that would render the debtor judgment proof by the end of the pending litigation] would be an exigent circumstance permitting postponing any notice or hearing until after the attachment is effected.”); *Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974) (upholding statute that provided for seizure of property without notice to owner debtor)

41. See Rhonda Wasserman, *Equity Renewed. Preliminary Injunctions to Secure Potential Money Judgments*, 67 WASH. L. REV. 257, 276 (1992) (“Many states authorize attachment only in certain kinds of cases—in contract actions, for example.” (footnotes omitted)) *But see* ILL. COMP. STAT. ANN. 5/4-101 (West 1992) (providing for attachment in cases sounding in contract or tort)

42. See Michael W. Gordon et al., *Arbitration of Commercial Disputes in Mexico and the United States: A Panel Discussion*, 2 U.S.-MEX. L.J. 111, 124 (1994) (“The United States is not party to any . . . bilateral or multilateral treaty for the enforcement of foreign judgments.”)

43. The possibility of change because they enable *all* debtors to defeat liability is explored in Part IV

44. In the discussion that follows, the principles will be referred to by the headings under which each was presented in this Part.

## II. JUDGMENT-PROOFING STRATEGIES

The liability system works solely through the entry and enforcement of money judgments. Debtors can defeat it by rendering themselves judgment proof. Judgment-proofing strategies are of four basic types: secured debt, third-party ownership, exemption, and foreign haven.

### A. Secured Debt Strategies

Secured debt strategies are the most complex and the most common of the judgment-proofing strategies. They are employed primarily by small, relatively uncreditworthy businesses, whose lenders insist on security interests. They are constructed from the three basic principles of subordination, productive use, and discharge on demand. The debtor becomes judgment proof by incurring secured debts in amounts exceeding the liquidation values of the debtor's properties.<sup>45</sup> Money judgments thereafter enforced against the debtor's properties are subordinate to the secured debt.<sup>46</sup> Enforcement is by liquidation of the debtor's property. Pursuant to the principle of subordination, the proceeds of liquidation go first to pay the secured creditors. Because the proceeds are less than the secured debt, no balance remains to be paid to the holder of the money judgment.<sup>47</sup> It follows that the holder of the money judgment cannot obtain full or even partial payment by exercising its legal remedies. The buyer at the sale of fully encumbered collateral will own the property and the judgment creditor will receive nothing.

Because it is costly and risky for a judgment creditor to liquidate the assets of its debtor and the judgment creditor recovers nothing anyway, judgment creditors who understand the system often give up without liquidating their debtors.<sup>48</sup> They simply write off the debt. When judgment creditors and

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45. In most kinds of businesses, "secured" loans in amounts that exceed the liquidation value of the collateral are not difficult to obtain. See WARREN & WESTBROOK, *supra* note 35, at 5 (citing Bank of America lending guide to effect that pledge of "all the assets in the business . . . generally is insufficient value to pay off the loan"). The lender understands that it will be partially unsecured in the event of liquidation, but bases the amount of the loan on the earning capacity of the business and charges a higher rate of interest to compensate for the additional risk. In some kinds of businesses—principally those in which the sole asset is real property—lenders typically seek to lend only the liquidation value of the collateral. If they lend precisely the liquidation value, that is sufficient substantially to judgment proof the debtor. If the debtor wants a loan in excess of the liquidation value, the debtor may be able to obtain it by providing the lender with personal guarantees, letters of credit, or other sufficient "credit enhancements."

46. See *supra* note 32 and accompanying text.

47. For simplicity, I have assumed that the holder of the first security interest exercises its rights to foreclose. If the holder of the first does not, the procedure is more complicated, but the result is the same. The value of the collateral is applied first to the most senior lien, then to subordinate liens in their order of priority until the value is exhausted or all liens have been paid. Only the balance is available to satisfy the new money judgment. See LOPUCKI & WARREN, *supra* note 8, at 527–31.

48. See Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 844 (1991) ("General creditors need not, and often do not, seek the aid of the courts and their officers to coerce repayment of delinquent debts."). For an economic model that attempts to identify the circumstances in which tort claimants should drop their cases, see Kathryn E.

potential judgment creditors behave in this manner, their debtors can continue in business indefinitely without paying their debts.

Some judgment creditors will attempt to liquidate their debtors. Those debtors can still prevail by any of three strategies. First, the debtor who has the cooperation of a strategically placed secured creditor can enlist the secured creditor's help in blocking the judgment creditor's levy. In recent years, several courts have held that a secured creditor whose own debt is in default has the right to possession of its collateral and that the right primes even the right of a sheriff who would seize the property under a judgment creditor's writ of execution.<sup>49</sup>

Second, the debtor may allow the sale to take place, but in some indirect manner become a purchaser at the sale.<sup>50</sup> Sale of the property will move ownership to a new legal entity, leaving the debt behind in the old. For this strategy to succeed, the debtor must find a surrogate to purchase the property for it and must prevent the judgment creditor from purchasing at the sale. In the most common circumstance, where the debtor is itself a corporation, the surrogate may be another corporation created specifically for that purpose and owned by the owners of the debtor or its managers. The surrogate can then permit the debtor to continue using the property, as a gift or in return for periodic payment of rent. The principle of enforcement only against the judgment debtor insulates the surrogate's interest from further attempts at enforcement of the judgment against the same property.

Theoretically, a judgment lien creditor could defend its position by becoming a bidder at the sale. If it bid the amount of its own lien and all prior liens, one of two outcomes would obtain. Either it would win the bid and acquire the property for a cash outlay equal to the prior liens, or someone else would bid higher and the judgment creditor would be paid in full. To put it another way, by "bidding in" the amount of its own debt in this manner, the judgment creditor can either assure its own payment in full or the debtor's loss of its property. For a debtor threatened with such a deprivation, one strategic

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Spier & Alan O. Sykes, *Capital Structure, Priority Rules, and the Settlement of Civil Claims* (Sept. 1995) (unpublished manuscript, on file with the *Yale Law Journal*)

49. See, e.g., *Security Pac. Bank v. Haines Terminal Highway Co.*, 869 P.2d 156, 158 (Alaska 1994) (stating in dicta that "the trial court properly held that [the judgment creditor] could not 'attach property that is subject to a security interest when that security interest is larger than any of the debtor's interests'" (citation omitted)); *Grocers Supply Co. v. Intercity Inv. Properties, Inc.*, 795 S.W.2d 225, 227 (Tex. Civ. App. 1990, no writ) (holding judgment creditor who did not notify secured creditor before levying against collateral liable for secured creditor's damages in recovering property from judgment creditor). However, the judgment creditor may eventually be able to force the sale. See *Frerenson v. United Farm Agency*, 868 F.2d 302, 305 (8th Cir. 1989) (holding that secured creditor can prevent execution only for purpose of enforcing its own interest, not to leave debtor in control).

50. This strategy dates at least from the equity receiverships of the late nineteenth century. See Theodore Eisenberg, *Baseline Problems in Assessing Chapter 11*, 43 U. TORONTO L.J. 633, 642 (1993) ("Indeed, the entire receivership procedure often was structured to assure that one and only one purchaser—the reorganization committee—could purchase the assets.") It continues in use today. See LOPUCKI, *STRATEGIES FOR CREDITORS*, *supra* note 12, at § 11.11.2 (describing use of strategy in cases under Chapter 11 of Bankruptcy Code).



solution is to make sure that the amount of the prior liens *exceeds* the value of the property. To defeat the debtor's judgment-proof structure by acquiring the property, the judgment creditor would then have to pay *more than* its value.<sup>51</sup>

For a debtor who can purchase its property at the sale by surrogate, a sheriff's sale becomes a device for freeing the property from the claims of judgment creditors. Not only can the debtor's surrogate obtain the property free of liens, but it often can get it for a fraction of its market value. State court supervision of sales is generally restricted to assuring that formal procedures have been followed and bidding has not been restrained by collusion. Sale procedures are highly formalistic and not reasonably calculated to expose the property to the market,<sup>52</sup> making collusion unnecessary. Debtors are often the only persons sufficiently familiar with their property to bid on it. Even the judgment creditor may find it difficult to get information about the property.<sup>53</sup> Courts routinely confirm foreclosure and execution sales in which the high bid is only a fraction of market value.<sup>54</sup> In partnerships with new financiers, debtors are often successful in reacquiring their properties at bargain prices, stripped of the judgment liens against them. In a common variant of this strategy, the secured creditor purchases at the sale and then transfers the property to the debtor's surrogate in accord with an agreement reached between them prior to the sale.<sup>55</sup> For the strategist *ex ante*, the effect of a bargain price at sale is to reduce the level of secured credit necessary to create a judgment-proof structure.<sup>56</sup>

In many circumstances, the strategy of stripping judgment liens from property through state court sales will not work. The sheriffs who conduct the

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51. To illustrate, a debtor with property worth \$100 grants a security interest to secure a debt in the amount of \$120. At any sale of this property, the secured creditor will be entitled either to have its lien survive the sale or to bid in at prices up to \$120, without having to pay in additional capital. See LOPUCKI & WARREN, *supra* note 8, at 527-31. To acquire this property by bidding at a sale, a subsequent judgment creditor probably will have to pay \$120, more than the property is worth.

52. See *id.* at 71-83.

53. See *id.* at 78-82.

54. See, e.g., *In re T.F. Stone Co.*, 72 F.3d 466 (5th Cir. 1995) (declining to set aside tax sale of property for \$325 even though property was soon resold for \$39,500 because tax sale was for "reasonably equivalent value" within meaning of fraudulent transfer law). Until recently, bankruptcy courts attempted to maintain sale prices in these state courts by standing ready to set aside state court sales for less than 70% of market value in a bankruptcy case filed within one year. See, e.g., *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 204 (5th Cir. 1980) (setting aside foreclosure sale). The Supreme Court recently barred the bankruptcy courts from setting aside regularly conducted, noncollusive state court foreclosure sales of real estate, regardless of the prices obtained. See *BFP v. Resolution Trust Corp.*, 114 S. Ct. 1757, 1767 (1994).

55. One practitioner estimates that 80% of financial distress situations involving less than three million dollars in assets are resolved by this method, principally because the parties feel that the cost of Chapter 11 is unjustified. Telephone Interview with David Lander, Partner, Thompson & Mitchell, St. Louis, Missouri (June 13, 1996).

56. To illustrate, assume that property has a market value of \$100, but would sell for \$70 in a judicial sale. By granting a mortgage against the property in the amount of \$75, the debtor creates a judgment-proof structure. That is, if judgments are later entered against the debtor, the alliance of debtor and secured creditor can control the property by purchasing it at sale for \$75.

sales may insist on interfering with the debtor's possession of the property and operation of the business between the time of the levy and the time the state court confirms the sale.

In those circumstances, debtors can employ a third and even more powerful strategy for defeating subordinate lien creditors. Under the principle of productive use, the bankruptcy court will permit a debtor to operate its business while attempting to sell it.<sup>57</sup> Thus protected, the debtor can propose a plan of reorganization that provides for the sale of the property to the new entity owned by the insiders, for an amount modestly below market value.<sup>58</sup> Provided that value is less than the amount of the prior liens, pursuant to the principle of subordination, the judgment creditor recovers nothing from the bankruptcy proceeding. Thus, Chapter 11 enables the debtor to strip from its property liabilities in excess of the property's value, even without the formality of a sale. It permits the debtor to do directly what it could do indirectly under state court or bankruptcy liquidation procedures.<sup>59</sup> By confirmation of a Chapter 11 plan, the debtor can reduce its total debt to the value of its property and reschedule that debt for future payment. The owner-managers of a debtor corporation ordinarily can retain ownership and control through Chapter 11.<sup>60</sup>

A debtor that enters Chapter 11 with secured debt exceeding the liquidation value of its collateral is likely to emerge with secured debt approximately equal to the value of that collateral.<sup>61</sup> The effect is that the emerging debtor is also judgment proof. If it incurs post-bankruptcy liabilities,

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57. See 11 U.S.C. § 1108 (1994) (providing for continued operation of debtor's business in bankruptcy reorganization); *id.* § 1123 (providing that reorganization plan may provide for sale of "all or any part of the property of the estate").

58. See, e.g., *In re Met-L-Wood Corp.*, 861 F.2d 1012, 1019 (7th Cir. 1988) (refusing to invalidate sale in which owner of debtor corporation purchased property through agent who did not disclose that owner was purchaser, because owner outbid at least one disinterested competitor).

59. See 11 U.S.C. § 1129(b) (mandating that court confirm plan of reorganization that respects rule of absolute priority among claims and interests). Provided that the debtor's assets are fully encumbered, that section mandates confirmation of a plan that provides no distribution to junior judgment lienors. See WARREN & WESTBROOK, *supra* note 35, at 713-14; see also LOPUCKI, STRATEGIES FOR CREDITORS, *supra* note 12, at § 11.11.2 (describing strategies by which debtor can strip liabilities through Chapter 11, without losing control of property).

60. See *In re Landau Boat Co.*, 8 B.R. 436 (Bankr. W.D. Mo. 1981), *In re Landau Boat Co.*, 13 B.R. 788 (Bankr. W.D. Mo. 1981) (confirming plan of reorganization that sold company to four members of board of directors); LOPUCKI, STRATEGIES FOR CREDITORS, *supra* note 12, at § 11.11.2 (describing commonly used methods for retaining ownership and control), Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM BANKR LJ 247, 264 (owner-managers retained control of 86% of businesses that closed during Chapter 11 and 75% of businesses that survived Chapter 11).

61. A creditor secured under nonbankruptcy law has, in bankruptcy, a secured claim for the amount of the debt or the value of the collateral. See 11 U.S.C. § 506(a). Even in a cram down (in which a bankruptcy court imposes a reorganization plan on the parties), the holders of secured claims are entitled to "retain the liens securing such claims . . . to the extent of the allowed amount of such claims." *Id.* § 1129(b)(2)(A)(i)(I). The emerging debtor has, in essence, 100% secured financing. See *In re E I Parks No. 1 Ltd. Partnership*, 122 B.R. 549, 554 (Bankr. W.D. Ark. 1990) (noting that debtor is receiving what amounts to 100% financing).

it can file another Chapter 11 case, and strip those liabilities from the assets.<sup>62</sup> This judgment-proof structure can operate perpetually.

The secured debt strategy is a relatively recent phenomenon. It is effective only in a system that permits debtors to encumber all, or substantially all, of their assets.<sup>63</sup> The Uniform Commercial Code was adopted widely during the 1960s. Prior procedures for granting security had been cumbersome, there had been gaps in authorizing legislation, and security interests in some kinds of assets had been of dubious validity.<sup>64</sup> The amounts of the secured debts of small businesses generally were considerably less than the values of their assets, so that forced liquidations resulted in substantial distributions to unsecured creditors.<sup>65</sup> Against that background, the drafters of the U.C.C. set out "to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty."<sup>66</sup> They largely succeeded in their effort. The effect was to increase dramatically the proportion of encumbered assets in the American economy. The change appeared first in bankruptcy liquidations.<sup>67</sup> Early bankruptcy liquidations produced at least some distributions to creditors in the majority of cases. By 1976, the percentage of bankruptcy liquidations in which there was a distribution to unsecured creditors had fallen to twenty percent,<sup>68</sup> by 1991–92 it had sunk to five percent.<sup>69</sup> In 1926–27, unsecured creditors recovered over twenty-seven cents on the dollar in assignment liquidations,<sup>70</sup> over ten cents on the dollar in involuntary bankruptcy liquidations, and about six and one-half cents on the dollar in voluntary

62. A Chapter 11 followed shortly thereafter by another for the same debtor has become known in the bankruptcy community as a "Chapter 22." *See, e.g.,* *Oliver v. Kolody*, 142 B.R. 486, 487 (Bankr. M.D. Fla. 1992) ("This is a Chapter 22 case . . . in that this is the second Chapter 11 case in which the Debtor seeks relief under Chapter 11 of the Bankruptcy Code.").

63. In a Chapter 11 case, unsecured creditors are entitled to the value of any unencumbered assets. *See* 11 U.S.C. §§ 1129(a)(7), (b)(2)(B).

64. *See* U.C.C. § 9-101 cmt. (1992).

65. *See, e.g.,* Thomas C. Billig, *What Price Bankruptcy: A Plea for "Friendly Adjustment"*, 14 CORNELL L.Q. 413, 436 (1929) (presenting data from liquidations in 1926 and 1927 showing unsecured creditors receiving 43% of dividends paid in bankruptcy cases and 73% of dividends paid in assignments for benefit of creditors).

66. U.C.C. § 9-101 cmt.

67. *See, e.g.,* Vern Countryman, *Code Security Interests in Bankruptcy*, 75 COM. L.J. 269, 269 (1970) ("[M]any practitioners and bankruptcy referees tell me . . . more and more bankruptcy cases emerge with every scrap of the bankrupt's property covered by some sort of a Code security interest . . . . That means, of course, that nothing will be distributed to any unsecured creditor, with or without priority.").

68. *See* ADMINISTRATIVE OFFICE OF THE U.S. COURTS, TABLES OF BANKRUPTCY STATISTICS 8–9 (1978) [hereinafter *BANKRUPTCY STATISTICS*].

69. *See* U.S. GEN. ACCT. OFFICE, CASE RECEIPTS PAID TO CREDITORS AND PROFESSIONALS 1 (July 1994); *see also* Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984–87*, 22 U. RICH. L. REV. 303, 316 (1988) (finding that 4.4% of Chapter 7 cases in study period resulted in distributions to unsecured creditors).

70. *See* Billig, *supra* note 65, at 433. An "assignment liquidation," more commonly referred to today as an "assignment for the benefit of creditors," is a legal proceeding by which a debtor assigns all of its nonexempt assets to a trustee. The trustee liquidates the assets and distributes the proceeds to creditors in accord with their priorities. *See* WARREN & WESTBROOK, *supra* note 35, at 192–94.

bankruptcy cases. By 1976, the average recovery in all bankruptcy cases had fallen to less than one cent on the dollar.<sup>71</sup>

Persuaded that expansion of secured debt is good for the economy, the Reporters for the Permanent Editorial Board Article 9 Study Committee have sought to make the transfer of a security interest "as easy, inexpensive, and reliable as possible."<sup>72</sup> In furtherance of that agenda, the Article 9 Study Committee has sought to eliminate nearly all of the remaining exclusions of personal property from the scope of an Article 9 security interest.<sup>73</sup> In the near future, security interests that encumber all of the debtor's assets beyond their liquidation value may be even easier to grant, and secured debt judgment-proofing strategies may be even easier to execute.<sup>74</sup>

### B. Ownership Strategies

Lenders to large, highly creditworthy businesses rarely insist on security interests.<sup>75</sup> Judgment proofing is less common among large businesses. When large businesses do judgment proof, they use different techniques. The two

71. See BANKRUPTCY STATISTICS, *supra* note 68, at A-16 (reporting data from which it can be calculated that only 19% of bankruptcy cases resulted in any distribution to general creditors and that, within that subset of cases, average dividend was 4.5 cents per dollar), Herbert & Pacitti, *supra* note 69, at 316 (finding average dividend to unsecured creditors in 4.4% of Chapter 7 cases that produced any dividend at all to be 3.2% of unsecured claims).

72. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2021 (1994) ("[W]e take as our 'first principle' that Uniform Commercial Code Article 9 should facilitate the creation of security interests. Stated otherwise, we think the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible.").

73. See *Report of the Article 9 Study Committee of the Permanent Editorial Board for the Uniform Commercial Code* 43, 48, 50, 56, 60, 67, 68 (Dec. 1, 1992) (arguing for expansion of Article 9 scope in areas of general intangibles, credit card receivables, intellectual property, insurance policies, tort claims, real estate, oil, gas and minerals-related collateral, and deposit accounts), U.C.C. §§ 9-102(a)(2)-(3), 9-104(7), (11), and Alternative B(12) & (13) (Apr. 16, 1996 Discussion Draft) (eliminating portions of exclusions for agricultural liens, payment intangibles, insurance policies, tort claims, and perhaps deposit accounts).

74. This development has prompted at least four proposals to modify the principle of subordination. See Lucian Ayre Bebhuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 909 (1996) (proposing to limit secured status to fixed fraction of amount of secured debt, for example, 75%); LoPucki, *supra* note 32, at 1907-16 (proposing to give involuntary creditors priority over secured creditors); Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Flipping Lien Priority*, 75 TEX. L. REV. (forthcoming 1996) (proposing that mechanic's liens have priority over construction mortgages); Memorandum from Elizabeth Warren, Leo Gotlieb Professor of Law, Harvard University, to Council of the American Law Institute (Apr. 25, 1996) (proposing to limit secured status to 80% of collateral value).

75. See LoPucki, *supra* note 32, at 1925-26 (discussing extent of unsecured lending), *id.* at 1930-31 (speculating that managers of largest companies protect themselves against ouster by causing their corporations to borrow unsecured, even though such borrowing is more expensive); Ronald J. Mann, *Explaining the Pattern of Secured Credit from the Ground Up*, 110 HARV. L. REV. (forthcoming 1997) (presenting evidence that creditworthiness, not size, is principal factor determining whether credit is secured or unsecured and arguing that highly creditworthy debtors are able to borrow unsecured because costs of securing debt exceed risk of loss from nonpayment); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 941 (1986) (arguing that small firms cannot provide proof of capable management or solid base of existing assets, but can offer security).

most common are both based on the principle that liability can be enforced only against property of the debtor. Through both these techniques, debtors arrange their affairs so that the liability-generating entity does not own the most valuable property of the business.

### 1. *Parent-Subsidiary*

In the parent-subsidiary strategy, the debtor isolates the most valuable assets of the business in an entity other than the one that conducts the liability-producing business activity.<sup>76</sup> For example, assume that a large company (Operations, Inc.) sells its products on credit and then borrows from banks against its accounts receivable. To employ a secured debt strategy, the company would grant the banks a security interest in the accounts. To employ the parent-subsidiary strategy, the company incorporates a subsidiary (Finance, Inc.), and retains ownership of all the stock. As Operations sells its products, it creates accounts receivable. Operations sells the accounts to Finance, and distributes any proceeds beyond its immediate cash needs to its shareholders. Under the principle of transferability, both transfers become final as they occur, leaving Operations with minimal assets. Finance pays for the accounts by borrowing on an unsecured basis from a bank. If Operations sells defective products and incurs liability, its creditors eventually will obtain judgments against Operations. They can force the liquidation of Operations's assets, including its shares of stock in Finance. But in the ensuing liquidation of Finance, the bank will have priority over the judgment creditors. The bank claims the assets of Finance as an unsecured creditor while the judgment creditors claim them as a shareholder. Unsecured creditors are entitled to absolute priority over shareholders, so by the principle of subordination the bank prevails and the judgment creditors take nothing.

If the bank makes sure that Finance engages in no liability-generating activities, but is merely a borrower and a repository of accounts receivable, the bank assures itself of priority over any liability the business generates. That is precisely the result obtained through use of the secured debt strategy. But the parent-subsidiary strategy is an ownership strategy rather than a secured debt

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76. Scholars writing about this phenomenon from an economic perspective tend to focus on isolation of risk rather than on isolation of assets. See, e.g., Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1920 (1991) ("[T]he subdivision [of a corporate group into constituent corporations] chosen for purposes of externalizing tort liability is likely to involve a larger number of subsidiaries and perhaps also a different partitioning of functions among them, as the firm tries to segregate its riskiest activities into separate corporations."); David W. Leeborn, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1613-14 (1991) ("A corporation can . . . limit its exposure to tort victims by segregating the business which causes injury into a separate corporate unit."). The difference may seem just a controversy over "half full" or "half empty," but the perspective adopted by these scholars appears to have prevented them from seeing the unrestrained potential of the parent-subsidiary strategy. Once one realizes that assets can be isolated, not just risks, the potential for judgment proofing becomes apparent.

strategy because the bank defeats the judgment creditors by proving ownership by a separate entity rather than subordination to secured debt.

This parent-subsidiary ownership strategy is in wide use among the largest companies in America.<sup>77</sup> Most large companies consist of numerous corporate entities. Limiting liability—that is, defeating part of it—is the principal reason for creating those entities.<sup>78</sup> But the parent-subsidiary strategy itself rarely renders companies entirely judgment proof. Alone, it defeats only liability in excess of the value of the assets of the operating company. Nevertheless, the parent-subsidiary strategy has had a major effect in the bankruptcy reorganizations of large, publicly held companies.<sup>79</sup> Its use in combination with a secured debt strategy can defeat a company's liability entirely.

77. See, e.g., MICHAEL MORITZ & BARRETT SEAMAN, GOING FOR BROKE LEE IACocca's BATTLE TO SAVE CHRYSLER 65–68 (1984) (discussing Chrysler's financial, leasing, and realty subsidiaries, and similar subsidiaries of Ford and General Motors); Lynn M. LoPucki & William C. Whitford, Wickes Companies, Inc. 2 (Oct. 8, 1990) (memorandum, on file with author) (noting that early in Wickes reorganization effort, unsecured creditors of Wickes credit subsidiaries were successful in winning confirmation of plans of reorganization providing them with payment in full); Lynn M. LoPucki & William C. Whitford, White Motor Co. 4 (Mar. 17, 1989) (memorandum, on file with author) (noting early confirmation of similar plan for White Motors credit subsidiary)

78. For example, the Eighth Circuit has written.

The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, on the whole, is socially reasonable and useful. We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment

*Radaszewski v. Telecom Corp.*, 981 F.2d 305, 311 (8th Cir. 1992) See also *In re Acushnet River*, 675 F.Supp. 22, 34 (D. Mass. 1987) (“[T]here is nothing fraudulent or against public policy in limiting one’s liability by the appropriate use of corporate insulation.”) (quoting *Miller v. Honda Motor Co.*, 779 F.2d 769, 773 (1st Cir. 1985)); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 6 (1994) (“The creation of a corporation . . . offers many advantages . . . but its most powerful effect is its insulation of participants from financial responsibility for debts of the enterprise.”); Michael T.K. Horvath & Michael J. Woywode, *Entrepreneurs and the Choice of Limited Liability* (1996) (Working Paper No. 129, John M. Olin Program in Law and Economics, Stanford Law School) (unpublished manuscript, on file with the author) (purporting to prove, from data on German firms, that “riskier firms tend to organize as limited liability firms, controlling for firm size and entrepreneur characteristics”)

Professor Robert Hamilton identifies isolation from the liabilities potentially generated by risky enterprises as the principal reason for maintaining the separate corporations in a corporate group. He also has identified the following as reasons for some separations: tradition, the desire for a separate board and officers; avoiding the jurisdiction of foreign courts; meeting minimum local ownership requirements in foreign countries; blocking the use of names and trademarks by others, and reducing the expenses of transferring the business of a subsidiary upon sale. Telephone Interview with Robert W. Hamilton, Minerva House Drysdale Regents Chair, University of Texas School of Law (July 6, 1995)

79. In our study of the 43 largest bankruptcy reorganization cases of the 1980s, Professor Whitford and I found nine cases—Anglo Energy, Braniff Airlines, Charter Company, Combustion Equipment, Dresco Energy, Evans Products, FSC Corp., HRT, Manville Forest Products, Penn-Dixie, and Wickes Companies—in which the percentage recoveries of unsecured creditors varied substantially depending on which wholly owned member of the corporate group owed the debt. See Lynn M. LoPucki & William C. Whitford, *Valuation Spreadsheets* (various dates in 1988) (unpublished calculations, on file with author) These statistics may understate this strategy’s importance because some members of corporate groups remained outside bankruptcy and paid their creditors 100 cents on the dollar while others paid less. See also *In re Silicone Gel Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1128, 1138 (N.D. Ala. 1993) (refusing to disregard corporate entity of bankrupt Dow Corning to reach parent companies) But see *In re Silicone Gel Breast Implants Prods. Liab. Litig.*, 887 F. Supp. 1455, 1460 (N.D. Ala. 1995) (vacating summary judgment in part to consider holding one parent company liable on “negligent undertaking” theory)

The parent-subsidary strategy is vulnerable to legal attack. In theory, at least, courts can disregard a corporate entity if it is being used too aggressively to defeat liability. But the rhetoric of entity disregard far outstrips the reality. For example, commentators argue that corporate entities should be disregarded more readily in the context of the parent-subsidary relationship<sup>80</sup> and talk of making liability "coextensive with the enterprise."<sup>81</sup> But in his empirical study of 1583 published opinions in corporate disregard cases, Professor Robert Thompson found that plaintiffs more frequently sought disregard of corporations owned by individuals than of those owned by corporations,<sup>82</sup> and courts more frequently ordered disregard of corporations owned by individuals than of corporations owned by corporations.<sup>83</sup> Among tort cases, courts more frequently ordered the disregard of corporations owned by individuals than corporations owned by corporations.<sup>84</sup> Overall, disregard of the entities that compose a corporate group remains very much the exception.<sup>85</sup>

These results are consistent with the legal doctrine governing disregard. To judgment proof a company, the strategist must undercapitalize the liability-generating entity. But one can undercapitalize an entity without rendering its separate existence vulnerable to disregard. Undercapitalization is only one of numerous factors the courts consider in deciding whether to disregard a corporate entity. Alone, it is almost universally regarded as legally insufficient for disregard.<sup>86</sup> For example, Dean Robert Clark has noted that

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80. For a brief survey of such arguments, see Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 173 (1992). See also Thompson, *supra* note 78, at 35 ("Analyzing the parent-subsidary cases under the economic factors discussed earlier . . . the case for limited liability, is, if anything, less persuasive.").

81. Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1131 (1958); see Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 575-76 (1986) (arguing that limited liability within corporate groups is neither historically nor economically justified).

82. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1055 (1991) (786 cases sought disregard to charge individual shareholders, 637 sought disregard to charge corporations).

83. *Id.* (showing piercing rate of 43% against individual shareholders and piercing rate of 37% against corporate shareholders).

84. See Thompson, *supra* note 78, at 23 ("[T]he percentage of courts piercing the veil in tort cases within corporation groups (26.32%) is even less than in all tort cases (30.97%) or all cases involving corporate groups (37.31%)."). Professor Thompson concludes that "there remains a perplexing judicial reluctance to hold a corporate parent liable for the obligations of its subsidiaries when the parent possesses both the opportunity to control and the potential to share in residual earnings of a subsidiary." *Id.* at 5.

85. See, e.g., *NLRB v. Fullerton Transfer & Storage Ltd.*, 910 F.2d 331, 336-39 (6th Cir. 1990) (upholding division of single business among three corporations—one to hire truck drivers, one to own trucks, and one to own real estate—and refusing to enforce NLRB back-pay order, obtained against corporation that hired drivers, against corporations that owned assets); PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROBLEMS IN THE BANKRUPTCY OR REORGANIZATION OF PARENT AND SUBSIDIARY CORPORATIONS, INCLUDING THE LAW OF CORPORATE GUARANTIES* 7, 699-703 (1985) (arguing for use of "enterprise" concept but acknowledging that "entity" concept, which allows disregard only in "exceptional" cases, remains rule in cases involving principle of limited liability).

86. See, e.g., *Alberto v. Diversified Group, Inc.*, 55 F.3d 201, 205 (5th Cir. 1995) (holding that no single factor can justify decision to disregard in Delaware); *In re Vermont Toy Works*, 82 B.R. 258, 307 (Bankr. D. Vt. 1987) ("The conclusion to disregard the corporate entity may not, however, rest on a single factor, whether undercapitalization . . . or what-not . . .") (quoting *DeWitt Truck Brokers v. W. Ray*

undercapitalization “[v]ery rarely, if at all” leads to disregard when other grounds are not present.<sup>87</sup> Thus, the strategist nearly always can prevail by undercapitalizing the company and making sure no other factors favoring disregard<sup>88</sup> are present.<sup>89</sup>

## 2. Asset Securitization

Asset securitization is the issuance of securities representing the ownership of designated assets.<sup>90</sup> In the prototypical asset-securitization transaction, the asset is the accounts receivable of a business. As part of the asset-securitization transaction, the debtor<sup>91</sup> creates a “bankruptcy-remote vehicle,”<sup>92</sup> a separate legal entity, and “sells” the accounts to it. The bankruptcy-remote entity obtains the money to buy the assets through a public or private offering of its own securities. The debtor may continue to service the accounts under contract with the bankruptcy-remote entity, processing payments, dunning customers who fail to pay, and filing lawsuits against some of them. All that necessarily changes is that the debtor no longer owns the accounts.

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Flemming Fruit Co., 540 F.2d 681, 687 (4th Cir. 1976)); *see also* Presser, *supra* note 80, at 165–66 (arguing that undercapitalization alone is not regarded by courts as sufficient grounds for disregard of corporate entity).

87. ROBERT C. CLARK, *CORPORATE LAW* 74 (1986) It is also worth noting that the doctrine of undercapitalization refers only to the initial capitalization of the corporation. *See* Presser, *supra* note 80, at 165. Debtors employing the parent-subsidary strategy may be able to avoid disregard by the simple strategy of initially providing a capitalization which later becomes inadequate by reason of business losses or a change in the nature of the business. Capital withdrawal that left an initially adequately capitalized corporation undercapitalized would arguably be a fraudulent transfer. *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a), 7A U.L.A. 652 (1985). The judgment creditor’s remedies for fraudulent transfer are considerably less effective than those available through disregard of the corporate entity. *See infra* notes 111–16 and accompanying text.

88. One such factor would be the exercise of direct control over the operational decisions made by the subsidiary. *See In re Silicone Gel Breast Implants Prods. Liab. Litig.*, 837 F. Supp. 1123 (N.D. Ala. 1993) (finding insufficient direct control to disregard corporate entity).

89. By this method, the strategist defeats only involuntary and unsophisticated creditors. Sophisticated lenders will require personal guarantees from the owners. *See supra* text accompanying note 15.

90. *See, e.g.*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *STAN. J.L. BUS. & FIN.* 133, 133 n.1 (1994) (defining asset securitization as “a company’s use of cash flows from its assets to raise funding”). Shenker & Colletta define asset securitization as:

[t]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.

Shenker & Colletta, *supra* note 7, at 1374–75.

91. Throughout this Section I refer to the originator of the asset-securitization transaction as the “debtor.” The parties to an asset-securitization transaction would not use that term because they seek to create an owner-account servicer relationship rather than a debtor-creditor relationship. The difference between the two relationships is, however, minimal and does not, in my opinion, justify the confusion that would be created by referring to the user of secured credit as a borrower and the user of assets securitization as an “originator” or some such term.

92. These entities are sometimes referred to as “special purpose vehicles” or “SPVs.” *See* Schwarcz, *supra* note 90, at 135–36 (describing use of “special purpose vehicles” in asset-securitization transactions).



Asset securitization is by far the most rapidly growing segment of the U.S. credit markets.<sup>93</sup> Financial historians have traced asset securitization back more than a century,<sup>94</sup> but the boom in asset securitization began in the 1970s with the U.S. government's efforts to encourage the development of secondary mortgage markets. Once the technique proved successful, it quickly spread to student-loan-backed securities, credit-card-receivable-backed securities and other sectors of finance. From 1990 to 1993, the percentage of all consumer debt that is securitized grew from 10.5% to 15.5%.<sup>95</sup> By 1988, securitized credit obligation issuers accounted for about 15.7% of total net borrowing by financial sectors of the U.S. credit markets; by the second quarter of 1993, they accounted for 38.8%.<sup>96</sup> It has been predicted that by 1997, 80% or more of all new capitalization might be securitized<sup>97</sup>—a prediction that may not be far off.

Asset securitization is both a substitute for borrowing<sup>98</sup> and a powerful new strategy for judgment proofing. Like the parent-subsidiary strategy, the asset-securitization strategy puts ownership of the company's valuable assets in an entity separate from the one that is at risk for liability. The advantage of the asset-securitization strategy over the parent-subsidiary strategy is virtual elimination of the risk that the courts will disregard the entity that holds the assets. Though the bankruptcy-remote vehicle is created pursuant to the debtor's plan, it is not only separately incorporated but is at all times controlled by arms-length investors. The terms of the transaction between the debtor and the bankruptcy-remote vehicle have real economic consequences for both. What is perhaps more important, by the time the issues are litigated, the bankruptcy-remote vehicle may be publicly held, with hundreds or thousands of innocent investors.<sup>99</sup> Considering that even the most provocative division of a company into separate asset-holding and liability-incurring entities—one with one hundred percent congruity of ownership—is likely to be honored by

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93. See, e.g., Fred Vogelstein, *Credit Cards Fuel Asset-Backed Issues*, WALL ST. J., Oct. 30, 1995, at C1 (reporting that original issuance of asset-backed bonds grew at annual rate of 36% for previous two years).

94. See Shenker & Colletta, *supra* note 7, at 1380–81 & n.49.

95. See 80 FED. RESERVE BULL. A-40 tbl. 1.5 ll. 5, 12 (Feb. 1994).

96. *Id.* at tbl. 1.57 ll. 29, 52.

97. See *Changes in Our Financial System: Globalization of Capital Markets and Securitization of Credit: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 137 (1987) (statement of Lowell L. Bryan) (explaining that such increases are made possible by benefits to players and sheer superiority of technology).

98. See Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249, 2267–69 (1994) (recognizing that sales of accounts produce same problems as assignment of accounts as security and advocating public notice through filing for both); Mann, *supra* note 75, manuscript at 13 n.35 (reporting interviews in which debtors indicate that they regard borrowing and selling assets as functionally equivalent methods of financing); Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2294–300 (1994) (criticizing Baird's filing proposals as unnecessary and impractical).

99. See Thompson, *supra* note 78, at 9, 29, 34, 40 (arguing that courts have been rightly reluctant to impose liability on passive shareholders, both in veil-piercing cases and failed leveraged buyouts, and concluding that "the insulation of limited liability should remain undisturbed for passive shareholders").

the courts,<sup>100</sup> it seems unlikely that the courts will consolidate the bankruptcy-remote vehicles created in asset securitizations, which typically have no congruity of ownership with the debtor.<sup>101</sup>

Today, asset securitization is used primarily with regard to obligations owing to the debtor, including accounts receivable, mortgages, student loans, credit card receivables, and commercial loans. But practitioner-commentators stress that any income-producing asset can be securitized, including, as Joseph Shenker and Anthony Colletta suggest, “office buildings, shopping centers and other commercial real estate[, as well as] computer, automobile, equipment, and other leases.”<sup>102</sup> Kravitt, Forrester, and Rosenberg also suggest “previously constructed and operational infrastructure projects such as power plants” can be securitized.<sup>103</sup> Steven Schwarcz notes that securitization techniques have even been applied to assets such as inventories that do not themselves produce a cash flow but will be converted later into assets that do.<sup>104</sup> Transaction costs are probably the only limit on what may be the subject of securitization.<sup>105</sup> By selling any asset to a bankruptcy-remote entity and leasing it back, the debtor can transform it into an “income-producing” asset that can then be securitized. Even a debtor’s bank account, which is both an account and an income-producing asset, might be included.<sup>106</sup>

Through asset securitization, a company potentially could divest itself of all of its assets, yet continue to use all of those assets in the continued operation of its business. To grasp the enormous potential, assume that,

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100. See, e.g., *NLRB v. Fullerton Transfer & Storage Ltd.*, 910 F.2d 331, 333, 341–42 (6th Cir. 1990) (upholding division of single business among three corporations—one to hire truck drivers, one to own trucks, and one to own real estate—and refusing to enforce NLRB back-pay order, obtained against corporation that hired drivers, against corporations that owned assets).

101. If courts showed any inclination to hold bankruptcy-remote vehicles to the liability of their sellers, strategist-originators of future asset-securitization transactions could omit the bankruptcy-remote vehicles from the transactions. Public investors would then be direct owners of the securitized assets of large corporations. Courts should be no more willing to disregard such a transaction than they are to disregard the entity of a publicly held company—which they apparently have never done. See Presser, *supra* note 80, at 158 & n.36 (discussing literature and concluding that no court has pierced corporate veil of publicly held company).

102. Shenker & Colletta, *supra* note 7, at 1380.

103. J. Paul Forrester et al., *Securitization of Project Finance Loans and Other Private Sector Infrastructure Loans*, FINANCIER: ACMT, 1994, at 7–10.

104. See Schwarcz, *supra* note 90, at 152. Shenker and Colletta state that securitization of raw land that is not income producing also is “conceivable.” Shenker & Colletta, *supra* note 7, at 1376 n.27. See also Vogelstein, *supra* note 93, at C18 (reporting deal in which cows are securitized and payments to investors “come from the sale of the fattened cattle for slaughter”).

105. Cf. *You Can Securitize Virtually Everything*, BLS WK., July 20, 1992, at 78 (discussing rapid growth of securitized finance and quoting Wall Street manager as saying “imagination is our only constraint—and time, because you can’t chase every deal”); Charles Gasparino, *Now They’re Thinking of Investing in Deadbeat Dads*, WALL ST. J., June 12, 1996, at C1 (reporting proposal from Morgan Stanley & Co. to New York City to securitize alimony and child support arrearages by issuing municipal bonds backed by security interest in arrearages).

106. Bank accounts are subject to wide, rapid fluctuations in amount. But the debtor might be able to deal with the problem by guaranteeing the bankruptcy-remote entity a fixed balance and assuring its own performance by providing “credit enhancement facilities” such as bank letters of credit or surety bonds. See Schwarcz, *supra* note 90, at 139–40 (discussing credit enhancement facilities).

through a series of asset securitizations, Exxon Corporation disposes of all of its assets.<sup>107</sup> As the cash from these transactions becomes available, Exxon distributes the cash to its shareholders in the form of dividends, leaving the company with neither assets nor liabilities.<sup>108</sup> (I will refer to this judgment-proof Exxon as "Zero-Asset Exxon.") Because Exxon contracts to continue use of each asset even as Exxon sells it, the operations of Zero-Asset Exxon remain exactly as they were when it was a multibillion dollar company.<sup>109</sup> But as a result of the asset-securitization transactions and the distribution of the proceeds, Zero-Asset Exxon is now judgment proof.<sup>110</sup>

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107. Companies rarely dispose of *all* assets that a judgment creditor might reach. Disposing of *nearly all* assets is almost as effective and is much easier. It follows that judgment proofing is not something that particular companies have or have not accomplished, but something that nearly all companies have accomplished to one degree or another. Later, I use the term "hard" judgment proofing to refer to situations where the judgment creditor can reach only nominal asset values and the term "soft" judgment proofing to refer to situations in which the judgment creditor can reach assets of substantial value, but insufficient value to satisfy the judgment.

To hard judgment proof Exxon would appear to leave it without the cash necessary to conduct its business. But Zero-Asset Exxon could solve that problem by borrowing whatever cash it needed to operate and allowing the lender to retain a right of set-off or a security interest in its cash and deposit accounts. See U.C.C. §§ 9-304(1), 9-305 (1992) (providing for perfection of security interests in money and instruments); 11 U.S.C. § 506(a) (1994) (treating right of set-off as equivalent to security interest for purposes of determining secured claims in bankruptcy); *In re Housecraft Indus., USA*, 155 B.R. 79, 93 (Bankr. D. Vt. 1993) (illustrating perfection of security interest in deposit accounts by giving written notice to depository banks).

108. To avoid taxation, the actual form of the distributions is likely to be more complex than cash dividends, but I assume cash dividends for simplicity of presentation. Few asset-securitization transactions today are followed by a distribution of the proceeds to shareholders. *But see Holiday Corporation Announces Finalization of Recapitalization Financing*, BUS. WIRE, Apr. 16, 1987 (describing transaction in which Holiday Corporation borrowed \$1.225 billion and immediately distributed part of financing in \$65-per-share dividend to shareholders). "Exxon" in this illustration distributes the proceeds to demonstrate the judgment-proofing potential of asset securitization in its simplest, most direct form. The typical purpose of an asset-securitization transaction today is to remedy a working capital deficiency, to replace more expensive financing, or to acquire the working capital necessary for expansion of the company's operations. The proceeds either remain with the company or are used to retire other financing.

Even so, the effect of these transactions is to reduce the ratio of available assets to potential liability, thereby "soft" judgment proofing the companies that engage in them. See *supra* note 107. These transactions soft judgment proof the company in a manner similar to secured lending but to a somewhat greater degree. Secured lenders usually require that the debtor retain equity in the asset that serves as collateral; that equity will be available to lower priority creditors. The point of asset securitization is that the debtor retains no significant equity. This makes asset securitization superior to secured lending for "hard" judgment proofing because it will defeat all or substantially all of the company's liabilities. Hard and soft judgment proofing are discussed further *infra* at text accompanying notes 203-04.

109. Its finances do not. From its revenues, Exxon would make periodic payments for the continued use of the assets it sold. A downturn in the business could throw Exxon into bankruptcy and its managers out into the job market. In modern finance theory, however, this is considered a positive feature of the financial structure rather than a problem with it. See *infra* notes 171-84 and accompanying text.

110. It is interesting to speculate on who would choose to own the shares in such a company. The shares would be a high risk investment because the company would be bankruptcy prone, and, if bankruptcy results, the shares likely would be extinguished in return for only nominal compensation. See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 141-43 (1990) (showing mostly nominal recoveries for shareholders of insolvent companies in bankruptcy reorganization). The right to control Zero-Asset Exxon might be a substantial part of the value of the shares. If so, perhaps the type of firm that would place the highest value on the shares would be a management company that would attempt to keep Zero-Asset Exxon out of bankruptcy.

Even in this extreme application, the courts are unlikely to disregard the asset-securitization transactions. Pursuant to the principle of transferability, the transactions are effective until avoided through litigation so that innocent parties who rely on the transactions in the interim are protected. An argument might be made that a particular securitization is avoidable because it was made “with actual intent to hinder, delay, or defraud any creditor of the debtor.”<sup>111</sup> But to recover from the bankruptcy-remote entity, the judgment creditor would have to prove that the bankruptcy-remote entity did not receive the transfer “in good faith and for a reasonably equivalent value.”<sup>112</sup> That seems highly unlikely with regard to an arms-length transaction in which the buyer paid the full fair market value of the property. To attack this judgment-proof structure would require extensive litigation. A judgment creditor of Zero-Asset Exxon who levied on assets used in the company’s business would be levying on assets owned by some bankruptcy-remote vehicle. By that wrongful levy, the judgment creditor would incur liability to the bankruptcy-remote entity for conversion.<sup>113</sup>

As an alternative source of recovery, judgment creditors of Zero-Asset Exxon could pursue the proceeds of the asset-securitization transaction that were used to pay dividends. To do that, the creditors would sue the shareholders who received the dividends under a theory that the dividends were a fraudulent transfer.<sup>114</sup> As a practical matter, however, the dividends would be unrecoverable. First, they may have been paid out to tens of thousands of shareholders, each of whom would be liable for only the amount that shareholder received.<sup>115</sup> Second, the statute of limitations on the most likely theory of recovery would run four years after the transfer, so that four years

111. UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1), 7A U.L.A. 652 (1985) (An asset securitization, however, clearly would not be avoidable under § 4(a)(2). That section provides that

A transfer made . . . by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose before or after the transfer was made . . . , if the debtor made the transfer . . . without receiving a reasonably equivalent value in exchange for the transfer . . . and the debtor

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due

*Id.* That the transaction is at arms length between the debtor and the public investors demonstrates that the debtor receives a reasonably equivalent value in an asset securitization

112. *See id.* § 8(a) (“A transfer . . . is not voidable under Section 4(a)(1) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee . . .”)

113. That liability for wrongful execution is the primary legal remedy available to defend a structure designed to defeat liability is ironic. If the attacker is judgment proof, the defender will have to be content with an injunction against future interferences with its property

114. *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2)(i), 7A U.L.A. 653 (1985) (providing that transfer is fraudulent “if the debtor made the transfer . . . without receiving a reasonably equivalent value in exchange for the transfer . . . and the debtor . . . was engaged or was about to engage in a business for which the remaining assets of the debtor were unreasonably small in relation to the business”)

115. *See infra* notes 240–41 and accompanying text (discussing difficulty of enforcing liability against individual shareholders of publicly held company)

after Exxon became a zero-asset company, its judgment-proof structure would for all practical purposes become legally unassailable.<sup>116</sup>

One might suppose that the problem lies with fraudulent transfer law for failing to provide an appropriate remedy. But in fact the problem runs much deeper. First, fraudulent transfer law is limited by the principle of transferability; allowing easy avoidance of transfers would disrupt markets by clouding nearly all transfers and forcing expensive and time-consuming investigations by would-be subsequent transferees. Second, the Zero-Asset Exxon structure could be achieved without Zero-Asset Exxon making any transfer at all. Exxon could form a new company, Zero-Asset Exxon, to which Exxon rents all of its assets. Because the new company would start with only nominal assets, it would be judgment proof. The new company could not be faulted for fraudulent transfer because it would not have made any transfer. This demonstrates that the fault lies not with fraudulent transfer law but with the more fundamental principle of enforcement only against property of the debtor.

The schemes in the preceding examples show the structure of the future that judgment proofing will produce. There will be entities that own things and entities that do things. Those that own things—the bankruptcy-remote vehicles—will not do anything, lest they expose their assets to liability. Those that do things—the operating companies—will not own anything, lest their judgment creditors have something to attach.<sup>117</sup>

From the fact that few large corporations have become entirely judgment proof, a purely economic analysis might conclude that the costs of judgment proofing exceed the benefits. But, to force a simple idea into the complex language of economic analysis, the costs of judgment proofing may be culturally determined. That is, judgment proofing may be costly solely because it conflicts with cultural norms. Reliance on such structures might bring consumer boycotts, management insecurity, and judicial hostility.

Asset securitization has not been restrained by cultural norms against judgment proofing because it has not been recognized as a judgment-proofing technique. Yet it is. Asset securitization is booming because investors are willing to pay more for securitized assets than for securitized businesses.<sup>118</sup>

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116. Even though Zero-Asset Exxon would remain solvent after the dividend, it could be argued that payment of the dividend was a fraudulent transfer under UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2), 7A U.L.A. 653 (1985). But the statute of limitations would run on claims under that section four years after payment of the dividend. *Id.* § 9(b).

117. Grundfest hints at the development of such a division in response to shareholder unlimited liability, calling it a "clientele effect." See Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 393 (1992) ("The result is a separating equilibrium in which no investor whose assets can be reached under a proportionate liability regime holds shares that could expose her to that risk.").

118. By "business securitization" I mean the sale of traditional interests in or claims against the business, such as stock or unsecured bonds. Asset securitization, by contrast, is a claim against the assets, not the business.

In an article aptly titled *The Alchemy of Asset Securitization*,<sup>119</sup> Professor Schwarcz attempts to explain why. He begins by acknowledging the troublesome principle of “exposure conservation.”<sup>120</sup> Finance theory tells us that selling securities that allocate the risks and returns from a business enterprise does not change the total risks and returns. Slicing the rights in different ways may add to the value of one type of security, but only by detracting from the value of another. Securitization renders investments liquid at lower transaction costs, so it is certainly plausible that *securitization* may add value. But that cannot explain why *asset securitization* would be chosen over *business securitization*. Schwarcz considers several possible explanations for the market’s preference for securitized assets over securitized businesses and ultimately selects the one most often mentioned by others: Asset securitization, unlike business securitization, “eliminat[es] the risk of bankruptcy to investors.”<sup>121</sup>

What risk of bankruptcy is eliminated by asset securitization? That depends on the form in which the investment would have been made if it had not been made through asset securitization. From Schwarcz’s description, it would appear that asset securitization is being substituted principally for unsecured bank lending and unsecured issues of public debt. Such debt is a liability, and in bankruptcy it shares pro rata with other kinds of liability claims. The owners of securitized assets, by contrast, keep their assets when the debtor files bankruptcy; they need not share with the holders of liability. In other words, debtors are substituting asset securitization, a judgment-proof financial structure, for unsecured debt, a non-judgment-proof structure.<sup>122</sup> That a debtor’s cost of funds obtained by asset securitization is lower than the cost of funds obtained by unsecured borrowing<sup>123</sup> may be just the market’s way of saying that it prefers judgment-proof companies because they are “efficient” liability avoiders.<sup>124</sup>

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119. Schwarcz, *supra* note 90.

120. *Id.* at 148.

121. *Id.* at 151.

122. That is, absent the availability of asset securitization as a financing device, these types of companies would finance through unsecured debt. I do not mean to assert that the companies generally are using the proceeds of asset securitization to retire unsecured debt, though some probably are.

123. See, e.g., Committee on Bankr. & Corp. Reorg. of the Assoc. of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 530–31 (1995) [hereinafter *Structured Financing Techniques*] (“Not only is the credit rating of the financing likely to be enhanced, but also the cost of the financing in the capital markets may be less than the cost of comparable financing in the bank or insurance company private market.”).

124. There could be other explanations. For example, bankruptcy reorganization may be an inefficient means for dealing with financial distress. See, e.g., Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) (asserting that bankruptcy liquidation may be more efficient than bankruptcy reorganization); Christopher W. Frost, *Structured Finance and Corporate Risk Allocation* 32 (May 23, 1996) (unpublished manuscript, on file with author) (“If the bankruptcy process is inefficient, structured finance may be a means by which all investors could make a binding promise to avoid the process (at least with respect to the securitized assets)”) *But see* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*,

Another way of stating essentially the same argument is to note that stocks and bonds are the most junior claims against the assets of a company. They are defeated by anyone with a direct claim against the assets. The claims of third-party owners, such as those created in asset securitization, are the most senior claims. That the market will pay more for senior claims against the same assets than it will pay for junior claims against them suggests that priority matters. Perhaps the principal advantage of third-party ownership of assets over mere ownership of the company is that third-party owners of assets have priority over liability claims while stockholders do not.<sup>125</sup>

Asset securitization may be the silver bullet capable of killing liability. In the few skirmishes in which asset-securitization structures have been challenged in bankruptcy, they have been upheld.<sup>126</sup> Though the effect ultimately may be to defeat liability interests, this outcome should not be surprising. Liability is in disrepute. Asset securitization, by contrast, is widely regarded as an engine of the U.S. economy.<sup>127</sup> Commentators all seem to agree that the savings available through asset securitization depend on the insulation of the securitized asset from bankruptcy<sup>128</sup>—in essence, from liability. For the courts to strike down routine asset securitizations simply because they render the debtors judgment proof would eliminate the central advantage of asset securitization over the more traditional issuance of public debt.

### C. Exemption Strategies

As previously noted, the laws of all fifty states and numerous federal statutes exempt various kinds of property from procedures to enforce

141 U. PA. L. REV. 669, 753–67 (1993) (presenting data indicating that bankruptcy liquidation would be less efficient).

125. Even when the asset securitization replaces secured debt, the debtor obtains an advantage. Claims of ownership get full respect in bankruptcy, while the claims of secured creditors do not. See Bebchuk & Fried, *supra* note 74, at 871 (arguing that “certain features of Chapter 11 reorganizations tend either to waste value or to enrich junior claimants at the expense of secured creditors”).

126. See *Structured Financing Techniques*, *supra* note 123, at 565–67.

127. On May 27, 1993, the Tenth Circuit Court of Appeals ruled that accounts sold to a third party prior to bankruptcy remained property of the debtor and were part of the bankruptcy estate. See *Octagon Gas Sys., Inc. v. Rimmer*, 995 F.2d 948 (10th Cir. 1993). As applied to asset securitizations involving accounts, the effect of *Octagon Gas* would have been to render the securitized accounts property of the bankruptcy estate. Asset securitization then would have failed in its essential purpose. In less than two weeks, the Permanent Editorial Board for the Uniform Commercial Code issued Commentary No. 14, U.C.C. § 9-102(1)(b), referring to the holding as “erroneously stated.” Commentators have criticized the decision for its potential to interfere with asset securitization. See Baird, *supra* note 98, at 2267 n.42 (criticizing *Octagon Gas* for making sales of accounts more difficult). Since *Octagon*, the issue has not arisen in a reported case.

128. See, e.g., Schwarcz, *supra* note 90, at 151 (arguing, in essence, that securitization reduces net financing costs for debtor “[b]y eliminating the risk of bankruptcy to [the bankruptcy-remote entity’s] investors”); see also Gregory R. Salath, Note, *Reducing Health Care Costs Through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549, 559–60 (1994) (“The savings available through securitization depend on the insulation of the collateralized receivables from bankruptcy.”).

judgments for money damages.<sup>129</sup> In addition to the types of assets previously mentioned, federal law exempts a debtor's pension funds without limitation as to dollar amount, and about twenty-three states recognize the doctrine of tenancy by the entireties. When property is held by a husband and wife in tenancy by the entireties, a judgment against only one of the spouses cannot be enforced against the property.<sup>130</sup> Simply by holding their assets in tenancy by the entireties, a married couple can defeat both their individual liabilities. Thus, in most states, debtors can own millions of dollars worth of unencumbered property but have no property their creditors can seize.

Employed in conjunction with secured debt strategies, exemption strategies make it possible for individual debtors to retain any property against their judgment creditors, regardless of its value. Consider two examples of such structures. In the first, a debtor entitled to a \$40,000 homestead exemption owns a \$100,000 homestead subject to a \$60,000 mortgage. Judgment creditors cannot reach this property.<sup>131</sup> In the second, a debtor is entitled to a \$5000 "floating" exemption which the debtor can apply to any property of the debtor's choosing. The debtor owns a \$600,000 Learjet, subject to a \$600,000 security interest in favor of a friendly creditor. The creditor can recover nothing from the Learjet itself; moreover, with the exemption in place, the creditor can no longer have the Learjet seized or sold.<sup>132</sup> Once a debtor becomes judgment proof through any of these techniques, the debtor can file bankruptcy. In bankruptcy, the debtor can discharge his or her unsecured debt, including most debt for liability, while keeping the exempt property.<sup>133</sup>

Exemption law not only permits a debtor who owns exempt property to keep it, but it also permits a debtor who owns nonexempt property to exchange it for exempt property. In some jurisdictions, the debtor can make the exchange even on the eve of bankruptcy. In at least one, the debtor can make the exchange with the specific intent to defraud his or her creditors and it will still withstand attack.<sup>134</sup> The system could respond to the strategy of investing in

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129. See *supra* notes 28-30 and accompanying text

130. See, e.g., *In re Huth*, 122 B.R. 724, 726 (Bankr. E.D. Mo. 1988) ("[A] creditor of only one of the debtors does not have a right to execute against property held as tenancy by the entireties.")

131. See, e.g., WARREN & WESTBROOK, *supra* note 35, at 132-33 ("Only when the value of the [collateral] exceeds the sum of the allowed secured claim and the debtor's exemption, would the [trustee in bankruptcy] be able to reach any value from the property.")

132. For a typical statute so providing, see WIS. STAT. ANN. § 815.18(h) (West 1994) ("'Exempt' means free from any lien obtained by judicial proceedings and is not liable to seizure or sale on execution or on any provisional or final process issued for any court, or any proceedings in aid of court process.")

133. See 11 U.S.C. § 522(b)-(c) (1994).

134. See *In re Reed*, 12 B.R. 41 (Bankr. N.D. Tex. 1981) (holding, based on comparison of language used by Texas legislature in personal property and homestead exemption statutes, that Texas legislature intended to permit debtors who acquire homesteads through fraud to retain them) *But see In re Reed*, 700 F.2d 986 (5th Cir. 1983) (denying Reed's discharge for fraud but still allowing him to retain fraudulently acquired homestead).



exempt property by enacting uniform federal exemptions capped as to dollar amount and declaring eve-of-bankruptcy investments in such exemptions fraudulent. The National Bankruptcy Commission recommended the first of these reforms in the mid-1970s,<sup>135</sup> but Congress declined to enact it.<sup>136</sup> The second change is unlikely because the eve-of-bankruptcy strategy is system-intended. Congress was concerned with equity between those already judgment proof and those who sought to become so on the eve of bankruptcy: "As under current law, the debtor will be permitted to convert nonexempted property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled by law."<sup>137</sup> At least in some states, reformers who attempt to save the liability system will be up against a strong populist tradition that opposes the involuntary collection of debts from the homestead or personal property of individual debtors.<sup>138</sup> In the language of strategic analysis, the exemption strategies used by individual debtors to defeat the collection of unsecured liabilities are system-intended.<sup>139</sup>

#### D. *Foreign Haven Strategies*

Removal of one's assets from the jurisdiction of the court is a time-honored strategy for defeating one's liability.<sup>140</sup> Upon removal, the principle of territoriality takes effect; to recover, the creditor must sue in the foreign legal system where the assets are located.<sup>141</sup> If the foreign legal system will not enforce liability against the assets of the debtor, removal achieves more than hindrance and delay; it bars recovery.

More than a half-dozen nations compete for foreign investment by refusing comity with respect to the enforcement of judgments<sup>142</sup> and providing havens

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135. See 3 COMMISSION ON THE BANKR. LAWS OF THE U.S. REP. 55 (1973) ("[T]he panel is very strongly agreed as to the desirability of making exemption rules uniform throughout the nation . . . and of doing this by establishing a national exemption law . . .").

136. See 11 U.S.C. § 522(d) (establishing "federal exemption" applicable in bankruptcy cases); *id.* § 522(b) (giving debtors right to choose between federal exemption and exemption available to them under state law).

137. S. REP. NO. 95-989, at 4 (1978).

138. See, e.g., COLEMAN, *supra* note 22, at 234-36 (explaining how Georgia attitudes that led to abolition of debtors' prisons also led to protection of homesteads beginning in 1845).

139. See LoPucki, *The Law in Lawyers' Heads*, *supra* note 12, at 1522-24.

140. To counter this strategy, the system provides for prejudgment attachment as an exception to the principle of enforcement only after judgment. The exception makes little practical difference, however, because its use is highly restricted, and creditors are seldom able to anticipate the debtor's removal strategy. See *supra* notes 39-41 and accompanying text.

141. See *supra* text accompanying note 42.

142. See, e.g., PETER SPERO, ASSET PROTECTION: LEGAL PLANNING AND STRATEGIES (1993); Savanna Mapelli, *Judgment Proofing Your Wealthy Clients*, N.J. L.J., Dec. 12, 1994, at 10, 32 ("The key is to choose a foreign jurisdiction that does not recognize U.S. judgments under the doctrine of comity."). The United States currently is not a party to any treaties for the enforcement of judgments. See *supra* note 42.

for judgment debtors from their foreign creditors.<sup>143</sup> They implement the latter policy principally by validating self-settled spendthrift trusts under which the settlor is a beneficiary. In the United States, such a trust is ineffective against creditors as against public policy.<sup>144</sup> A self-settled spendthrift trust amounts, in essence, to a declaration that one wishes to own one's assets free of the claims of one's judgment creditors—that is, free of liability. One commentator estimates that this offshore trust industry already administers a trillion dollars in assets.<sup>145</sup>

To understand the strategy of removing assets to a spendthrift trust jurisdiction, consider the example of a medical doctor who lives and practices medicine in the United States. Assume that the doctor owns a nonexempt home, a medical practice, and liquid assets in a brokerage account. Each of the three assets is worth approximately one million dollars, for a total of three million dollars. All of the assets are located in the United States. The doctor is a defendant in one malpractice case (the present creditor)<sup>146</sup> and expects he might be sued by other patients he will injure in the future (the future creditors). Through a U.S. lawyer who specializes in such transactions and works with a trust company in the Cook Islands, the doctor establishes a spendthrift trust there. The doctor is both the settlor and the sole beneficiary of the trust. The trustee is a recognized international banking institution with offices located in the Cook Islands.<sup>147</sup> Cook Islands law permits the doctor

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143. See Bureau of Nat'l Affairs, *International Taxes, Treasury 'Scrambling' to Issue International Regulations, Official Says*, DAILY REP. FOR EXECUTIVES, Jan. 17, 1992, at G-6 ("Asset-protection trusts in such jurisdictions as the Bahamas, Gibraltar, and the Cayman Islands are being marketed, often on a 'cookie cutter' basis . . ."); Mapelli, *supra* note 142, at 32 (naming Bahamas, Belize, Bermuda, Cayman Islands, Cook Islands, Cyprus, Gibraltar, and Turks and Caicos Islands as countries where "legislators have drafted special asset-protection trust legislation in order to attract the offshore trust business"); Gideon Rothschild, *Asset Preservation: Legal and Ethical Strategies*, N.Y.L.J., Mar. 11, 1994, at 1, 11 n.2 (naming same countries as "having statutes favorable to asset protection trusts," and naming British Virgin Islands, Isle of Man, Jersey, Liechtenstein, and Malta as "among the offshore financial centers . . . not usually considered as desirable for asset protection trusts").

144. The Restatement reads:

- (1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interest, his transferee or creditors can reach his interest.
- (2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit.

RESTATEMENT (SECOND) OF TRUSTS § 156 (1957). For a more extensive discussion of U.S. policy against self-settled spendthrift trusts, see Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 28-56 (1994).

145. See William J. Zink, *Assets of Foreign Grantor Trust Not Includible in Grantor's U.S. Gross Estate*, TAX ADVISER, Feb. 1994, at 84.

146. Most lawyers who specialize in offshore asset-protection planning discourage planning designed to defeat present creditors. See, e.g., Mapelli, *supra* note 142, at 32 ("[A]n attorney should not assist a client in transferring assets to a foreign situs trust if the client already is a judgment debtor or if litigation is pending or a threat of suit has been made.")

147. See Thomas S. Carles, *Asset Protection Trusts: Potent Claims Shields*, N.J.L.J., Nov. 8, 1993, at 10 ("[T]he trustee usually is a recognized international banking institution.") To assure control over the trust, some lawyers recommend that the doctor name family members or associates as cotrustees, when "a threat of a claim appears on the horizon the foreign trustee has the power, pursuant to the trust agreement,

to serve as a "protector" of the trust assets with the power to remove and replace trustees and to veto investment decisions.<sup>148</sup> Over one aspect of trust management, the doctor retains no control or power of revocation: Whoever is trustee may not expose trust assets to the claims of the doctor's creditors. The standard trust documents also mandate that the trustee ignore instructions made by the doctor under duress, such as an order from a U.S. court that the doctor cause the trust to return assets so that they may be applied to the claim of a creditor.<sup>149</sup>

Once the trust has been established, the doctor deeds his home and transfers ownership of his medical practice into it.<sup>150</sup> Though both are now foreign-owned, the home and the medical practice remain physically in the United States. The trust will permit the doctor to use them without charge; the structure functions as a form of distribution to the doctor as trust beneficiary. The doctor also transfers the liquid assets in his brokerage account to the Cook Islands trustee, who then proceeds to invest them in accord with nonbinding instructions furnished by the doctor.<sup>151</sup> The investments can be anywhere in

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to remove the domestic trustee(s) (to protect them from any potential court order)." Rothschild, *supra* note 143, at 4.

148. See Cook Islands International Trusts Act 1984 § 2 (as amended 1991), reprinted in LEWIS D. SOLOMON & LEWIS J. SARET, ASSET PROTECTION STRATEGIES 361 (1993) [hereinafter Cook Islands International Trusts Act] (defining "'protector' in relation to international trust [to mean] person who is the holder of power which when invoked is capable of directing trustee in matters relating to trust and in respect of which matters trustee has discretion and includes person who is holder of power of appointment or dismissal of trustees"); Rothschild, *supra* note 143, at 4 ("The Cook Islands, for example, has expanded the traditional scope of a protector's power by providing that the settlor may be a protector and may have certain powers over the trustees. These powers include the power to remove and replace trustees and veto investment and distribution decisions . . ."). An example of a "typical trust protector veto power provision" appears in HOWARD D. ROSEN, ASSET PROTECTION PLANNING A-13-14 (1994).

149. See ROSEN, *supra* note 148, at A-12 (providing example of duress provision); Mapelli, *supra* note 142, at 10 ("The trust documents also must mandate that the trustee ignore instructions made under duress so that if, for example, the U.S. settlor is court ordered to demand the return of assets protected by the trust, the trustee must ignore the settlor's directions.").

150. Planners generally recommend that real estate be deeded to the trust in order to avoid adverse tax consequences in the United States. See, e.g., Rothschild, *supra* note 143, at 4 (recommending conveyance of family residence or vacation home to trust to maintain mortgage interest deduction). Planners generally recommend that the doctor place the medical practice in a U.S. family limited partnership. As limited partner, the trust holds 99% ownership but has no control except the power to dissolve the partnership. As general partner, the doctor holds 1% ownership but has full control. When a claim threatens, the trust will dissolve the family limited partnership, so that the practice is owned directly by the trust. The family limited partnership is used because it maximizes the doctor's control over the assets and has valuable judgment-proofing characteristics that are beyond the scope of this Article. See ROSEN, *supra* note 148, at A-4-8 (discussing asset protection aspects of limited partnerships under Revised Uniform Limited Partnership Act of 1976); Barry S. Engel & Ronald L. Rudman, *Family Limited Partnerships: New Meaning for "Limited"*, TR. & EST., July 1993, at 46, 47 (noting that creditor's charging order remedy against interests in limited partnership is much more limited than remedy creditor would have against property that was contributed, but arguing that recent court decisions have eroded protection); Rothschild, *supra* note 143, at 4.

151. Where the trustee fails to follow an instruction, the doctor could remove the trustee and substitute another. See *supra* note 148 and accompanying text (discussing powers of trust "protectors").

the world, including the United States.<sup>152</sup> The transaction is tax neutral.<sup>153</sup>

With his financial affairs so arranged, the doctor will be in a powerful position to negotiate settlement with his present and future creditors. If a significant case against him fails to settle, the doctor can respond at any of three levels. Each increase in the level of the doctor's response increases the doctor's likelihood of escaping liability, but each will also increase the doctor's level of inconvenience. At the first level, the doctor can merely litigate the effectiveness of the protections already in place. To the judgment creditor's claim that the trust violates public policy of the United States, the doctor's argument will be that under international law, the validity of a trust is governed by the law chosen by the settlor,<sup>154</sup> provided only that the trust has sufficient contacts with that jurisdiction. The argument continues that the trustee's location in the Cook Islands is a sufficient contact to make Cook Islands law applicable, and that the trust is valid under Cook Islands law. To the future (now judgment) creditor's claim that the transfer to the trust was in fraud of creditors, the doctor has the additional argument that the transfer was not fraudulent even under U.S. law because the doctor did not have the intent to defraud specific creditors, present or future, but was merely "looking to his future wellbeing."<sup>155</sup> If the transfer is more than four years old by the time a future creditor challenges it, the challenge will be barred by the statute of limitations contained in the Uniform Fraudulent Transfer Act.<sup>156</sup>

152. Investment in the United States might give a U.S. court the excuse it needs to apply U.S. law to void the spendthrift aspect of the trust. But the trust could remove the assets from the United States before the U.S. court could discover and attach them, rendering the court's ruling ineffective. See, e.g., *Rothschild*, *supra* note 143, at 4 ("Assets may be more at risk of becoming subject to a court's jurisdiction while physically in the U.S. even though they are owned by the trust. However, most individuals prefer not to transfer them offshore until it becomes necessary.").

153. See Priv. Ltr. Rul. 93-32-006 (Aug. 20, 1992), *Zink*, *supra* note 145, at 84 (summarizing ruling). But see Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake*, 15 VA. TAX REV. 399 (1996) (arguing existence of minor tax advantages to overseas asset-protection trusts).

154. See, e.g., Article 6 of the Hague Convention on the Law Applicable to Trusts and on Their Recognition ("A trust shall be governed by the law chosen by the settlor"), reprinted in ROSEN, *supra* note 148, at B-701; Cook Islands International Trusts Act, *supra* note 148, § 13G(3) ("A term of an international trust that the laws of the Cook Islands are to govern a particular aspect of the trust is valid and effective accordingly.").

155. *Oberst v. Oberst*, 91 B.R. 97, 101 (Bankr. C.D. Cal. 1988). The full passage reads:

While the Court finds it very difficult to locate the exact line between bankruptcy planning and hindering creditors, Congress has decided that the key is the intent of the debtor. If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future wellbeing, the discharge will be granted. This is an uncomfortable test and does not seem equitable, but it is the law.

*Id.* See also *Hurlbert v. Shakleton*, 560 So. 2d 1276, 1278 (Fla. Dist. Ct. App. 1990) (remanding for finding of specific intent case of medical doctor who transferred his business to make it unreachable by his creditors because, as he explained, "I wasn't able to get malpractice insurance, and I wanted to cover all the bases."). But see *Mapelli*, *supra* note 142, at 10 ("[A] foreign situs trust should be a planning tool for an individual fearing litigation but who is not currently involved in litigation as a defendant or even about to become a defendant.").

156. UNIF. FRAUDULENT TRANSFER ACT § 9, 7A U.L.A. 665 (1985) (fixing statute of limitations as four years from time transfer was made for most actions). If the plaintiff's action is based on actual intent to defraud, the plaintiff may bring it "within one year after the transfer was or could reasonably have

At the second level, the trust, at the doctor's "suggestion," can remove the value of his remaining assets from the United States before litigating the validity of the trust. To remove the value of his home and practice, he would liquidate that value, either by borrowing against the assets or selling them, and transfer the proceeds to the Cook Islands. Once the trust has removed the last of its assets from the United States, the principles of territoriality<sup>157</sup> and enforcement only against property<sup>158</sup> will combine to make enforcement in the United States highly unlikely. No U.S. court is likely to attempt to administer enforcement against assets located outside the United States.<sup>159</sup> Enforcement in the Cook Islands will be even less likely. The Cook Islands will not recognize or enforce the judgment of the U.S. court invalidating the trust.<sup>160</sup> It will apply Cook Islands law to determine the validity of the trust.<sup>161</sup> In fact, it probably will not recognize even the judgment of the U.S. court determining liability in the malpractice case against the doctor.<sup>162</sup> The plaintiff may have to relitigate both the validity of the trust and the doctor's negligence in the Cook Islands. Even if the plaintiff were by some miracle to win the case in the Cook Islands, the plaintiff probably still would be unable to collect the judgment. The terms of the trust typically provide that the trust may "flee" to another foreign jurisdiction if the trust or its assets are attacked.<sup>163</sup> Once the plaintiff committed resources to attacking the trust in the Cook Islands, the trustee could move the trust to another liability haven. Absent a mistake on the part of the doctor or his lawyers, collection in the Cook Islands would be impossible.

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been discovered by the claimant." *Id.* An effective strategy for the doctor in this illustration would probably be to notify a malpractice plaintiff of his transfers at the time of the filing of the malpractice action, or even earlier. Plaintiff's counsel may not be aware that the statute of limitations will be running during the malpractice action. Astute plaintiff's counsel should then file the fraudulent transfer action along with the malpractice case, creating a complex litigation environment.

157. See *supra* note 42 and accompanying text (discussing principle of territoriality).

158. See *supra* notes 21–23 and accompanying text (discussing principle of enforcement only against property).

159. The U.S. court might, however, have the power to do so if the doctor were served in the main action before leaving the United States. The initial pleading in an action for money damages typically states only a cause of action for money damages. But where state statutes authorize enforcement of a judgment without additional service of process, the courts hold such enforcement constitutional. See *Threlkeld v. Tucker*, 496 F.2d 1101 (9th Cir. 1974) (permitting enforcement of California judgment against defendant who had consented to jurisdiction of California court, but removed himself from state prior to entry of judgment); *Smith v. O'Byrne*, 831 P.2d 709 (Or. App. 1992) (holding that Oregon court could conduct sale of intangible property of judgment debtor even though judgment debtor had removed himself from Oregon prior to entry of judgment and property was not located in Oregon).

160. See Cook Islands International Trusts Act, *supra* note 148, § 13D.

161. *Id.* § 5 (providing that trust "registered under this Act shall be a valid trust notwithstanding that it may be invalid according to the law of the settlor's domicile or residence or place of current incorporation").

162. See *Mapelli*, *supra* note 142, at 32 (suggesting necessity of relitigation of underlying claim). *But see Rothschild*, *supra* note 143, at 4 ("Even where a judgment is entered in a U.S. court, many trust-friendly jurisdictions do not honor U.S. judgments that are based on the application of laws contrary to their own substantive laws.").

163. See *Mapelli*, *supra* note 142, at 10; see also *ROSEN*, *supra* note 148, at A-12–13 (describing flight provisions and setting forth example).

In response to the doctor's deployment of such strategies, it is possible to imagine the U.S. judge abandoning on equitable grounds the principle of enforcement only against property. The court might determine the trust to be invalid and the doctor to be the owner of the assets, and then order the doctor to surrender them to a sheriff within the jurisdiction of the court.<sup>164</sup> Absent compliance, the U.S. court might order the doctor imprisoned for contempt of court.<sup>165</sup> The doctor's defense would be that he was not in contempt because from the time he was served with the court's order, he lacked the ability to comply with it.<sup>166</sup> As previously noted, the typical asset-protection trust contains a duress provision, barring the trustee from acceding to the settlor's demands for distributions ordered by a court.<sup>167</sup> The Cook Islands trustee would almost certainly comply with the trust document and refuse to surrender the assets.<sup>168</sup> To continue to live and work in the United States, the doctor ultimately would have to comply, to the best of his ability, with any orders issued and upheld by courts in the United States. But it is far from clear that the legal system in the United States would make full use of the contempt power to preserve the liability system. To do so would require abandonment of the principles of territoriality and enforcement only against property. Abandoning these judicial self-restraints would test as-yet-unexplored limits of judicial power and put the prestige and position of the judiciary at risk. In deciding who can or cannot retrieve his assets, the courts would be working with highly imperfect information; they would make mistakes. Imprisoning debtors who could not pay, on the ground that they created the impossibility

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164. See *supra* note 159.

165. See, e.g., CAL. CIV. PROC. CODE § 482.080 (West 1979 & Supp. 1996) (providing for entry of orders directing debtors to transfer property to levying officer and inclusion in such orders of notice that failure to comply may subject defendant to punishment for contempt of court)

166. See, e.g., *United States v. Rylander*, 460 U.S. 752, 757 (1983) ("In a civil contempt proceeding such as this, of course, a defendant may assert a *present* inability to comply with the order in question. Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action."); *United States v. Bryan*, 339 U.S. 323, 330-31 (1950) ("Ordinarily, one charged with contempt of court for failure to comply with a court order makes a complete defense by proving that he is unable to comply. A court will not imprison a witness for failure to produce documents which he does not have, unless he is responsible for their unavailability . . ."), *FTC v. Blaine*, 308 F. Supp. 932, 933 (N.D. Ga. 1970) (stating with respect to documents respondent failed to produce: "However, the respondent can not be said to be 'responsible for their unavailability' if prior to the time he was served with a subpoena to produce the documents he had previously disposed of the same in good faith.")

167. While the settlor as protector has the authority to veto decisions of the trustee, he or she has no authority to take affirmative action. See *Mapelli*, *supra* note 142, at 10 ("[I]f, for example, the U.S. settlor is court ordered to demand the return of assets protected by the trust, the trustee must ignore the settlor's directions."); *Rothschild*, *supra* note 143, at 4 ("Since the protector's power is a negative power (as opposed to an affirmative power to initiate action) the protector cannot be compelled by a court to take action.")

168. To surrender assets in even a single case might damage the salability of Cook Islands trusts in the United States. Given the importance of the asset-protection trust industry to the Cook Islands, the Cook Islands financial institution that served as trustee would expect to be protected by the Cook Islands courts if it refused to surrender, and punished if it did not. In a contest of wills between a U.S. court determined to force the doctor to retrieve assets and a Cook Islands trustee determined to preserve its country's industry, the trustee clearly would win. The United States has a strong tradition against imprisonment for debt, even when the debtor behaved stupidly in getting into the situation that prevented payment

by their wrongful act of establishing an offshore asset-protection trust, would open the courts to valid criticism from both sides. Opponents of this expansion of judicial power would soon have examples of the folly of imprisonment for debt that would rival those of the late eighteenth and early nineteenth centuries. Proponents, on the other hand, would point out that most of the approximately 900,000 Americans who file bankruptcy each year have deliberately done some wrongful act that has made payment impossible—they have bought something they could not afford, borrowed money they could not repay, or made deliberate decisions to live beyond their means. The proponents would want to know why the principle that justifies imprisoning debtors who cannot retrieve assets from offshore asset-protection trusts does not also justify imprisoning debtors who rendered themselves unable to pay by other fraudulent or wrongful acts. The proponents' arguments might be sound, but they would be arguments for widespread imprisonment of debtors who would not "hold the keys to their own cells"<sup>169</sup>—a drastic change in American legal culture.

At the third level of defense, the doctor might choose to remove himself from the United States to eliminate the possibility of being imprisoned for contempt. From his safe haven, perhaps in the Cook Islands, the doctor could negotiate to settle the U.S. action. Upon settlement, there would be no bar to the doctor's return. The settlement could provide for the vacation of contempt orders entered during the doctor's absence.

The essence of the offshore asset-protection trust problem is that the world recognizes the right of an owner of liquid wealth to move it to any nation that offers a better deal. A significant number of nations now offer to protect that wealth against liability.<sup>170</sup> Unless the world community overrules those nations by imposing some sort of sanctions, they will continue to provide strategists with the means to defeat liability in individual cases, demoralize nonstrategists, and thereby contribute to the ultimate demise of liability itself.

### III. CONSTRAINTS ON JUDGMENT PROOFING

Any debtor could become judgment proof using the strategies described in the preceding Part. For a large, publicly held company, the most effective strategy would be a combination of secured debt and ownership strategies. The debtor would first reduce its assets through asset securitization, then compartmentalize by incorporating subsidiaries and dividing its assets among them. Finally, it would encumber the assets in those subsidiaries beyond their remaining value. With such redundant judgment proofing in its structure, a

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169. See, e.g., Linda S. Beres, *Civil Contempt and the Rational Contemnor*, 69 *IND. L.J.* 723, 742 (1994) (stating that disparate treatment of civil and criminal contemnors is based on view that civil contemnors "hold the keys to their own cells").

170. See *supra* notes 142–45 and accompanying text.

company would be beyond the reach of liability. Problems such as those that plagued Manville, Texaco, A.H. Robbins, Union Carbide, Dow Chemical, Smith Manufacturing, and Exxon would no longer be of concern. Those members of a corporate group that incurred large liabilities would file under Chapter 11 of the Bankruptcy Code, stripping away the liabilities without paying any significant portion of them. The investors who set up such structures generally would not be able to retain interests in the operating companies as they emerged from Chapter 11. But those investors already would have profited by setting up the structures that externalized liability and enabled them to pay less for their financing at the time they established their enterprise.<sup>171</sup> Anything the investors got from Chapter 11 would be gravy.<sup>172</sup>

If judgment-proofing strategies insulate companies from the bane of liability, why doesn't everyone use them? Among small- and medium-sized companies, the answer is that the large majority enjoys most of the benefits of being judgment proof already.<sup>173</sup> They have secured debt that exceeds the liquidation value of their assets. Many carry liability insurance, but liability insurance is nearly always subject to dollar limits, limits as to the types of risk insured against, and contractual defenses.<sup>174</sup> The limits of the liability insurance these companies carry is often quite low.<sup>175</sup> Their liability is probably even more likely than that of large companies to exceed the limits of

171. This point is elaborated *infra* text accompanying notes 179–81

172. In our study of the bankruptcy reorganizations of the 1980s, Whitford and I discovered the existence of a settlement norm requiring that everybody at the bargaining table get something, even those clearly lacking an entitlement in adjudication. See LoPucki & Whitford, *supra* note 110, at 158–60 (discussing norm).

173. For an explanation of how and why this occurs, see LoPucki, *supra* note 32, at 1903–06, 1931–36. The median firm in the American economy is surprisingly small. For example, the median firm proceeding under Chapter 11 of the Bankruptcy Code in the early 1980s had only about \$250,000 in assets. See U.S. DEP'T OF JUSTICE, EXECUTIVE OFFICE FOR U.S. TRUSTEES, AN EVALUATION OF THE U.S. TRUSTEE PILOT PROGRAM FOR BANKRUPTCY ADMINISTRATION 47 (1983). This would suggest that, after adjustment for inflation, the corresponding figure today would be considerably less than \$500,000. Even in the Central District of California, a district notorious for its large bankruptcy cases, approximately 45% of the cases fall in the under \$1 million categories. See Lisa Hill Fenning & Craig A. Hart, *Measuring Chapter 11: The Real World of 500 Cases*, 4 A.B.I. L. REV. 119, 137 (1996).

174. Lack of adequate insurance at even the largest companies in America is commonplace. Manville, Texaco, A.H. Robbins, Union Carbide, Dow Chemical, Smith Manufacturing, and LTV were all in bankruptcy in part because they carried grossly inadequate liability insurance or because their carriers denied liability. See also *Youell v. Exxon Corp.*, 74 F.3d 373 (1996) (describing litigation in which Exxon Corporation's liability insurers seek declaratory judgment that they are not liable for liability arising out of Exxon Valdez oil spill).

175. For example, Hansmann and Kraakman report, on the basis of an interview, that as of 1990 [O]f the roughly 350,000 insurance policies that Aetna writes for the "standard market"—which includes all business firms except the Fortune 500—one-third have coverage limits of about \$300,000 per accident, one-third have limits of about \$500,000 per accident, and one-third have limits of about \$1 million. In addition, 10% of all firms carry additional "umbrella" coverage. Of the latter firms, half carry \$1 million in umbrella coverage per accident, one-quarter carry \$2–3 million, and one-quarter—about 2.5% of all firms insured—carry \$5 million or more. Hansmann & Kraakman, *supra* note 76, at 1889 n.25.



their policies. When that occurs, the excess liability is nearly always uncollectible.<sup>176</sup>

The mystery is why so few of the largest companies are judgment proof at the time of their bankruptcy reorganizations.<sup>177</sup> Despite the critical advantage that secured debt would have brought to companies such as Manville in negotiating with asbestos claimants or Texaco in negotiating with Pennzoil, the largest companies eschew secured financing.<sup>178</sup> The constraints that might explain why large companies are seldom judgment proof are the subject of the remainder of this Part.

#### A. *The Self-Immolation Argument*

Some commentators argue that shareholders have nothing to gain by judgment proofing their companies. Bankruptcy sweeps away liability, but when used by large, publicly held companies, it sweeps away shareholdings as well. Thus, in the very situations where judgment proofing actually provides benefits, the shareholders will no longer be around to share in them. One might suppose this would leave shareholders with no incentive to judgment proof their companies in the first place. Professor Stephen Presser used essentially this argument to assert that unlimited shareholder liability was unnecessary to discourage projects that externalize tort risk:

A shareholder does not invest to lose even the initial investment. One invests in the belief that one will derive a profit, from appreciation of shares, or from dividends. One selects one's investment after having concluded that the investment is one that will *make* money, not *lose* it. This is the same calculation that one would perform if there were unlimited liability. . . . [I]t is the quality of the investment opportunity itself, and not the elimination of possible personal liability that leads an investor to commit his or her capital.<sup>179</sup>

Professor Presser is correct in asserting that an investment with no potential for profit cannot be rendered desirable by reduction in the potential

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176. Small businesses tend to be owned by an individual or a family, and, as noted above, their assets are usually fully encumbered. There is little reason to expect that judgments in excess of policy limits are any more collectible from them than from automobile owners and drivers. One study indicated that only about 1% of automobile accident tort liability payments came from uninsured sources. See ALFRED F. CONARD ET AL., *AUTOMOBILE ACCIDENT COSTS AND PAYMENTS* 48 (1964). The figure is particularly striking when one considers that many drivers underinsure and an estimated 17.5% of drivers do not insure at all. See *infra* note 360.

177. See LoPucki & Whitford, *supra* note 110, at 142, 177 (showing substantial recoveries by unsecured creditors of insolvent companies).

178. See LoPucki, *supra* note 32, at 1924–25 (describing findings from empirical study of large companies in reorganization); Mann, *supra* note 75, at 60–61 (citing “the well known fact that the strongest companies use secured debt with relative infrequency”).

179. Presser, *supra* note 80, at 159.

for loss. But he incorrectly asserts that the desirability of an investment that does have potential for profit cannot be rendered more desirable by reduction in the potential for loss. To calculate the value of an investment, one must take account of its potential for profit, its potential for loss, and the likelihood of each. Serious investment opportunities are not, as Professor Presser implies, simply good or bad; most have the potential at the time of the investment decision to be either. The risks of the investment are reflected in their value *ex ante*.<sup>180</sup> If an investment is structured to externalize liability, it will have a higher value *ex ante* than if it is not. Those who create and initially control the investment opportunity may choose to take the role of shareholders, but that choice does not require that they forgo the profit from defeating liability. The profit is real and inherent in the value of their shares. Their shares are worth more than they would be without judgment proofing because, with judgment proofing, the company's financing is at a lower interest rate. The financing is at a lower interest rate because the financier has priority over future liability and therefore carries lower risk of nonpayment. The shareholders can cash this value by selling their shares before the uncertainty of the tort liability resolves.

To illustrate, assume a project that costs investors 40 and will be worth 100. There is a 50% chance the project will generate no liability and a 50% chance that it will generate liability of 130. The potential gain to society from this project is 60 (100 of value produced, less 40 of investment); the potential loss is -70 (100 of value produced, less 40 of investment and 130 of liability). Each of these outcomes are equally probable, so the social utility of the project is the average of the two, -5. Society is better off without the project. But if the project can be financed in a manner that externalizes liability—through a corporation in which shareholders have limited liability—the promoters of the project can reap a profit. The possible outcomes to the investors are a gain of 60 (100 of value produced, less 40 of investment) or a loss of 40 (investors recover nothing because liability absorbs all assets). Each of these outcomes are equally probable, so the profitability of the project is +10 to the investors. The investors could realize that profit by selling the right to do the project before the liability is incurred.

The investors could increase the profitability of this project through further judgment proofing. For example, if 30 of the 40 necessary to complete the project comes from secured creditors or asset securitizers, that 30 will have priority over liability claimants. Viewed from the perspective of the investors as a group, the potential loss is reduced to -10 (the amount investors will lose if the project is bankrupted by liability), giving the investment a positive value of 25 (the sum of a 50% chance of gaining 60 (worth 30) and a 50% chance

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180. That is, before the risk resolves into a favorable or unfavorable outcome

of losing 10 (worth -5)). Again, these values exist in the hands of those organizing the project before the liability is incurred.

Another way of viewing this transaction is that the organizers "sell" to secured creditors or asset securitizers the opportunity to defeat liability,<sup>181</sup> reaping their profit in the enhanced value of their shares. Though the shares may later become worthless, that is a risk that will be borne by those who own the shares when and if the liability accrues. The value of the organizers' shares reflects the organizers' profits even *after* they are discounted for the probability of the future liability. Because the organizers have the opportunity to pull their profits out of the business before the liability risk of the business resolves, Professor Presser's self-immolation argument fails. Externalizing liability can generate profits, not just control losses.

### B. *The Precarious Position of Managers*

For large companies to remain perpetually judgment proof would put managers in a precarious position. To reap the full benefit of judgment proofing, the companies occasionally would have to sweep away their liabilities in Chapter 11. The Chapter 11 reorganization of a large, publicly held company almost inevitably results in a shift in control<sup>182</sup> and that shift of control almost invariably sweeps top management from office.<sup>183</sup>

Economically minded writers generally consider this characteristic of Chapter 11 to be positive. They tout high debt levels as an efficient means of disciplining management. They argue that the inability of the company to meet its debt obligations signals the failure of management to achieve expectations. The Chapter 11 case provides the opportunity for the investors to intervene.<sup>184</sup>

The interests of the managers are exactly the opposite of those of the investors. To the extent that the managers of large, publicly held companies have power independent of their shareholders, they can benefit themselves by operating their companies with substantial cushions of equity. Their purpose in maintaining these cushions is to protect themselves against creditors and shareholders; the incidental effect of doing so is to expose investments in their

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181. See LoPucki, *supra* note 32, at 1899 ("Security is an agreement between A and B that C take nothing.").

182. See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 610-11, 618 (1993) (presenting data and concluding that "it was rare for existing shareholders to retain a majority of the reorganization shares").

183. See Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355, 356 (1990) (finding high CEO turnover during Chapter 11 reorganizations of large companies); LoPucki & Whitford, *supra* note 124, at 729 (stating that 95% of CEOs in office at time of business failure that led to bankruptcy had lost their positions by confirmation of plan).

184. Debt has been described as a means of controlling managers. See Oliver Hart & John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 AM. ECON. REV. 567-68 (1995) (describing finance literature).

companies to liability unnecessarily.<sup>185</sup> Even though their investors are better off with judgment-proof structures that externalize the risk of liability,<sup>186</sup> managers can be expected to resist them.

Once this conflict between the interests of owners and managers over the judgment proofing of investments is generally recognized, it is likely to be resolved in ways that promote judgment proofing. That solution maximizes benefits to the alliance of owners and managers.<sup>187</sup> By contract, owners and managers can then divide between them benefits gained by externalizing liability. Managers might, for example, be given higher pay or collateralized severance pay to compensate them for the additional risk of job loss in a judgment-proof company.

### C. *The Marginality of Liability*

To judgment proof a business, managers must finance it differently. Specifically, they must change the source of the company's financing from equity, in the form of public stock offerings and unsecured debt in the form of commercial loans and public bond offerings, to a combination of asset securitization and secured loans. The managers must be willing to take the company through bankruptcy reorganization to sweep away liability that cannot be settled. To justify the change in method of financing, the savings from the elimination of liability must exceed the additional costs, if any, of the new forms of financing and the occasional bankruptcy reorganizations. For many businesses, judgment proofing is not cost effective for the simple reason that

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185. As Easterbrook and Fischel have suggested:

Managers who have firm-specific investments of human capital cannot diversify the risk of business failure. . . . The purchase of insurance in amounts greater than the amount of the firm's capital is one method of reducing the amount that the firm must pay [managers for personal risk taking]. A firm with insurance against tort claims is less likely to become bankrupt, and thus less likely to impose costs on managers and other employees

Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 107-08 (1985); see LoPucki, *supra* note 32, at 1930-31 ("By borrowing unsecured, the managers may be sacrificing the best interests of their companies to render their own positions less precarious.")

186. See Thompson, *supra* note 78, at 2 (1994) ("If the liability is shifted to a tort victim, the use of the corporate form seems particularly troublesome, permitting the enterprise to externalize part of the cost of doing business."); see also Easterbrook & Fischel, *supra* note 185, at 107 ("When corporations must pay for the right to engage in risky activities, they will tend to undertake projects only where social benefits equal social costs at the margin."); Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375, 1375 (1994) ("Commentators have long recognized that the existence of judgment-proof tortfeasors seriously undermines the deterrence and insurance goals of tort law. The deterrence goal is undermined because, irrespective of the liability rule, judgment-proof tortfeasors will not fully internalize the costs of the accidents they cause." (footnote omitted)).

187. The assumption underlying this conclusion is that the gains from judgment proofing the company—an average of about five million dollars per year, see *infra* text accompanying note 190—exceed the value to managers of avoiding Chapter 11 and the accompanying probability that they will lose their jobs. That is, the level of increased compensation the company would have to pay its top managers to accept the higher risk of bankruptcy and job loss that accompanies judgment proofing would be less than five million dollars per year.

the businesses generate little liability and thus have only low costs to eliminate.

How great are the costs of liability? In a survey of 729 relatively large U.S. and Canadian firms,<sup>188</sup> Tillinghast-Towers Perrin and the Risk Insurance Management Society found that "total liability risk financing costs"<sup>189</sup> averaged about .255% of the companies' total revenues.<sup>190</sup> The average revenues for respondent companies was \$1.966 billion, so the average liability risk-financing cost for one of these companies was about \$5 million a year. To a company of that size, \$5 million would not be inconsequential. The \$5 million a year savings available from judgment proofing would come with a bonus: Immune from liability, the company could engage in higher risk activities without increased costs. Whether such a company should attempt to capture these savings will at least in part depend on what the company has to do to get them. Large companies that do not consider the savings worth the expense and hassle of judgment proofing themselves today may come to the opposite conclusion once other large companies break the ice.

The basis for large companies' reluctance to use judgment-proofing techniques today is similar to the basis for their reluctance to use bankruptcy reorganization in the 1970s. In each case, the new strategy raised moral issues, was untried and therefore uncertain, and threatened to bring with it public relations problems capable of destroying the company. The flow of large corporate bankruptcy cases began as a trickle in the early 1980s, and by 1990 had become a flood.<sup>191</sup> For example, before Continental Airlines filed its first petition in 1983, commentators speculated on whether the reorganization of an airline was even possible.<sup>192</sup> Once pioneers had shown the way, it was much easier for other companies to follow. By 1992, at least seven major carriers had filed for reorganization: Air Florida, Frontier, Eastern, Pan Am, Midway, American West, and TWA. Bankruptcy had "lost [its] . . . stigma" and had become "an acceptable, trendy reorganizing tool."<sup>193</sup>

Unfortunately for the liability system, total liability risk financing cost differs widely with the size of the company,<sup>194</sup> and also from industry to

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188. See 1995 COST OF RISK SURVEY I.

189. Total liability risk financing costs are the sum of liability insurance premiums and retained liability losses (uninsured losses). *Id.* at 21.

190. *Id.*

191. See *infra* note 225 and accompanying text.

192. See, e.g., John Brecher, *A Proud Bird Loses Its Wings*, NEWSWEEK, Oct. 3, 1983, at 71 (quoting airline analyst prediction that "[i]f Continental can operate in bankruptcy . . . a lot of airlines are going to go bankrupt to alter their labor agreements") (alteration in original).

193. Fred Faust, *Retailers Tighten Their Belts for a Lean '96*, ST. LOUIS POST DISPATCH, Jan. 16, 1996, at 6C (quoting consultant on mergers, acquisitions, and restructurings).

194. See 1995 COST OF RISK SURVEY, *supra* note 188, at 46 (showing ratios of liability premiums to company revenues to be about eight times as high for \$100 million companies (.75%) as for \$5 billion companies (.096%)).

industry.<sup>195</sup> In some industries, the costs of liability are clearly high enough to drive company strategy.<sup>196</sup> In those kinds of industries, judgment proofing flourishes.<sup>197</sup> Once the techniques have been developed, they are transported to other industries where the risks are only marginally lower. As was demonstrated in the toxic waste treatment, storage, and disposal industry, the system can, through a concerted effort, prevent judgment proofing in a single, highly visible industry, at least temporarily.<sup>198</sup> But as the number of industries in which judgment proofing is cost effective increases, the system's battle becomes increasingly hopeless.

Companies that judgment proof will be able to capture three kinds of savings. First, through bankruptcy reorganization they will be able to discharge liability to suppliers, employees, taxing authorities, and other creditors who deliberately assumed the role of unsecured creditor. Until these kinds of creditors adjust to the new environment in which judgment proofing is common, judgment-proof debtors will profit greatly from the discharge of this kind of liability. Eventually, most of those who can adjust to the new environment will. Suppliers and employees can withhold their goods and services unless they are admitted to the privileged circle of the secured creditors. Taxing authorities have the power to grant themselves liens. I have argued elsewhere, however, that the reaction of these creditors will be incomplete; some will be slow to understand the change or will lack the liquidity or flexibility to change their ways. They will provide a permanent subsidy to judgment-proof debtors.<sup>199</sup>

The second kind of cost savings available to a judgment-proof debtor is the reduction of recurring, predictable liability to "involuntary creditors." Involuntary creditors are creditors who do not contract for their status as creditors but are thrust into it by the wrongful act of their debtor. Most tort creditors are involuntary. Some—but far from all—involuntary claims can be insured. But when involuntary creditors' claims are recurring and predictable, insurance does not necessarily result in any savings. Insurance companies

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195. *Id.* at 49 (showing liability premiums as percent of revenue to be about 60 times as high for finance banks, savings & loans, and holding companies (.011%) as for real estate, and securities and commodities brokers (.656%)).

196. See Charles Robert Tremper, *Compensation for Harm from Charitable Activity*, 76 CORNELL L. REV. 401, 420 & n.97 (1991) (observing that during 1987-88 average insurance expenses of United Way agencies and other sources available for property and liability coverages (other than motor vehicle) reached between two and three percent of total operating expenses); Lee Berton, *Ledgerdemain? Coopers & Lybrand Revised Notes of Audit a Year After the Fact*, WALL ST J., Nov. 2, 1995, at A1 ("Settlements of [malpractice] suits now devour an astonishing 12% of accounting and auditing revenue at the Big Six accounting firms."); *Policing Cabs*, SACRAMENTO BEE, Dec. 2, 1994, at B8 (noting that insurance for cab drivers can run as high as \$9000 per year).

197. See, e.g., William J. Cook, *An Easy Way out of this Mess*, U.S. NEWS & WORLD REP., June 25, 1990, at 14 (reporting decision by Royal Dutch/Shell Oil Company to ship oil to United States on independent tankers "[r]ather than risk being stuck for [liabilities for cleaning up any possible spills]");

198. See *infra* note 298.

199. See LoPucki, *supra* note 32, at 1954-58.

incorporate the cost of paying the predictable claims into the premiums they charge debtors. If debtors choose to pay the premiums, it is not to reduce risk, but only to gain the insurers' loyalty and expertise in claims administration<sup>200</sup> or to comply with laws requiring financial responsibility.<sup>201</sup> Solvent debtors must pay the full costs of recurring and predictable liability, whether insured or not.

By contrast, debtors who are both uninsured and judgment proof cannot be compelled to pay even their recurring and predictable liabilities. Instead, a standoff ensues. The creditor cannot forcibly obtain payment, but it might be able to disrupt the debtor's business. The debtor can extinguish the claim through bankruptcy reorganization, but that would be costly and disruptive. Most of these standoffs are resolved through compromise. Claims of particularly obstreperous involuntary creditors can either be discharged by the running of the relevant statutes of limitations, or, if the plaintiffs can find attorneys willing to invest in them, be reduced to judgments. Judgments obtained remain effective until discharged in bankruptcy reorganization or paid as a result of some fluke that renders the company no longer judgment proof. Overall, the savings to judgment-proof debtors from dealing with recurring, predictable liability in this manner probably are substantial. But for a large company to operate this way in a world where others do not might be a public relations disaster. This last consideration is discussed in the next subsection.

The third kind of cost savings available to a judgment-proof debtor is the elimination of unpredictable catastrophic liability. This category includes the kinds of liability resulting to Manville from its asbestos manufacturing, to Texaco from the *Pennzoil* verdict, or to Dow Chemical from the breast implant litigation. Some of this liability is insured against, but much is in excess of policy limits or outside policy coverage entirely.<sup>202</sup> As should be apparent from the number of large companies that have filed for bankruptcy, bankruptcy already is the standard method of dealing with liability of this magnitude. The companies that use this method can be thought of as engaging in a "soft" kind

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200. See MARK R. GREENE ET AL., *RISK AND INSURANCE* 541, 543 (8th ed. 1992) (explaining that "[i]f each small group were . . . required to pay for its own losses, risk transfer would not be achieved," but also focusing on claims management as another key function of insurers).

201. See Robert J. Gilbert, *Playing It Safe in Today's Real Estate Market with Environmental Insurance*, MASS. LAW. WKLY., SUPP.: REAL EST., Dec. 5, 1994, at 1, 8 n.2 ("Many companies offer 'insurance' that essentially constitutes a surety bond; the insurer merely guarantees that the handler or transporter will be able to pay damages to third parties up to the amounts required in the financial responsibility law: the handler or transporter typically is obligated to repay the insurer for any amounts paid under the policy.").

202. Even large companies carry relatively low levels of insurance. See 1995 COST OF RISK SURVEY, *supra* note 188, at 69 (showing mode umbrella/excess liability limits carried by firms with revenues of \$100 million to \$500 million to be only \$31 million to \$50 million). In mass tort cases where the liability is in the hundreds of millions or billions of dollars, the insurers commonly deny coverage and litigate. See, e.g., Andrew Blum, *Dow Corning Gets Some Cash*, NAT'L L.J., Feb. 19, 1996, at A6 (describing litigation between Dow Corning and its insurers over insurers' attempt to void policies for Dow Corning's failure to disclose information about dangers of breast implants).

of judgment proofing: one that contemplates payment of judgments in relatively small amounts but discharge of judgments in relatively large amounts.<sup>203</sup> Any company that becomes "lean" through the reduction in its capital to the levels for which there is a "reasonably foreseeable" need has accomplished this kind of judgment proofing. Soft judgment proofing externalizes the cost of a company's economic activity no less certainly than the kind of "hard" judgment proofing that aims at denying all recovery to every plaintiff.<sup>204</sup>

The absence of hard judgment proofing from the largest companies in the U.S. economy may signal any of three things. First, the benefits of such judgment proofing may not be sufficient to exceed the added costs of secured or asset-securitized financing and the occasional bankruptcy.<sup>205</sup> Second, hard judgment proofing may be cost effective for investors in the business, but it may be artificially constrained by managers' conflicts of interest.<sup>206</sup> The third and most likely possibility is that hard judgment proofing is not cost effective for large companies, but only because of cultural and political constraints. Those limitations are discussed in Section E.

#### D. *Legal and Clerical Costs*

Liability is a form of government regulation; that is, the government mandates particular behavior through the rule of law and creates private rights of action as the means of enforcing the mandate. Corporate financiers routinely employ strategies to escape limitations imposed by regulation.<sup>207</sup> For example, stockbrokers invented cash management accounts as a strategy to escape regulations limiting the amount of interest that could be paid on a bank account, and investment bankers invented asset securitization as a strategy to escape involvement in the debtor's bankruptcy. Strategies such as these depend heavily on computerized recordkeeping and were simply not possible at earlier levels of technology.<sup>208</sup>

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203. "Soft" and "hard" judgment proofing are defined at *supra* note 107

204. See, e.g., William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes Lurching Toward a Coherent Outcome?*, 66 *COLO. L. REV.* 1001, 1036 (1995) ("[I]t is clear that the rule of limited liability allows incorporated firms to shift to others some of the cost of their economic activity . . .").

205. See *supra* note 196 (estimating costs of liability insurance)

206. See *supra* notes 182-85 and accompanying text (explaining conflict). Ultimately, managers may have no choice. The losses from failure to judgment proof a large debtor will fall on consensual unsecured creditors and shareholders. The impetus to judgment proof them can be expected to come from those groups. Unsecured lenders should demand security; the market for corporate equities should demand securities that evidence direct ownership of the corporation's assets as well as ownership of its operations.

207. See, e.g., Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 *J. FIN. & QUANTITATIVE ANALYSIS* 459, 459 (1986) (arguing that "[t]he major impulses to successful financial innovations have come from regulations and taxes" and discussing numerous examples).

208. For discussions of the role of computer technology in recent financial innovation, see Tim S. Campbell, *Innovations in Financial Intermediation*, 32 *BUS. HORIZONS* 70, 70 (1989) ("Much of the actual work in financial services involves recording and communicating transactions. The cost of these services



Regulations rarely prohibit the accomplishment of particular objectives. To prevent strategists from achieving a particular objective, regulators bar use of the form ordinarily used to achieve it. Strategies designed to defeat regulation are generally of a single basic structure. The strategist devises and adopts some combination of permissible forms ("the new form") that achieves the objective. To devise the new form may require considerable cleverness. Had the regulator been able to anticipate the combination of permissible forms capable of defeating the regulation, the regulator probably would have barred the combination as well.

The new form typically is more complex than the old form. To make the new form understandable to users accustomed to the old, the strategist may provide for a translation between the two forms. To the regulator, the strategist documents the transaction in the new form permitted by law; to the customer, the strategist documents the transaction in the familiar form prohibited by law.

For example, consider the modern technique by which cash is managed within a corporate group. To minimize its cost of capital, the corporate group must minimize the amount of cash it keeps on hand. To minimize the amount of cash it must keep on hand, the group maintains only a single fund of cash that it employs wherever it may be needed within the group. Thus described, the technique constitutes a disregard of corporate formalities and provides the basis for substantive consolidation of the group should the group enter bankruptcy. To be entitled to treatment as separate entities, corporations must operate as separate entities. In the language employed here, the single fund is a prohibited form.

There exists a permissible form for accomplishing the same objective. Each member of the corporate group maintains its own fund of cash. Whenever cash is needed by another member of the group, the member with the cash lends it to the member with the need. Provided that such a loan is properly documented and repaid when due, the making of the loan provides no basis for disregard of the corporate entity of lender or borrower. Using the permissible intragroup loans form, payment of the obligations of all members of a corporate group by a single member of the group can be reinterpreted as a series of transactions in which the single member lends money to the other members, to be repaid at a future date. When the group receives cash from operations, the cash goes into the single fund. The deposit can be reinterpreted as a series of transactions in which the single member receives repayment of the loans from the particular group members who earned the funds deposited.

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is largely a function of the level of computer and communications technology. With the increasing refinement of the microchip, more sophisticated systems for managing financial transactions have become practical."); John D. Finnerty, *Financial Engineering in Corporate Finance: An Overview*, 17 FIN. MGMT. 14, 29 (1988) ("The innovative financial processes [described in the article] reflect three basic causal factors: . . . (iii) the availability of relatively inexpensive computer technology to facilitate quicker financial transactions.").

The attribution of the funds to the efforts of various members of the group can be made on any basis the regulator prefers because the loan and repayment accounts within the corporate group need never balance. For loans to be due only when the “debtor” and “creditor” agree that they are due is a permissible form.<sup>209</sup>

To do business in this manner requires a great deal of recordkeeping. Before the development of computerized systems for funds transfers, the necessity of such formality and documentation may have been sufficiently burdensome to slow the proliferation of corporations within a group. But today, corporate groups manage their cash as a single fund, while the computer documents the movement as a symphony of loans and repayments, complete with interest at rates that fluctuate daily if desired.<sup>210</sup> The computer composes two translations of the complex movement of funds. The manager of the cash sees it on the computer screen as a single fund, from which payments are made and into which receipts are deposited. For the court that may later determine whether the separate identities of members of the group have been respected, the computer documents each movement of cash as a set of intercompany loans or loan repayments.<sup>211</sup>

Asset securitization also depends heavily on computer translation. To qualify the transaction as bankruptcy remote, it must be a sale of assets to the investors. But the investors do not want to own assets; typically they want the kind of guaranteed, stable cash flow that results from loan repayment. To structure the transaction, one must first convert ownership into a cash flow. With some kinds of assets this might be accomplished through a sale and lease back. The lease payments become the cash flow. With accounts, the problem is considerably more complex. For the investors to “own” the accounts, fluctuations in the value of the accounts must accrue to them. But both parties want the fluctuations to accrue to the debtor. The solution is a complex arrangement in which the turnover of the accounts produces the cash flow, the debtor is constantly swapping new accounts into the pool owned by the

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209. For example, a debtor and creditor can agree that the loan be repayable “on demand” until a demand is made, the loan is not overdue. Such a loan can remain outstanding for years. See U.C.C. § 1-208 cmt. (referring to “demand instruments . . . whose very nature permits call at any time with or without reason”).

210. See *In re Hillsborough Holdings Corp.*, 166 B.R. 461, 465–66 (Bankr. M.D. Fla. 1994) (describing complex cash management system in which each corporate subsidiary had its own checking account and had discretion to pay its own expenses, but checking accounts balances were maintained at zero by transferring group funds into accounts on daily basis).

211. See, e.g., *Southmark Corp. v. Grosz (In re Southmark)*, 49 F.3d 1111, 1114 (5th Cir. 1995) (“Although each company’s receipts and disbursements are commingled in the [cash management system] for cash management purposes, they are segregated for record keeping purposes and can be readily identified.”); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 967 (Bankr. S.D. Ohio 1990) (“Funds from different segments of the organization were routinely used to support other operations of the organization. On occasion, funds from cash-rich partnerships were used to support underperforming or immature properties of other partnerships. These intercompany transfers were reflected in the cash management system as advances and reimbursements.”).

investors in a manner regulated by contract, and the investors have a razor-thin “equity” in the accounts which is generally regarded as a deadweight transaction cost because the investors do not really want it.<sup>212</sup>

Transactions such as these are cost effective only because of computers. In this sense, they are a direct product of computer technology. Computer technology is generally acknowledged to be a driving force behind asset-securitization and debtor-haven strategies.<sup>213</sup> Not surprisingly, these are the two fastest growing strategies for judgment proofing.

Despite the already high level of computerization in the private sector, judgment-proofing strategies continue to be constrained by transaction costs. This results primarily from the failure of the public sector to organize, computerize, and provide an efficient interface with the private sector. For example, computerization of the Article 9 filing system has lagged badly, not only because government filing offices have been slow to computerize their systems,<sup>214</sup> but also because the drafters of the Uniform Commercial Code have been slow to redesign the system so that computerization could be effective within it.<sup>215</sup> Commentators generally agree that the transaction costs involved in the simple task of filing a one-page document and searching to see who else has done the same can be sufficiently high in some circumstances as to constrain significantly the taking of security.<sup>216</sup> The somewhat more formidable—but hardly gargantuan—task of restructuring a debtor’s finances under Chapter 11 today generates direct costs, ranging from a low of about three percent of the entire value of the debtor’s assets for large companies, to a high of over twenty-one percent for small companies.<sup>217</sup> The indirect costs

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212. See Schwarcz, *supra* note 90, at 141–42 (“To achieve a true sale, an originator must limit, if not forego, its right to the residual value of the receivables sold to the SPV. . . . Because the amount of receivables sold may turn out to be greater than what was needed to pay the SPV’s securities, the overpayment represents an indirect, but real, cost to the originator.”); Steven L. Schwarcz, *The Parts Are Greater than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139, 153–54 (referring to equity as “over-collateralization” and “cumbersome and expensive solution”).

213. See, e.g., *Asset Protection Planning: Expert Outlines Advantages of Offshore Trusts to Preserve Assets*, 6 INSIGHTS & STRATEGIES, July 23, 1993, at 1, 2 (quoting Ronald L. Rudman that “[w]ith advanced telecommunications and international banking facilities, it is just as easy to hold accounts and assets overseas as it is in another U.S. city”).

214. See Peter A. Alces & Robert M. Lloyd, *Report of the Uniform Commercial Code Article 9 Filing System Task Force to the Permanent Editorial Board’s Article 9 Study Committee* 19–25 (1991) (discussing lag in implementation of new technologies in statewide Article 9 filing systems).

215. See *id.* at 20–21 (noting technological superiority of British Columbia filing system).

216. See Peter A. Alces, *Abolish the Article 9 Filing System*, 79 MINN. L. REV. 679, 689–93 (1995) (presenting empirical evidence of high cost of filing and searching). *But see* Mann, *supra* note 75, at 45–49 (discussing information costs of secured lending); *id.* at 51–53 (expressing doubt that filing fees alone could be sufficient to alter decision to lend secured or unsecured).

217. See Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1076–78 (1984) (finding direct costs of large reorganization cases to average 6.0% of total assets); Daryl M. Guffey & William T. Moore, *Direct Bankruptcy Costs: Evidence from the Trucking Industry*, 26 FIN. REV. 223, 231 (1991) (finding direct costs of trucking industry reorganizations to average 9.12% of total assets); Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 868 (finding in study of Chapter 11 cases in

are generally conceded to be much greater.<sup>218</sup>

Help is on the way. The co-reporters of the current Article 9 revision process have resolved to make the granting of secured credit easier and more efficient.<sup>219</sup> Given the continuing controversy over costs and delays in bankruptcy reorganization, the National Bankruptcy Review Commission can be expected to exhibit the same concerns regarding Chapter 11. These systems cannot be fixed overnight, but they can become progressively more efficient. As they do, the transaction costs of judgment-proofing strategies will continue to decline.

The marginal cost of a fully computerized judgment-proofing transaction approaches zero. Even if the savings resulting from judgment proofing a firm are small, they can easily exceed the costs in a fully computerized environment. The attraction of asset securitization is that it provides a cheaper source of financing than traditional lending. This suggests that for many businesses, computerization has already tipped the balance between the costs of soft judgment proofing and the benefits that the business can gain from it.

#### E. *Culture and Politics*

For Americans to accept the hard judgment proofing of the nation's largest companies would require substantial cultural and political change. Rights enforced through liability are among the most precious we hold. These include the civil rights of minorities, the rights of access of the disabled, and the right to be compensated for the infliction of injury to one's person, property, or reputation. The successful implementation of important social policies—such as those relating to the environment, product safety, pensions, and health care—depend upon liability. If a major American company were caught attempting to deliberately deploy the strategies I described in the preceding Part in order to defeat liability and eliminate the need to pay liability insurance premiums, all hell would break loose.

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Memphis, Tennessee division of bankruptcy court that direct costs of bankruptcy averaged 21.55% of debtors' total assets as reported in petition); Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 343 (1977) (finding direct costs of large reorganization cases to average 4.0% of market value of assets); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 290 (1990) (finding direct costs in large reorganizations to average 3.1% of total assets); Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 484 (1983) (finding direct costs of large reorganization cases to average 6.0% of disbursements to all creditors)

218. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1068 (1992) (attributing putative \$14 billion loss in stockholder wealth in listed firms to change in bankruptcy law); Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295, 297 (1989) (attributing \$3.4 billion decline in combined trading values of Texaco and Pennzoil stock to threat of bankruptcy by Texaco and resulting costs).

219. See *supra* note 73 and accompanying text; Harris & Mooney, *supra* note 72, at 2021 (“[W]e think the transfer of an effective security interest ought to be as easy, inexpensive, and reliable as possible.”)

Judgment-proofing strategists would feel a variety of effects. Adverse publicity might chill the market for the company's products or the company's appeal in the employment market. Judges, juries, legislators, and regulators might retaliate against the company. Activists might boycott a company that seemed to be evading environmental or civil rights liability, even if such liability was not the main target of the strategies being employed. Concern about all these effects might discourage investment in the company. In short, the company might develop a reputation for sleaze.<sup>220</sup>

The Exxon Valdez oil spill provides a good illustration. Exxon Corporation has been assessed about nine billion dollars in liability.<sup>221</sup> Exxon Shipping Company, a \$100 million subsidiary of Exxon USA, owned and operated the Exxon Valdez. Exxon USA was in turn a wholly owned subsidiary of Exxon Corporation. Theoretically, liability for the Exxon Valdez spill might have been confined to Exxon Shipping Company. As a practical matter, no one seriously thought that it would be so limited. Within twenty-four hours after the spill, Exxon Corporation made a public statement assuming "responsibility" for it. Two weeks later, Exxon CEO L.G. Rawl was grilled about the extent of this assumption of responsibility by skeptical members of the U.S. Senate Committee on Commerce, Science, and Transportation.<sup>222</sup> For Exxon to attempt to confine liability to the subsidiary not only would have been futile, but in all probability would have been counterproductive.<sup>223</sup>

On the other hand, most American businesses already are judgment proof outside of narrowly drawn, dollar-limited liability insurance coverage. Credit managers, tax collectors, environmental regulators, and tort lawyers are already accustomed to the reality that, upon the failure of the typical business with

220. Recent events involving Marriott Corporation illustrate the depth and sensitivity of contemporary cultural and political attitudes toward judgment proofing. See Pauline Yoshihashi, *For Bill Marriott Jr., The Hospitality Trade Turns Inhospitable*, WALL ST. J., Dec. 18, 1992, at A1. In October of 1992, Marriott announced a plan to split the \$8.3 billion dollar company in two. One of the emerging companies would own the most promising assets, and the other would take "virtually all of Marriott's debt" and "scads of unsold land and hotels." *Id.*

Even though this soft judgment proofing was directed at consensual bond investors rather than involuntary creditors and presumably did not violate their legal rights, in reporting on it the *Wall Street Journal* used the words "sleaze" and "sleazy" and spoke of "angry" institutional investors, the company "get[ting] a lot of heat," and "sully[ing] their reputation." *Id.*

221. See, e.g., Scott Kerin, *Alaska Sport Fishing Association v. Exxon Corporation Highlights the Need to Take a Hard Look at the Doctrine of Parens Patriae When Applied in Natural Resource Damage Litigation*, 25 ENVTL. L. 897, 902 n.30 (1995) (listing payments made by, and liability assessed against, Exxon).

222. See *Exxon Oil Spill: Hearing Before the Senate Comm. on Commerce, Science, and Transp.*, 101st Cong. 47, 52-53, 56-61 (1989) (statement of L.G. Rawl, Chairman of Board and Chief Executive Officer, Exxon Corp.).

223. See *Exxon "Strictly Liable"*, NAT'L L.J., Oct. 8, 1990, at 6 (reporting that, in *In re Exxon Valdez Oil Spill Litigation*, Alaska Superior Court Judge Brian Shortell ruled that Exxon Corporation and Exxon Shipping were strictly liable for all damages proximately caused by Exxon Valdez oil spill); Rovert Iraola, *Criminal Liability of a Parent Company for the Conduct of Its Subsidiary: The Spillover of the Exxon Valdez*, 31 CRIM. L. BULL. 3, 7-9 (1995) (describing basis for U.S. district court ruling that Exxon Corporation was criminally liable for conduct of its subsidiary, Exxon Shipping, which operated Exxon Valdez).

assets worth \$500,000 to \$1 million, the secured banks and finance companies will take everything, and their own claims will be discharged without payment. "The company went bankrupt" is considered an adequate explanation. Could Americans come to see the judgment proofing of the largest companies in the same way?<sup>224</sup>

Attempting to predict whether cultural and political constraints will dissipate is a highly speculative undertaking. However, events that began in the 1980s are perhaps already showing us the answer. In the 1980s, the bankruptcy reorganization of large publicly held companies became a common feature of the economic landscape.<sup>225</sup> In our study of the 1980s bankruptcy reorganization of publicly held companies with \$100 million or more in assets at the time of filing, William Whitford and I found considerable evidence of soft judgment proofing. Some firms were highly leveraged, while others were divided into numerous entities in ways that potentially disadvantaged various classes of unsecured creditors.<sup>226</sup> In the five most egregious cases, companies with scheduled assets of \$2.5 billion paid unsecured creditors a total of \$46.3 million, an average of 1.8 cents on the dollar.<sup>227</sup> Shocking as these bankruptcies were to the American public, they resulted in no reevaluation of any of the principles that made such judgment proofing possible. "The company went bankrupt" was considered an adequate explanation.

Asset securitization was in its infancy at the time of our study and was not evident in any of our cases.<sup>228</sup> Today, asset securitization is employed principally in companies the size of those we studied,<sup>229</sup> suggesting that soft judgment proofing through asset securitization may have contributed to the increase in large bankruptcy reorganizations since our study. Nevertheless, when the assets and insurance of a large, publicly held company are

224. See, e.g., MICHAEL MORITZ & BARRETT SEAMAN, GOING FOR BROKE 316–17 (1981) (describing incident in which debtor Chrysler Corporation managed to cast small Rockford, Illinois bank as villain for refusing to sign workout agreement that unilaterally reduced amount Chrysler owed bank)

225. Of the 40 largest bankruptcy reorganizations, 38 occurred after 1979. See BANKRUPTCY YEARBOOK & ALMANAC 63 (Christopher M. McHugh ed., 3d ed. 1993)

226. The numbers of corporations in groups ranged from 2 to 352, most groups had between 3 and 26. See Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS L REV 11, 21 (reporting data and noting that in some cases, all entities were components of single enterprise). Blumberg reports that the 1000 largest companies in the United States have an average of approximately 48 subsidiaries. See PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 465–68 (1983) (tbl.).

227. The five are Seatrail Lines, MGF, Towner Petroleum, Air Florida, and Braniff Airlines. This statistic is calculated from previously published data. See LoPucki & Whitford, *supra* note 110, at 142 (providing data on distributions to unsecured creditors); LoPucki & Whitford, *supra* note 182, at 614 (providing appendix listing value of assets of companies studied)

228. Sales and leasebacks were. The bankrupt airlines in our study were lessees of most of the fleets, so that the aircraft were not part of the bankruptcy estate. The effect of such a transaction is functionally similar to asset securitization.

229. See Schwarcz, *supra* note 90, at 139 ("[P]ublic securitization is rarely cost effective for transactions of less than \$50 million and is more common for transactions in the \$100 million or higher range.").

insufficient to pay its liabilities, most commentators still consider it the result of financial reversals rather than of strategic preparation for the possibility of financial reversals.

To be culturally and politically acceptable, the process of judgment proofing must appear to be something other than what it is. There is every reason to believe that it will. The reality of asset securitization is that it reduces the financial responsibility of the company while leaving the company's level of liability-generating financial activity constant. The public image of asset securitization is that of the invisible hand of the market, aided by modern technology, generating wealth by forging increasingly sophisticated financial structures. Eventually it will become obvious that the invisible hand is not an efficient allocator of resources, because it is moved only by the interests of *contract* creditors. But so long as the companies march into this new world in tandem, each objecting that it is forced into its course of action by competitive pressures,<sup>230</sup> it will be difficult for indignation to take hold.<sup>231</sup> The problem will be seen, not entirely incorrectly, as systemic rather than moral. Attention will turn to proposals for reform, which are discussed in Part IV.

#### IV. RADICAL SYSTEM RESPONSES

As the transaction costs of judgment-proofing strategies decline, the fundamental contradiction of the current system for enforcing liability will become increasingly apparent. Liability adheres only to the unencumbered property that happens to be owned by the debtor entity. Except in highly regulated industries, such as banking and insurance, the owners of those entities control how much unencumbered property they own. As the system currently operates, liability is, for wrongdoers, a voluntary system.<sup>232</sup>

To save liability as an involuntary system that implements a wide range of public policy,<sup>233</sup> the system's designers will have to make radical changes in it. The available options fall into three categories. First, if the system designers are willing to abandon the principle of enforcement only against property of the debtor, they can extend liability to the shareholders, affiliates, trading partners, and asset providers of those currently liable. If the net of

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230. A judgment-proof company has lower costs than a vulnerable company in three respects. First, financing is available to the judgment-proof company at lower rates because the financiers are insulated from liability. Second, the judgment-proof company need not purchase liability insurance. Third, the judgment-proof company can settle litigation against it more cheaply because judgments obtained will be uncollectible.

231. This is essentially the formulation successfully employed by many of the same companies during the 1980s when they were criticized for actions that reduced their labor costs.

232. See, e.g., Hansmann & Kraakman, *supra* note 76, at 1920 ("[L]imited liability in tort permits the firm's owners to determine unilaterally how much of their property will be exposed to potential tort claims, thereby inviting opportunism and inefficiency.").

233. See *supra* text accompanying note 3.

liability can be cast broadly enough, parties potentially liable may find it more cost effective to contract among themselves to assure that the liability is paid than to judgment proof the numerous entities that might be sued.<sup>234</sup>

Second, the designers could subordinate the claims of secured creditors to those of involuntary creditors. Third, the designers could condition the right to do business in the United States on demonstrating financial responsibility. That might be accomplished through maintenance of a specified level of liability insurance, posting a bond, or furnishing proof of solvency. The next Section will assess the effectiveness of these system strategies by analyzing the strategies likely to be employed in response.

#### A. *Shareholder Unlimited Liability*

In recent years, corporate law scholars have vigorously debated a proposal by Professors Henry Hansmann and Reinier Kraakman that shareholders have liability for torts committed by their corporations.<sup>235</sup> That is, if the assets of a corporation are insufficient to satisfy its liabilities, involuntary creditors should be entitled to enforce their judgments against the assets of individual shareholders.

Proponents of shareholder liability hope that shareholders will respond by compelling the corporations in which they invest to purchase insurance against liability and, when liability is nevertheless uninsured, to pay it.<sup>236</sup> None of the proponents argue that that will happen in all or substantially all cases.<sup>237</sup>

234. The contracts contemplated will place the liability on the lowest cost avoider, who will have the incentive to take all cost-effective safety and compliance measures. See Susan Block-Lieb, *The Unsecured Creditor's Bargain: A Reply*, 80 VA. L. REV. 1989, 1997-2000 (1994) (explaining means by which "second-best actors" return liability to lowest cost avoider). Professor Reinier Kraakman has described this system strategy as "third-party enforcement." See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (describing "gatekeeping liability" as liability imposed on private persons such as accountants and lawyers "to prevent misconduct by withholding support").

235. See, e.g., Janet C. Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Grundfest, *supra* note 117; Henry Hansmann & Reinier Kraakman, *Do the Capital Markets Compel Limited Liability? A Response to Professor Grundfest*, 102 YALE L.J. 427 (1992) [hereinafter Hansmann & Kraakman, *A Response to Professor Grundfest*]; Henry Hansmann & Reinier Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 HARV. L. REV. 446 (1992); Hansmann & Kraakman, *supra* note 76, at 1880 (arguing weakness of existing justifications for shareholder limited liability and asserting that burden is now on proponents of limited liability to provide persuasive exposition); Leebron, *supra* note 76, at 1650 ("With [certain] exceptions, limited liability of shareholders seems on balance to be justified."); Thompson, *supra* note 78.

236. See, e.g., Hansmann & Kraakman, *supra* note 76, at 1890 ("Thus we have good reason to believe that a shift to unlimited liability would be less likely to greatly increase risk-bearing by shareholders of small corporations than to induce those shareholders to purchase adequate insurance.")

237. One indicator of the proponents' expectations is their unanimous preference for pro rata liability rather than joint and several liability among shareholders. One who expected all liability to be paid would prefer a system based on joint and several liability among shareholders. If the system designer were confident that the loss could be transferred to any equity holders, it is a short, easy step to transfer it to the appropriate equity holders. None of the commentators advocate joint and several liability, suggesting that they doubt that deep pocket shareholders would be able to obtain contributions from other shareholders. See, e.g., Grundfest, *supra* note 117, at 388 ("[A] search for alternative liability regimes seems to have



They realize that many shareholders will do neither, that the liability system will then have to attempt to compel payments, and that it will often,<sup>238</sup> if not usually,<sup>239</sup> be unsuccessful.

Under the rules of the liability system, modified only by extending liability to shareholders, shareholders who choose to defeat that liability would have little difficulty doing so. The following subsections provide just a sampling of the strategies that might be employed.

### 1. *Passive Strategies*

Liability is enforced only through cumbersome civil procedure. If a shareholder with liability does not pay, someone must sue the shareholder, obtain service of process, litigate to judgment, discover property of the shareholder, and enforce the judgment against that property.<sup>240</sup> Many of the debts will be tiny. The person bringing these actions will have to decide, on the basis of scanty information, who is worth suing and who is not. Potential

settled on proportionate liability as the most plausible substitute for the traditional limited liability rule."); Hansmann & Kraakman, *supra* note 76, at 1894 ("[T]he pro rata rule is clearly the superior alternative for publicly-held corporations. The advantage of promulgating a single rule for all corporations makes the case for the pro rata rule compelling for closely-held firms as well."); Leebron, *supra* note 76, at 1649.

238. See Hansmann & Kraakman, *supra* note 76, at 1901 (arguing that "the collection effort would not need to reach every shareholder to serve its purpose. So long as it could succeed against most shareholders, including the largest shareholders, it would force public corporations to bear the bulk of their expected liability costs.").

239. As Leebron has suggested:

The costs of locating, suing, and enforcing what will probably be small judgments against a large number of shareholders would be large compared to the amount of such judgments. The amount collected, unless unlimited liability were extended to the costs of collection, would be substantially diminished. This would be another reason to expect shareholders and financial creditors to contract around such unlimited liability.

Leebron, *supra* note 76, at 1611.

240. In addressing this problem, Hansmann and Kraakman make the simplifying assumption that all shareholder liability accrues to the owners of stock on a single "liability date" for "a particular action or pattern of conduct [that] was expected to give rise to tort claims that might exceed the net value of the firm." Hansmann & Kraakman, *supra* note 76, at 1898. This unrealistic assumption is the basis for further assumptions that it will be easy to identify the liable shareholders and determine the amounts of their liabilities, that only a single action will be necessary against each shareholder, and that the action will therefore be analogous to the action by a bankruptcy trustee to collect "accounts receivable from hundreds or thousands of debtors." *Id.* at 1900. The assumption is unrealistic because much mass tort and environmental liability accrues over long periods of time as a result of numerous, successive acts. Setting a liability date before the course of conduct is complete makes shareholders liable for management decisions that have not yet taken place. For example, by setting liability dates today, the tobacco industry could place liability on today's shareholders for a pattern of action that is not yet complete, and, at the same time, exempt future shareholders from liability for that pattern of action. Yet if Hansmann and Kraakman modify their proposal to permit successive actions against shareholders as a liability situation deteriorated, or to permit management to wait to sue until the "pattern of conduct" was complete, solvent shareholders would have time to dump their shares before liability attached to them.

Hansmann and Kraakman would use management's announcement that "a particular action or pattern of conduct was expected to give rise to tort claims that might exceed the net value of the firm" as the trigger for shareholder liability. *Id.* at 1898. But in an insolvent company, every tortious act gives rise to liability expected to exceed the value of the company. Management would have to make another announcement every time a company truck hit a pedestrian, imposing a new flood of liability in petty amounts on shareholders who might number in the tens of thousands.

defendants can simply wait and see whether the system can enforce against them. Even Hansmann and Kraakman acknowledge that some of that liability will be unenforceable because the judicial enforcement machinery is antiquated and inefficient.<sup>241</sup>

The system could respond to this passive strategy in either of two ways. First, the civil court system could be redesigned to make it more efficient. To do that, however, Americans would have to confront their own ambivalence toward the enforcement of liability. A system that could obtain and enforce \$100 judgments against tens of thousands of shareholders might be dangerous. Second, the system might impose collection costs, including attorneys' fees, on losing shareholders.<sup>242</sup> If proponents were successful in winning the adoption of such a controversial rule, the effect would be to force shareholders who choose to rely on a judgment-proofing strategy to do so early and decisively. Imposition of fees and costs would increase the risk of such a strategy to the shareholder and therefore might decrease the frequency of use somewhat. But shareholders using a sound judgment-proofing strategy would not be deterred because they could avoid the collection costs along with the principal amount of the debt.<sup>243</sup>

## 2. *Pass-Through Strategies*

Hansmann and Kraakman's optimism regarding collection of assessments for shareholder liability is based largely on estimates that institutional investors own almost half the equity of the largest public companies.<sup>244</sup> Hansmann and Kraakman, along with others, assume that those holdings will be easy targets for enforcers of shareholder liability.<sup>245</sup> Probably most of those institutional investors, however, are securities brokers and dealers, mutual funds, or pension

241. *See id.* at 1901 ("[T]he collection effort would not need to reach every shareholder to serve its purpose. So long as it could succeed against most shareholders, including the largest shareholders, it would force public corporations to bear the bulk of their expected liability costs."). *But see* LOPUCKI & WARREN, *supra* note 8, at 5–20 (describing difficulty of collecting small unsecured debts through judicial process)

242. *See* Hansmann & Kraakman, *supra* note 76, at 1900 ("Moreover, even small shareholders might be induced to cooperate simply by adding collection costs to the assessment bill of shareholders who unsuccessfully sought to contest their assessments.").

243. *See* Leebron, *supra* note 76, at 1612 ("[T]he transaction costs of collecting from small shareholders would significantly blunt its effect."); Thompson, *supra* note 78, at 20 ("Yet as Leebron recognizes, the costs would consume the benefit of collecting from many small shareholdings so that enforcement is likely only to be feasible for entities such as parent-subsidary groups.")

244. *See* Hansmann & Kraakman, *supra* note 76, at 1900 n.57; *see also* Carolyn Kay Brancato, *The Pivotal Role of Institutional Investors in Capital Markets 19–20* (1990) (Columbia Law School mimeo) (paper presented at the Salomon Brothers Center's and Rutgers Center's Conference on the Fiduciary Responsibilities of Institutional Investors) (estimating that "institutional investors now hold 45% of total U.S. equities and 48.1% of the equity in the 1,000 largest U.S. corporations")

245. *See* Hansmann & Kraakman, *supra* note 76, at 1899–901; Thompson, *supra* note 78, at 31 ("[P]ro rata liability of shareholders for torts of their corporations . . . would discourage mutual funds from holding large blocks of stock since a large, well-financed shareholder would be a much more attractive defendant than would many dispersed shareholders.").

funds that hold the equity for others. To the extent that they do, they can pass that liability through to the true owners simply by clarifying their role. For example, they could modify their computerized recordkeeping systems to show the beneficial owners of securities as the record owners. The investor who today holds a 1/1000th interest in a mutual fund will tomorrow hold a 1/1000th interest in each share of stock in the mutual fund. The broker or dealer who manages the fund would no longer be liable as a shareholder for the simple reason that the broker or dealer would no longer *be* a shareholder.<sup>246</sup>

To the extent that enforcement is sought against the assets of pension plans, the new policy in favor of shareholder unlimited liability will clash directly with current policy under ERISA. Congress has specifically barred enforcement of money judgments against the debtor's interest in a pension fund.<sup>247</sup> To permit invasion of a pensioner's nest egg because a corporation in which the pension-fund-held stock committed a tort, but not to permit invasion when the pensioner committed the tort personally, would be as ironic as it would be unlikely.

### 3. *Trust Strategies*<sup>248</sup>

Generally speaking, trusts are limited liability entities. If a trust is operated in such a manner as to injure third parties, those third parties can obtain and enforce a judgment against the person committing the tort and against the trust under the doctrine of respondeat superior, but not against the separate property of either the trustee<sup>249</sup> or the beneficiary.<sup>250</sup> If the system stripped

246. In dealing with pass-through strategies, the system will be hampered by its focus on ownership. "Ownership" is merely a form. Strategists can avoid it by using other forms that accomplish their purposes equally well.

247. See 29 U.S.C. § 1056(d)(1) (1994) (providing that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated"); *Patterson v. Shumate*, 112 S. Ct. 2242 (1992) (holding that debtors' interests in ERISA pension plans are excluded from debtors' bankruptcy estates).

248. Grundfest describes a strategy for replicating equity returns while avoiding a proposed proportionate liability by placing the equity in trust and having the trust issue debt securities. See Grundfest, *supra* note 117, at 409. His strategy seems to be in no way dependent on use of a trust as its vehicle and in no way related to the strategies presented in this subsection.

249. See *Cook v. Holland*, 575 S.W.2d 468, 475 (Ky. Ct. App. 1978) ("[Sections 7-306 and 3-808 of the Uniform Probate Code] were designed to make the trust estate a 'quasi-corporation' for the purposes of tort liability. The . . . trustee is treated as though he were an agent for a corporation."); RESTATEMENT (SECOND) OF TRUSTS § 265 (1959) ("Where a liability to third persons is imposed upon a person, not as a result of a contract made by him . . . but because he is the holder of the title to property, a trustee as holder of the title to the trust property is subject to personal liability, but only to the extent to which the trust estate is sufficient to indemnify him."); UNIF. PROBATE CODE § 7-306(b), 8 U.L.A. 560 (1983) ("A trustee is personally liable for obligations arising from ownership or control of property of the trust estate or for torts committed in the course of administration of the trust estate only if he is personally at fault.").

250. See *Just Pants v. Bank of Ravenswood*, 483 N.E.2d 331, 335 (Ill. App. Ct. 1985) ("Where the trustee is given full control in the management of the business of the trust, the beneficiaries have no personal liability."); *Cook*, 575 S.W.2d at 476 ("The beneficiaries have no personal liability for [the trust employee's] negligence."); RESTATEMENT (SECOND) OF TRUSTS § 276 (1959) ("The beneficiary as such is not personally liable to third persons for torts committed by the trustee in the course of the administration of the trust.").

corporations but not trusts of limited liability, those who invest in businesses could retain limited liability either by insisting that the businesses in which they invest operate as trusts<sup>251</sup> or by the much simpler expedient of keeping each of their corporate stockholdings in a separate trust.

The system could respond to the first of those strategies by stripping business trusts of limited liability. But stripping all the beneficiaries of trusts of protection against liability for trust activity would be a difficult step for the system to take. Unlike the shareholders of corporations, the beneficiaries of trusts often have no right of control over the trusts' investments and are often persons of diminished capacity, such as minors and incompetents. To hold the minors and incompetents, not just the assets of the trust, liable for the torts of a corporation in which the trust held shares would be a harsh result. Probably the best strategic response the system could make would be to exempt minors and incompetents from liability, but that might lead to the use of the trusts of minors and incompetents as liability shields. To trace all the possible reforms and strategies that might be used in response to them is beyond the scope of this Article, but it should be apparent that the system would be locked in a difficult battle which it might well lose.

#### 4. *Foreign Investment Strategies*

Professor Joseph Grundfest has described a foreign investment strategy capable of defeating shareholder unlimited liability.<sup>252</sup> With apologies to Professor Grundfest, I restate his argument here in systems/strategic terms. The argument begins with the quite reasonable assumption that even if the United States changes its rule to make shareholders liable for the debts of their corporations, at least some other countries would decline to do so. Assuming that some country, for example, Germany, retained shareholder limited liability, strategic investors in that country could invest in U.S. companies without exposing their assets to tort liability. The German investor who held the assets would form a German corporation, and transfer the funds to be invested to it. The German corporation would use the entire amount to purchase shares in a single U.S. corporation. When the U.S. corporation incurred liability beyond its ability to pay, that liability would attach to the German corporation as shareholder. The U.S. courts probably would not have jurisdiction over the German corporation to enforce its shareholder liability.<sup>253</sup> Even if the U.S. courts did, the action would reach only the assets of the German corporation,

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251. See, e.g., *Inside Scoop, Inc. v. Curry*, 755 F. Supp. 426, 430 (D.D.C. 1989) (discussing use of Massachusetts Business Trusts and noting that they have limited liability); Robert M. Lloyd, *Article 9 and Real Estate Law: Practical Solutions for Some Bothersome Problems*, 29 IDAHO L. REV. 583, 623-26 (1993) (discussing use of Illinois Land Trusts).

252. See Grundfest, *supra* note 117, at 395-99.

253. See Alexander, *supra* note 235, at 394-404.

which at that point would already be worthless. German law would control the relationship between the German corporation and the German investor, and that law would not impose shareholder liability.

This strategy would create a class of foreign investors in U.S. corporations who would not be subject to shareholder liability. Grundfest demonstrates that in modern capital markets, those investors could outbid U.S. investors for the shares of U.S. corporations.<sup>254</sup> He predicts that the change in stock prices would be de minimis.<sup>255</sup> The necessary implication is that shareholders would not pay significant amounts of corporate liability because they overwhelmingly would be judgment proof—principally by reason of their foreign location. The effect of the U.S. rule of unlimited shareholder liability would not be to force shareholders to pay the debts of U.S. corporations, but only to substitute German investors for U.S. investors.<sup>256</sup> Substitution of foreign investors would be more difficult for closely held companies, but perhaps not impossible. U.S. investors could own a German corporation that owned their American corporation.<sup>257</sup> Once revealed, such a simple structure might not withstand legal attack, but the need for attack and revelation might be enough to deter many plaintiffs.

Hansmann and Kraakman respond to Grundfest with a proposal that amounts, in essence, to a limit on the proportion of investment in U.S. corporations that can come from poorly capitalized foreign investors.<sup>258</sup> Grundfest counters that poorly capitalized foreign investors could evade such a restriction by investing in poorly capitalized domestic investment intermediaries that in turn invest in the U.S. corporation.<sup>259</sup> Hansmann and Kraakman respond with a supplementary proposal that poorly capitalized U.S.

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254. See Grundfest, *supra* note 117, at 399 (noting that existence of attachment-proof foreign investors means that introduction of proportionate liability may not change equity prices at all).

255. See *id.* at 390 (“The stock price effect of a proportionate liability rule can therefore never be greater than the transaction cost of the cheapest arbitrage that avoids liability generated by the rule.”); *id.* at 399 (“Simply put, the presence of these [remote] investors means that the introduction of proportionate liability may not change equity prices at all.”).

256. The funds invested by German corporations probably would be American. That is, Americans would buy stock in German limited liability corporations which would then invest the funds in American unlimited liability corporations. The United States could not prevent such investment because: (1) it would be incapable of tracing the funds through Germany; and (2) prevention probably would close the investment door to American funds without ending the German domination—the money would come from elsewhere.

257. See Grundfest, *supra* note 117, at 399 (“Foreign capital would be able to enter U.S. markets quickly and easily to take advantage of any opportunities created by the adoption of proportionate liability, and domestic capital would be invested in foreign vehicles that purchase domestic U.S. securities or are otherwise immune to proportionate liability judgments . . .”).

258. See Hansmann & Kraakman, *A Response to Professor Grundfest*, *supra* note 235, at 433. Hansmann and Kraakman wisely refrain from proposing either minimum capital requirements for investors or minimum capital requirements for businesses. The former probably would substantially reduce the amounts of capital available for investment in U.S. corporations and also would close the U.S. markets to ordinary Americans. The latter would reduce business opportunities for the least-advantaged Americans. See *infra* Section IV.G.

259. See Grundfest, *supra* note 117, at 424 n.149.

investment intermediaries with foreign investors be considered poorly capitalized foreign investors.<sup>260</sup>

Hansmann and Kraakman's supplementary proposal is unworkable. They would limit the amount of foreign investment in advance of the liability-generating incident; it follows that their regime would have to know the source of the funds in advance. In fact, they specifically acknowledge that "a proportionate liability regime must see through intermediary ownership structures to prevent opportunistic evasions of tort liability."<sup>261</sup> "Seeing through intermediary ownership structures" is nothing short of knowing the *ultimate* source of all money invested in U.S. corporations. That they could propose such a regime suggests that Hansmann and Kraakman grossly underestimate the difficulty of tracing funds. For example, assume that I have invested \$50,000 in Dow Chemical Company; aside from my investment, I am judgment proof. Among my debts are \$30,000 I borrowed from a German investor and \$40,000 I borrowed from a U.S. bank. Am I an "investment intermediary" for the German investor? Would I be if I specifically borrowed the money to invest in Dow Chemical and agreed to pay interest based on the success of my investment? If I already owned the Dow Chemical shares before I accepted the German investment? Such tracing of funds requires elaborate and often arbitrary rules of attribution. A scheme of regulation that would vet millions of investors in U.S. corporations as to the ultimate "source" of their funds would be massively expensive. Yet strategists could easily defeat it simply by furnishing false information.

### B. *Involuntary Creditor Priority*

I have argued elsewhere that economic efficiency is best served when creditors who did not intend to become creditors of a debtor (involuntary creditors) have priority over those who did (consensual creditors).<sup>262</sup> The argument is simple. As the system currently operates, consensual creditors can contract for security. Once they have done so, they have priority over involuntary creditors. Knowing that they themselves will be paid in any event, the secured creditors have grossly inadequate incentives to limit the debtor's liability-generating activity. As a result of the encumbrance, equity holders may also have grossly inadequate incentives to limit the debtor's liability-generating activity. Given that there is no one else with adequate incentives, it should be apparent that firms whose assets are encumbered will tend to generate too much liability.<sup>263</sup> As a result, secured credit has become a

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260. See Hansmann & Kraakman, *A Response To Professor Grundfest*, *supra* note 235, at 433 n 18

261. *Id.*

262. See LoPucki, *supra* note 32, at 1907-16.

263. For an analysis of the problem in the language of economics, see Bebchuk & Fried, *supra* note 74, at 895-903 (demonstrating that full priority for secured creditors is "inefficient")

fundamental building block of strategies for the defeat of liability to involuntary creditors.<sup>264</sup> The immediate solution is to give involuntary creditors priority over consensual creditors, including secured creditors.<sup>265</sup> That rule maximizes the probability that debtors will be forced to pay their involuntary creditors and thus be unable to externalize the risks of their business. Consensual creditors will not be prejudiced. Knowing that they will be subordinate, consensual creditors can protect themselves by selecting and monitoring their debtors and charging a premium for those risks that they cannot eliminate cost effectively.

Large, publicly held companies would probably rely heavily on asset securitization as the means for evading the new rule establishing involuntary creditor priority. The bankruptcy-remote entity used in an asset-securitization transaction is in genuinely separate ownership from the debtor. It is neither a creditor nor an owner of the business. To consolidate it with the debtor would require the disregard of a sale transacted at arms length for market value. Yet through a series of securitizations, a business could divest itself of substantially all of its assets, rendering it judgment proof.

Smaller companies could evade involuntary creditor priority by leasing real property, equipment, and intangibles used in the business, accepting their inventories on consignment, and selling their accounts receivable as they are generated. All of these techniques are used by small businesses today. Today, they are relatively expensive ways of doing business. Those who can borrow money at the rates charged by commercial banks and own their own assets generally prefer to do so. But the mere fact that borrowing and owning are cost effective in the current, secured-first regime does not establish that they would remain cost effective under a tort-first regime. The tort-first regime would impose liability on borrow-and-own small businesses that those businesses externalized under the old, secured-first regime, without imposing that liability on businesses that did not own the assets they used. By doing so, they would alter the relative costs of the two ways of doing business. Under

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264. See *supra* Section II.A.

265. Fittingly, the solution was first proposed by students. See Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080-83 (1984) ("Tort-claim superiority over secured creditors is, therefore, the most efficient and equitable solution."); Note, *Developments in the Law: Toxic Waste Litigation*, 99 HARV. L. REV. 1458, 1594-1601 (1986) (advocating exemption of government regulation of toxic wastes from automatic stay and advocating priority for tort claims by victims of hazardous wastes); see also Kathryn R. Heidt, *Cleaning Up Your Act: Efficiency Considerations in the Battle for the Debtor's Assets in Toxic Waste Bankruptcies*, 40 RUTGERS L. REV. 819, 849 (1988) (advocating priority for costs of toxic waste cleanup); Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 100-01 (advocating priority for claims of Pension Benefit Guaranty Corporation over secured creditors).

In a variant of this solution, Bebchuk and Fried have recently proposed limiting the priority given to secured creditors to 75% of their secured claims. See Bebchuk & Fried, *supra* note 74, at 909-11. Elizabeth Warren has proposed an amendment to U.C.C. § 9-301 to "carve out" 20% of secured creditors' collateral for unsecured creditors. See Letter from Elizabeth Warren, Leo Gotlieb Professor of Law, Harvard University, to Geoffrey Hazard, Trustee Professor of Law, University of Pennsylvania (Apr. 25, 1996) (on file with author).

the tort-first regime, small businesses might well find that leasing, consignment, and factoring, which would render them judgment proof, would be more effective than secured borrowing.

It is difficult even to guess what proportion of businesses would attempt to judgment proof themselves in a tort-first regime. Certainly those engaged in businesses with high risks of liability would still find it advantageous to do so. Their use of judgment-proofing strategies would generate pressures for their competitors to use them, resulting in a domino effect. Once particular judgment-proofing techniques are proven effective, their use can be expected to spread to the businesses for which they are already cost effective. That spread creates higher volumes for vendors of the technique, enabling them to spread their fixed costs, including product development costs, over larger numbers of transactions. Larger product development expenditures improve the product and lower the transactions costs of use. At the same time, the business and legal worlds become accustomed to the techniques, and the stigma attached to using them declines. In a world where most businesses operated without assets, the average costs of doing so should approach the average costs of operating businesses with assets. In such a world, the ability to defeat liability can be expected to render the form without assets more cost effective.

The system might go even further, imposing liability on the consensual creditors of a corporation to pay liabilities to involuntary creditors.<sup>266</sup> In an unlimited shareholder liability regime, this rule would have the virtue of providing parallel treatment of debt and equity investments.<sup>267</sup> That, in turn, would prevent the market from “arbitraging around” shareholder unlimited liability by transforming equity into debt.<sup>268</sup> But even those drastic steps—making both shareholders and consensual creditors liable to involuntary creditors—would not be sufficient to save liability. Businesses could still defeat liability by avoiding the ownership of assets altogether.<sup>269</sup>

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266. Arguably, the system has already adopted this strategy with regard to secured creditors that have the capability to influence their debtors' decisions regarding hazardous waste. See *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990) (holding that secured creditor participating in management of facility containing hazardous waste could be liable under 42 U.S.C. § 9607(a)(2) (1993), even though secured creditor's involvement was insufficient to render it “operator” of facility)

267. See Note, *Investor Liability: Financial Innovations in the Regulatory State and the Coming Revolution in Corporate Law*, 107 HARV. L. REV. 1941 (1994) (advocating parallel treatment of debt and equity investments in order to avoid arbitrage potential described by Grundfest), cf. Hansmann & Kraakman, *supra* note 76, at 1919–20 (arguing against unlimited liability for contract creditors)

268. See Grundfest, *supra* note 117. Based largely on putative strategies that would convert liability-encumbered equity into liability-free debt, see *id.* at 408–10, Professor Grundfest concludes that shareholder unlimited liability of the kind currently under consideration “is not a practical alternative to limited liability—at least for corporations with liquid, actively traded equity” *id.* at 420

269. Commentators have falsely assumed that all investments in a business are in the form of debt or equity. See, e.g., Note, *supra* note 267, at 1956 (making assumption that parallel treatment of debt and equity was parallel treatment of “all forms of investment”). Ownership of the assets used in a business constitutes a third form.



### C. *Asset-Provider Liability*

The previous Section argued that in a world with unlimited shareholder liability and involuntary creditor priority, strategists could still judgment proof their businesses and defeat liability by operating with assets belonging to others. The system could respond to that strategy either by: (1) giving involuntary creditors priority in the assets used in the business regardless of whether the assets were owned by the business; or (2) imposing liability on the owners of those assets. Under such rules, it would not matter how a business acquired its assets or who owned them; all assets used in the business would be available for the enforcement of judgments for liability. True lessors to the debtor would be treated the same as secured creditors<sup>270</sup> and asset-securitization transactions would no longer be bankruptcy remote.

Even these drastic steps would not provide the system with a permanent victory over strategists seeking to externalize the liability generated by their businesses. Probably the strategists' most effective response would be what Hansmann and Kraakman call "disaggregation." Large businesses would spin off smaller ones and reestablish their structure through contract:

Thus, a large oil company, rather than continuing to ship its oil in tankers that it owns and operates through subsidiary corporations, might sell each of its tankers to a separate individual who would then contract with the company to ship its oil. Similarly, small firms with only one or a few high-rolling shareholders might replace large drug companies in the development and initial marketing of pharmaceuticals; these small firms would then sell a product line to a large company for mass production and marketing only when it proved safe.<sup>271</sup>

Implicit in Hansmann and Kraakman's argument is the fact that small firms are much easier to judgment proof than large ones. Even though the aggregate level of wealth deployed in these businesses might remain constant, all of the entities that engaged in liability-generating activities would be judgment proof.

Hansmann and Kraakman assumed in the foregoing passage that large firms would continue to exist. Given the computerization of contracting and recordkeeping, even that assumption may be unwarranted. Finance theorists

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270. Professor Ayer has argued persuasively that there is no real distinction between the lender who finances the debtor's purchase of an asset and the owner who leases the assets, but merely a continuum of possible transactions. See John D. Ayer, *On the Vacuity of the Sale/Lease Distinction*, 68 IOWA L. REV. 667 (1983); John D. Ayer, *An Unrepentant View of the Sale-Lease Distinction*, 4 J. BANKR. L. & PRAC. 291 (1995).

271. Hansmann & Kraakman, *supra* note 76, at 1913-14. Disaggregation did not distress Hansmann and Kraakman because their focus was on economic efficiency rather than the future of liability. They saw disaggregation as a possible offset to excessive incentives for aggregation. To the extent they were concerned with liability, they saw the solution to disaggregation as lying in the more extreme measures discussed in the next two sections. See *infra* Sections IV.D-E.

long ago reconceptualized the corporation as a web of contracts among participants in the firm.<sup>272</sup> With computerization, the web of contracts may move from concept to reality. A plant where 10,000 people work might become a society of 10,000 "independent" businesses, bound together only by contract—just as the department store became the mall and the restaurant in the mall became the food court.<sup>273</sup> In the most extreme form of disaggregation, each human participant would be a separate business that owned only the assets that that human participant used. If three mechanics on the shop floor shared the use of a monkey wrench, for example, each might own a one-third time share. One might suppose that the problems of contracting among so many participants would be prohibitive. But once standardized contracts evolved, the problem would be merely one of recordkeeping. Building construction, where hundreds or even thousands of independent contractors come together for brief times on a project-by-project basis, demonstrates the potential.

In high risk industries such as taxicabs, small firms have long predominated.<sup>274</sup> When the tobacco industry's legal defenses began to appear shaky in the early 1990s, disaggregation came swiftly to that industry as well.<sup>275</sup> Data on the numbers and sizes of firms in the American economy

272. See Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV J L & PUB POL'Y 671, 681–82 (1995) (describing "a nexus or web of explicit and implicit contracts" theory as "prevailing theory of the firm"); Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (characterizing bounds of firm as that range of exchanges over which market system was suppressed and resource allocation was accomplished instead by authority and direction); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J FIN ECON. 305, 311 (1976) ("The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . . [I]t makes little or no sense to try to distinguish those things which are 'inside' the firm (or any other organization) from those things that are 'outside' of it")

273. Franchising is another example of disaggregated enterprise. Franchisors seek to profit from huge, far-flung operations while isolating themselves from the liability generated by those operations. The system has responded predictably, seeking to impose vicarious liability on franchisors in some situations. It is a half-hearted response, however, usually limited to those situations where the franchisor controls the liability-generating conduct. See, e.g., David A. Beyer, *Franchise Vicarious Liability in Florida*, 69 FLA BAR J. 62, 65 (1995) (comparing grounds for holding franchisors liable)

274. See *Goldberg v. Lee Express Cab Corp.*, 634 N.Y.S.2d 337, 338 n 1 (Sup Ct 1995) (noting that "what appears to be a rather common practice in the taxicab industry of vesting the ownership of a taxi fleet in many corporations, each owning only one or two cabs" remains a common practice in the taxicab industry to this day." (quoting *Walkovszky v. Carlton*, 223 N.E.2d 6, 7 (N.Y. 1966))), *Walkovszky v. Carlton*, 223 N.E.2d 6, 7 (N.Y. 1966) (describing group of corporations engaged in taxicab business in New York City, each with minimal assets); Bill Gifford, *Zoned Out*, WASH. POST, Nov. 6, 1994, (Magazine), at W10 (describing largest Washington D.C. taxicab business, which four coowners have divided into eleven taxicab operating companies along with other supporting corporations)

275. See, e.g., Glenn Collins, *Hungry Shareholders vs. Wary Managers*, N.Y. TIMES, Nov. 4, 1995, § 1, at 37 (describing shareholders' efforts to force RJR Nabisco to spin off tobacco operations and noting that another tobacco company, Liggett Group, Inc., had already completed spinoffs); Glenn Collins, *New Pressures on Philip Morris*, N.Y. TIMES, Sept. 21, 1994, at D1 (describing pressures on Philip Morris to spin off tobacco operations "to wall off the tobacco business from Philip Morris's food and beer business . . . as investors see the troublesome potential for legal liability and higher taxes on cigarettes"); Glenn Collins, *Paper Maker to Spin off Tobacco Units*, N.Y. TIMES, May 10, 1995, at D1 (describing announcement by Kimberly-Clark Corporation that its tobacco operations would produce \$100 million in cash in coming months, and that Kimberly-Clark would use cash to purchase its own shares, that Kimberly-Clark would then spin off its tobacco operations as separate corporation, and noting that "analysts said [the

suggests that a powerful general trend toward disaggregation is under way<sup>276</sup> and that disaggregation now can be prompted by much subtler incentives.<sup>277</sup> Computerization of the kind that will facilitate the intensive contracting necessary to permit disaggregation to flourish remains in its infancy. But the potential should be clear. Only the traditional conceptualization of economic theory has prevented us from grasping the possibilities.<sup>278</sup>

If the strategy of disaggregation is successful, it will bring the system full circle to where it was before respondeat superior and other forms of vicarious liability evolved. Every person will be liable for his or her own acts. No entity, however, will be liable for the acts of any other, because all relationships will be among "independent contractors"—a relationship that would not transmit liability in the world under consideration in this section, just as it does not under current law.<sup>279</sup>

In a world of unlimited shareholder liability, the existence of artificial entities would not protect the owner-operator of the entity from liability for his or her own acts. In such a world, artificial entities would no longer serve a liability-limiting function. They may cease to exist,<sup>280</sup> a possibility that I will refer to as "de-entification."<sup>281</sup>

spin off] had been prompted by shareholders' concern over the legal liabilities of cigarettes"); Eben Shapiro, *Philip Morris May Be Vulnerable over Tobacco Even if Firm Splits*, WALL ST. J., May 25, 1994, at B3 (speculating about possible spin off to separate company's food and tobacco operations and noting they already are separately incorporated).

276. See, e.g., U.S. SMALL BUS. ADMIN., ANNUAL REPORT ON SMALL BUSINESS AND COMPETITION 36 (1995) (reporting that number of businesses with employees "has grown at a rate just under 2 percent a year, about equal to the rate of growth of the general population and of the work force" while rate of growth in number of business filing tax returns has grown at compound rate of 3.9% per year over most recent 12-year span). That the number of businesses filing tax returns has grown so much faster than the number of businesses with employees suggests that persons formerly "employees" have instead become "independent contractors." The change may have the effect of insulating the employers from liability for their acts. The SBA also reports a growth in small business's share of total employment, but (for reasons not stated in the report) attributes the increase "more to the growth of industries in which small businesses have been leaders than to any current economic advantage of small operations." *Id.* at 43.

277. See Alan Murray, *Mom, Apple Pie and Small Business*, WALL ST. J., Aug. 15, 1994, at A1 (speculating that low wage businesses will disaggregate to take advantage of 25-worker exemption from Democratic health care proposal).

278. The traditional conceptualization holds that the forms in which business is conducted—department store, mall, or food court—are the products of efficiencies of scale inherent in the nature of the tasks being performed. Because the nature of the task cannot change, the traditional conceptualization is static; changes in economies of scale are described as changes in task and each new task comes as a surprise. The conceptualization I advocate is one in which computerization has freed the form of organization from the task. Any task can be accomplished through any organization. The costs of all sizes of organization are potentially the same because the computer can translate one size of organization to another at a cost that can be negligible. The concept of economy of scale should be recognized as unrelated to firm size.

279. See, e.g., *Robinson v. Jiffy Executive Limousine Co.*, 4 F.3d 237, 241 (3d Cir. 1993) (concluding that under New Jersey law, persons hiring financially irresponsible independent contractors are not liable for torts those contractors commit).

280. They may continue to exist for tax or other purposes.

281. Klein and Zolt's proposal that every sole proprietor and partner enjoy limited liability without having to endure the formalities of incorporation may prove to have been the first shot in the battle for de-entification. See Klein & Zolt, *supra* note 204, at 1037 (referring to their new default provision regarding limited liability as "opt out" rather than "opt in" provision); Larry E. Ribstein, *Limited Liability and*

#### D. *Enterprise Liability*

To determine what wealth can be applied to the satisfaction of a money judgment, the liability system looks first to the entity structure established by the strategist. The system can disregard entities only in extreme circumstances.<sup>282</sup> As entities proliferate in response to the lowered costs of separate incorporation and the wealth available to satisfy particular judgments shrinks correspondingly, the system will be pressed to respond. One response that has already been suggested is to attach liability to *enterprises* rather than *entities*.<sup>283</sup> In its more conservative version, enterprise liability is virtually indistinguishable from liberal piercing of the corporate veils within corporate groups. In its more radical version, it calls for the complete disregard of entities, leaving it to the courts to determine the scope of the enterprise.<sup>284</sup>

Whether this approach could be viable depends on whether there are in fact identifiable, stable boundaries between enterprises. If there are, the courts could discover them on a case-by-case basis. If there are not, the courts would be assigning liability arbitrarily and generating probably intolerable uncertainty for investors.

Blumberg has attempted to specify the boundaries of the firm based on “the degree of economic integration [within the corporate] group.”<sup>285</sup> But he assumes throughout his discussion that liability should attach to entities and that the issue is which entities should be considered part of the enterprise.<sup>286</sup> Ultimately, he fails to specify what constitutes “economic integration” or to address the issue of whether enterprises are in fact separable from one another.<sup>287</sup>

Strategists would find it difficult to construct judgment-proof structures in a world where the standard for consolidation of entities into enterprises was vague and uncertain. But such a standard would produce intolerable uncertainty for other system participants as well. Judgment creditors would have to litigate the boundaries of the enterprise to know which assets they could enforce against. Insurers would be uncertain which risks they assumed when they issued a policy. Business investors would have no way of knowing in advance the scope of the enterprise whose tort risk they were assuming. Trading

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*Theories of the Corporation*, 50 MD. L. REV. 80, 129 (1991) (“[L]imited tort liability should be available without formal incorporation.”).

282. See *supra* Subsection II.B.1.

283. See PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS BANKRUPTCY LAW* § 18.02, at 699–704 (1985) (advocating expansion of enterprise liability in place of entity liability).

284. To my knowledge, no one has seriously proposed this radical form of enterprise liability.

285. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 22.03.2, at 431 (1983).

286. See, e.g., *id.* at 435 (“In the strongly integrated group, the parent and subsidiaries comprise a single business enterprise . . .”).

287. See BLUMBERG, *supra* note 283, § 10.10 1, at 417–18 (discussing substantive consolidation of corporate groups in bankruptcy).

partners would find it difficult to assess the financial conditions of the firms with which they dealt, because the boundaries of the firms would remain uncertain until the courts ruled.<sup>288</sup> These are the very kinds of pressure that prevent courts from wantonly disregarding corporate entities in sympathetic cases today. The great virtue of the principle of enforcement against only the property of the debtor is that it yields a reasonably predictable result; the systems issue is whether sufficient predictability could be achieved under some competing system.

Finance theory offers an alternative basis for determining the boundaries of the firm. It conceives of the firm as a "command structure" that operates by fiat from the top, and it contrasts that with the contacts by which one firm relates to another. At any given time, the extent of a command structure might provide an adequate basis for fixing the extent of liability. But there are two serious problems with attempting to make the command structure the basis for assigning liability. First, the command structure ties people and activities together, but it may be only loosely related to the assets, which are the target of the liability system as currently conceived. To illustrate the nature of the problem, assume that an airline is run by a command structure that extends from the board of directors to the pilots and crews, but the firm contracts for maintenance of the leased aircraft and for landing rights at the municipal airport.<sup>289</sup> Should the aircraft or the city-owned airport be available to satisfy liability arising out of the wrongful act of a pilot? Of a mechanic? Our natural inclination is to revert to an ownership analysis, which is, at bottom, an entity based analysis. Nothing about a command structure tells us what property should be available to satisfy a judgment rendered on the basis of that structure's misconduct. The second problem with using command structure as the basis for determining the boundaries of the firm is that command structures are unstable. The firm that contracts for maintenance one day may hire employees to perform it the next, and vice versa. Through such changes, the firm seeks efficiency in its operations. If liability depended on these decisions,

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288. Financial statements would be of little use because they pertain only to the entity structure the debtor *sought* to create; no one would have the incentives or the ability to prepare meaningful financial statements for the "enterprise" that would later be declared by the court.

289. Current law can be read to respond to situations such as this with the doctrine of nondelegable duty:

One who employs an independent contractor to do work which the employer should recognize as likely to create during its progress a peculiar risk of harm to others unless special precautions are taken, is subject to liability for physical harm caused to them by the failure of the contractor to exercise reasonable care to take such precautions . . . .

RESTATEMENT (SECOND) OF TORTS § 416 (1965); *see Dickerson, Inc. v. United States*, 875 F.2d 1577, 1583 (11th Cir. 1989) ("Under Florida law, if the work contracted for is an inherently dangerous activity, the employer has a nondelegable duty of reasonable care to take precautions ensuring that the independent contractor carries out the task in a non-negligent manner."). But this doctrine presupposes a delegator who is not judgment proof. The strategist can frustrate the doctrine by identifying the entity the court will regard as delegator and rendering that entity judgment proof. The doctrine is ineffective against the strategist because the doctrine is rooted in entity rather than enterprise theory. Any attempt to shift it to enterprise theory encounters the problem discussed here: inability to define the enterprise.

the decisions could be expected to react to liability. Command structures would truncate in order to externalize liability and contracting out would extend well beyond the realm in which it was efficient.

Enterprise liability, whether based on "economic integration" or "command structure," does not provide a workable alternative to a system based on entities that the courts occasionally disregard. The most basic problem is that the relationship between liability and entity is so deeply ingrained in our thinking that it is virtually impossible to exorcise. De-entification will deprive the system of a fundamental concept for ordering and specifying liability.

#### E. *Trading Partner Liability*

In a brief passage in their initial article, Hansmann and Kraakman suggest what may be the strongest response that the system can make to the judgment-proofing strategies discussed in this Article. They posit that "in the case of the oil tankers, for instance, making companies that produce, own, or intend to receive the oil jointly and severally liable for spills may well remove any incentive for inefficient disaggregation."<sup>290</sup> Once liability has been extended in this manner, disaggregation presumably will no longer defeat it. Every fragment of the divided firm will bear the total liability of the unified firm, jointly and severally, with every other fragment. Because disaggregation will not defeat liability, Hansmann and Kraakman posit, participants in the shipping of oil instead will provide for its payment.<sup>291</sup>

It is worth noting that this suggestion is contrary to current legislative and academic trends that call for *reductions* in joint and several liability. State legislatures are relieving wholesalers and retailers of liability for the products they do not manufacture but merely sell.<sup>292</sup> The argument is that the wholesalers and retailers do not have the ability to evaluate the products they

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290. Hansmann & Kraakman, *supra* note 76, at 1915

291. As an embellishment on their proposal, Hansmann and Kraakman propose the imposition of mandatory insurance on those engaged in high risk industries. They acknowledge that mandatory insurance will not itself work to assure payment of liabilities. But they theorize that the cost of the insurance may be sufficient to offset the incentives toward disaggregation. *See id.* at 1915 n 96 ("That is, one would not rely on the insurance requirement to solve the externality problem itself, but only to discourage inefficient disaggregation."). Their embellishment is difficult to evaluate because they do not indicate which fragments of a disaggregated firm would be required to carry the insurance

292. *See Status of States*, 81 A.B.A. J., Aug. 1995, at 59 (asserting that 41 states have modified or abolished joint and several liability since 1986); e.g., 1995 N.J. Sess. Law Serv. 141 (West) (relieving sellers of defective products of strict liability claims except where manufacturer "has no known agents, facility, or other presence within the United States" or "has no attachable assets or has been adjudicated bankrupt and a judgment is not otherwise recoverable from the assets of the bankruptcy estate") While this wording theoretically leaves open the possibility of suing the seller after pursuing to judgment the action against the manufacturer, the practical effect will be to deprive the plaintiff of any remedy at all in cases where the manufacturer is in business at the time the plaintiff commences the action, but not at the time the plaintiff seeks to collect the judgment.

sell or to control their manufacture.<sup>293</sup> In the field of securities fraud, leading academics propose to fix the liability system by relieving the enterprises that employ the wrongdoers from liability, leaving only the wrongdoers liable.<sup>294</sup> In the field of medical malpractice, leading academics propose to fix the liability system by relieving negligent physicians of their liability, leaving only the enterprises with which they associate liable.<sup>295</sup> In the field of corporations, leading academics propose to extend limited liability to sole proprietors so that “no person is vicariously liable beyond the assets committed to the business activity giving rise to the liability.”<sup>296</sup> The principal relevance of this trend toward narrowing liability is not that it demonstrates the worth of the ideas behind it, but that it demonstrates how difficult it will be to persuade the body politic to pursue the opposite course. The real issue is whether, if the system holds *everybody* liable, *anybody* will pay.

The trend does help illustrate the fundamental theoretical problem with the system strategy of casting the net of liability widely. The problem is simply to define its boundary. To whom, precisely, will this expanded liability extend?<sup>297</sup> The trend suggests that the body politic will not easily accept arbitrary boundaries.<sup>298</sup> But even if that problem is overcome, there remains

293. The underlying premise is that parties should not be liable for what they cannot control. Trading partner liability almost inevitably violates this premise.

294. See Arlen & Carney, *supra* note 5 (proposing to hold liable particular agents who commit fraud on securities markets and to excuse their employers from vicarious liability unless employer is in bad faith).

295. See Kenneth S. Abraham & Paul C. Weiler, *Enterprise Medical Liability and the Evolution of the American Health Care System*, 108 HARV. L. REV. 381 (1994) (proposing to excuse doctors from liability for medical malpractice and instead hold enterprises with which they are associated vicariously liable). The Abraham-Weiler proposal is not entirely a reduction in liability; it provides for some expansion of liability to enterprises that would not have liability under current law.

296. Klein & Zolt, *supra* note 204, at 1040. But see Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 868–76 (1984) (advocating manager and director liability for torts of corporations as means of protecting against “asset insufficiency”).

297. The Third Circuit has wrestled with this issue of definition. In *Becker v. Interstate Properties*, 569 F.2d 1203 (3d Cir. 1977), the court held an employer liable for the tort of its independent contractor because the independent contractor was only minimally insured and not otherwise financially responsible. Sixteen years later, in *Robinson v. Jiffy Executive Limousine Co.*, 4 F.3d 237 (3d Cir. 1993), the court retreated from *Becker*, noting that the New Jersey Courts had, in the interim, declined to follow it. Quoting the dissent in *Becker*, the Robinson court opined that holding employers liable for the torts of their financially irresponsible independent contractors would “cause uncertainty and doubt for every financial strata and every court, as well as hinder the employment opportunities of an independent contractor trying to enter the market place but lacking much in the way of start-up capital.” *Id.* at 242. The court also asserted that the rule would “impose prohibitive obligations [of investigation] on employers of independent contractors.” *Id.* at 242–43. In reversing its position, the Third Circuit retreated to the basic system principle of collection only from the property of the debtor.

298. The difficulty of defining boundaries is evident with regard to liability for the treatment, storage, and disposal of hazardous waste (TSD). See Michael Lange, *Corporate Strategies for Evading Environmental and Tort Liability* (Mar. 8, 1991) (unpublished manuscript, on file with author). The TSD industry arguably came into existence as a disaggregation response to the imposition of liability for the handling of toxic wastes. That is, the generators of waste, many of whom were large, solvent companies, responded to the imposition of liability by contracting the work out to small TSD companies that could externalize the risk of liability. See William Goldfarb, *Keponex: A Case Study*, 8 ENVTL. L. 645, 658–60 (1977); Debra K. Rubin, *Cleanup Firms Cover Their Assets*, ENGINEERING NEWS-RECORD, Mar. 6, 1986, at 50 (describing strategic formation by engineering firms of “independent” entities to do hazardous waste consulting). The system responded by imposing liability on the generator of toxic waste for acts committed

the systemic problem of fixing and communicating the boundaries to participants in the system. Hansmann and Kraakman propose liability for spills such as the Exxon Valdez on those who "intend to receive the oil."<sup>299</sup> Surely they do not include me, even if I regularly fill up at the Exxon station. Yet they must include someone beyond the first entity that intends to take the oil from the Exxon Valdez, or the strategist will defeat the extended liability by receiving it in a shell corporation. I can imagine no logical stopping point in between.<sup>300</sup>

System designers could arbitrarily define a stopping point for oil spill liability. Liability, however, arises in an almost infinite number of contexts. Each would present the same problem of definition. For the system to accomplish its goal of enforcing liability, those who have it would have to know they have it. Only then could they insure against it, or protect against the acts of others that might impose it on them. Unless the stopping points were fixed on the basis of some generalizable principle rather than on ad hoc, industry-specific determinations, the problem of communication would be overwhelming. For participants in the system, liability would seem to strike out of nowhere, and there would be little they could do about it except to harden their own judgment-proof structures. Without a generalizable principle for determining its stopping point, expanded liability might lead to chaos.

#### F. *Liability Insurance*

Arguments that the liability system will remain viable into the foreseeable future usually rely heavily on the continued existence, if not the expansion, of liability insurance. Typically, the arguments falsely assume that: (1) nearly all liability is of an insurable nature, making liability insurance a functional

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by others in the treatment, storage, or disposal of the generator's waste. See 42 U.S.C.A. § 9607(a)(3) (West 1995). The gambit was a success in that it elicited the desired response from the industry. TSD companies increased their capital. See Lange, *supra*, at 54. It is, however, no coincidence that the system's success has come in a field that has generated tremendous controversy over the imposition of liability on innocent parties who have no means of avoiding it. See, e.g., Michael I. Greenberg & David M. Shaw, *To Lend or Not to Lend—That Should Not Be the Question: The Uncertainties of Lender Liability Under CERCLA*, 41 DUKE L.J. 1211, 1211 (1992) ("Uncertainty and confusion pervade environmental liability standards . . ."). The system successfully expanded liability but is now locked in controversy over what is necessarily an arbitrary boundary.

299. Hansmann & Kraakman, *supra* note 76, at 1915.

300. When faced with this problem in an analogous context, Hansmann and Kraakman chose to make the stopping point the first "well-capitalized" institution. See Hansmann & Kraakman, *A Response to Professor Grundfest*, *supra* note 235, at 433 (fixing stopping point by inquiring into whether investor in shares is liability-evading foreigner). While that method of fixing a stopping point might at first seem principled, it ultimately proves tautological. The problem they were addressing was to determine the value that should be available to involuntary creditors. Yet to define "well-capitalized" requires the same determination. In attempting to answer the second question, Hansmann and Kraakman will have to define "well-capitalized," and, perhaps more problematically, they will have to provide some means for system participants, such as the customer who pulls up to the Exxon pump, to know the capitalization of those through whom they are receiving the product.



substitute for solvent debtors; (2) debtors will continue to purchase liability insurance because they have economic incentives to do so; and (3) when economic incentives are insufficient to cause debtors to purchase liability insurance voluntarily, the system can achieve the same result by requiring the purchase of liability insurance. In fact, much, if not most, liability is of an uninsurable nature. The incentives to purchase liability insurance are principally social and cultural rather than economic, and the effectiveness of liability insurance is sharply diminished when the insurance is compulsory. Liability insurance is a valuable adjunct to the working of an otherwise sound liability system, but it can neither save nor replace an unsound one.

### 1. *The Limitations of Liability Insurance*

Liability insurance cannot substitute for a liability system in which actors have their own assets at risk. The primary reason is that many liability-generating occurrences are not of an insurable nature.<sup>301</sup> To understand this limitation, consider the kinds of events that generate liability as lying along a continuum. At one end of the continuum are events over which the insured has complete control (“intended events”); at the other end are events entirely beyond the debtor’s control (“accidental events”).<sup>302</sup> By definition, purely accidental events cannot be deterred. The insured has no intention to cause the event in the first place. With respect to them, the system can only compensate the injured party and spread the resulting loss. Because the losses are unintentional from the standpoint of both the insured and the victim, compensating the losses does not cause them to increase. Insurance does not lead to an increase in the conduct insured against.

On the other hand, purely intended events are completely deterrable. Threaten the debtor with a sufficiently large penalty and the probability of the event occurring will approach zero. Absent insurance, the liability system discourages debtors from imposing unreasonable risks of loss on third parties by threatening to return the losses to the debtor through litigation. The response of the liability system to risk-generating activity is a measured one. It recognizes that some conduct that imposes risk on third parties, such as driving a car or building a skyscraper, is nevertheless economically desirable because it generates an even greater benefit for the debtor. By allowing the debtor to engage in the activity, but by compelling the debtor to pay losses thereby inflicted, a well-functioning liability system could provide appropriate levels of incentives for conduct.

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301. The argument presented here is an elaboration of an argument I have made elsewhere. See LoPucki, *supra* note 32, at 1906–07.

302. For an elaboration of the idea presented here, see Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 347 (1990) (arguing that “there is a range of inadvertent negligent conduct that is imperfectly controllable”).

Liability insurance tends to upset this delicate balance by reimbursing debtors for the consequences of their wrongful acts, while permitting them to retain the benefits of their liability-generating activity.<sup>303</sup> In this regard, the liability insurance system works in opposition to the liability system.<sup>304</sup> In recognition of the moral hazard involved in insuring against liability for certain kinds of intentional harm, courts void such coverage as contrary to public policy.<sup>305</sup> This is a realm where liability is appropriate, but insurance is not.

Liability-producing events are rarely either purely intended or purely accidental. Whether such a mixed event is insurable depends on the degree to which the risk of its occurrence is likely to increase once the risk is insured against. The tendency of risks to increase when insured against is referred to as "reactivity" of the risk.<sup>306</sup>

The fact that risk is reactive does not alone make it inappropriate for insurance. Debtors often buy insurance so that they will be free to engage in activities they consider too risky without it. If the level of reactivity is predictable and not too high, the insurer can adjust for it by increasing the premium. Such premium adjustments are of essentially two types. "Feature" rating takes account of various characteristics of the insured or the situation, such as the type of business in which the insured is engaged and the kind of safety precautions the insured is taking. It discourages dangerous activities and methods by charging higher premiums while they are in use. "Experience" rating takes account of the insured's loss history. It encourages the debtor to avoid liability now so that future premiums will be lower.<sup>307</sup>

A liability insurance system in which the premium rating system took perfect account of the risk-generating conduct of the insured would provide the insured with essentially the same economic incentives as a liability system that

303. See, e.g., Schwartz, *supra* note 302, at 313 (noting that "many scholars share in the view that tort law's deterrence objective is 'severely, perhaps fatally undermined' by the prevalence of insurance" (citations omitted)).

304. See, e.g., Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 131 (1990) ("That insurance can blunt the deterrence effects of a liability rule is uncontroversial." (footnotes omitted)) The problem is sometimes discussed as one of "moral hazard." That is, the insurance creates a moral hazard because once the premium for the year is fixed, the insured may be able to profit by increasing the risk to others, with no additional cost to the insured. The problem is considered "moral" because the insured can take advantage at the cost of others.

305. See, e.g., Sean W. Gallagher, Note, *The Public Policy Exclusion and Insurance for Intentional Employment Discrimination*, 92 MICH. L. REV. 1256, 1322 (1994) (arguing that "the primary reason that courts impose a public policy exclusion to void coverage for intentional employment discrimination is to maintain the deterrent effect of discrimination liability")

306. The same concept is sometimes captured in the phrase "elasticity of risk" or in the economist's term, "moral hazard." See KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 15 (1986) (discussing insurers' controls over moral hazard); GREENE ET AL., *supra* note 200, at 11 (explaining moral hazard); Schwartz, *supra* note 302, at 343 ("The unavailability of insurance . . . may verify that [the system] . . . is targeting for liability precisely those forms of conduct that are so readily controllable by defendants as to render unacceptable to insurers the moral-hazard prospect of insurance policies.")

307. See ABRAHAM, *supra* note 306, at 71-74 (discussing feature rating and experience rating)

perfectly shifted losses from third parties to the debtors in the absence of insurance.<sup>308</sup> The insured would pay for the level of risk it generated, and the insurer, for an additional fee, would absorb the variance in that risk that resulted from chance and was therefore outside the control of the insured.<sup>309</sup>

When they insure solvent debtors, insurers have additional means for reducing the tendency of risk to react to the insurance. Coinsurance is a contract under which the insurer pays a percentage of the loss and the insured is responsible for the balance. Similarly, deductibles and policy limits both leave the insured responsible for portions of any loss the insured itself inflicts. These means reduce inappropriate incentives and moral hazard, though they do not eliminate them. But given the remote nature of many of the risks insured against and the insureds' other incentives to avoid activity that inflicts loss on others,<sup>310</sup> reduction of inappropriate incentives is often enough to alter insureds' conduct. At the extreme, some insurance contracts seek to transfer all risk of loss to the insured. They do so either by subrogating the insurer to the rights of the injured third party to the extent the insurer pays the claim, or, more commonly, by retroactively adjusting the premium to an amount equal to the insurers' payouts over the policy period.<sup>311</sup> Assuming that the insurer can actually collect, these devices perfectly align the interests of insurer and insured.<sup>312</sup>

In a system where insurance is voluntary, insurers can protect themselves against unanticipated risks through provisions in the policy that entitle them to deny coverage even for losses already incurred. For example, the insurer can

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308. See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 210–11 (1987) (assuming “insurers can determine injurers’ levels of care, their liability insurance policies will supply them with full coverage and will have provisions inducing them to take optimal care”); Logue, *supra* note 186, at 1375–76 (arguing that liability insurance can ameliorate judgment-proof problem through feature and experience rating and by making insurance proceeds available along with debtor’s own assets). *But see* Steven A. Kunzman, *The Insurer as Surrogate Regulator of the Hazardous Waste Industry: Solution or Perversion?*, 20 *FORUM* 469, 481–88 (1985) (challenging assertion that insurance premiums can force firms to internalize costs).

309. See ABRAHAM, *supra* note 306, at 77 (“Because the members of each [risk] class are charged in accord with [the insurers’] expected costs, total premiums are designed to cover the aggregate losses of the class. No subsidies run from one risk class to another. The only subsidy under this ideal flows from the lucky to the unlucky.”).

310. The primary incentive not to drive carelessly may be to avoid injury to one’s self in an accident, not to avoid liability to another. Conduct that results in civil liability may also result in criminal liability or action against the wrongdoer.

311. Insureds might purchase such a policy to gain the insurer’s expertise in claims administration, *see supra* note 200, or as a means of complying with financial responsibility laws, *see supra* note 201. *See also* Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 *COLUM. L. REV.* 942, 980–85 (1988) (arguing that retroactive indexing of premiums might ease environmental liability crisis but noting that bankruptcy of insured would thwart technique).

312. See ABRAHAM, *supra* note 306, at 18 (“The law governing the devices that are used in combination with differential pricing to mitigate moral hazard in insurance—exceptions to coverage, coinsurance, and application screening, among others—should take the function of these devices into account if the effects of civil liability and insurance law are to work in tandem and not at cross purposes.”).

eliminate the risk that it will not learn of a third party's claim in time to prepare and present a defense. The insurer accomplishes this by adding a policy provision requiring the insured to notify the insurer of the claim and entitling the insurer to refuse coverage if the insured does not. The insurer that reserves the right to deny coverage for fraud in the application for insurance can also count on some cooperation from the insurance applicant in the determination of an appropriate premium.<sup>313</sup>

In combination, these techniques enable liability insurers to write profitable policies that insure even those risks over which the insured has a significant measure of control. However, even with the benefits of feature and experience rating, provisions that require the insured to bear a portion of the insured losses, and the right to deny coverage after loss for misconduct of the insured, there remains a vast realm of uninsurable liability. Most intentional torts fall into this category;<sup>314</sup> so do many new, apparently risky kinds of activities, for which insurance companies lack sufficient rating data.<sup>315</sup>

313. Compulsory liability insurance, by contrast, is for the benefit of the injured third party. With respect to compulsory liability insurance, it makes no sense to permit insurers to deny coverage for fraud in the insurance application. Current law reflects this distinction. *See, e.g., Pekin Ins Co v Super*, 912 F Supp. 409, 413 (S.D. Ind. 1995) (holding that "when a third party is injured by an insured who gained their [sic] policy by fraud, an insurer may assert the common law defense of material misrepresentation so as to avoid coverage in excess of the levels required by Indiana's Financial Responsibility Law, but that an insurer may not avoid coverage up to that amount in any circumstance"); *Omaha Property & Casualty Co v. Crosby*, 756 F. Supp. 1380, 1384 (D. Mont. 1990) ("When a state compulsory insurance statute exists, courts have 'universally held or recognized that an insurer cannot, on the ground of fraud or misrepresentations relating to the inception of the policy, retrospectively avoid coverage so as to escape liability to a third party.'" (citations omitted)).

314. *See, e.g., GREENE ET AL., supra* note 200, at 45 ("From the standpoint of the insurer, there are several requisites of insurable risks that must be met . . . The loss, should it occur, must be accidental and unintentional in nature from the viewpoint of the insured."); INSURANCE SERV. ORG., Commercial General Liability Coverage Form (CG 00 01 11 88), reprinted in KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 442, para. 2.a (2d ed. 1995) ("This insurance does not apply to '[b]odily injury' or 'property damage' expected or intended from the standpoint of the insured"). Abraham, *supra* note 311, at 952 ("[T]here is no coverage against liability for harm that is caused intentionally or nearly intentionally."); James L. Rigelhaupt, Jr., Annotation, *Construction and Application of Provision of Liability Insurance Policy Expressly Excluding Injuries Intended or Expected by Insured*, 31 A.L.R. 4TH 957 (1984). Even though no exclusion of punitive damages appears in the commercial general liability policy, a substantial minority of courts refuse to permit coverage on public policy grounds. *See* Gary S. Franklin, Comment, *Punitive Damages Insurance: Why Some Courts Take the Smart Out of "Smart Money"*, 40 U. MIAMI L. REV. 979, 1000-01 n.84 (1986) (citing cases permitting and denying coverage on public policy grounds).

315. *See* Gary Marchant, *Modified Rules for Modified Bugs: Balancing Safety and Efficiency in the Regulation of Deliberate Release of Genetically Engineered Microorganisms*, 1 HARV. J.L. & TECH. 163, 192 (1988) ("Many biotechnology companies are new, and relatively small, and may not have sufficient assets to withstand a large damage claim. The problem of judgment-proof firms is exacerbated by the unavailability of liability insurance for companies undertaking releases of genetically engineered microorganisms into the environment."). *But see Product & Professional Liability Insurance for Biotechnology Products Now Available*, 6 BIOTECH. L. REP. 404 (1987) ("The Association of Biotechnology Companies has announced that it has secured, after lengthy negotiations, product and professional liability insurance for biotechnology products, including those released into the environment.")

## 2. *The Lack of Economic Incentives to Purchase Liability Insurance*

Writers who approach the subject of insurance from a purely economic perspective sometimes mistakenly conclude that the only reason to purchase liability insurance is to protect one's assets from the liability system.<sup>316</sup> Were that so, we would expect liability insurance to disappear along with liability. But it is not so. Even a judgment-proof debtor may purchase liability insurance in the hopes of avoiding the necessity to file under Chapter 11 to deal with its obligations,<sup>317</sup> to satisfy contracting parties who require them to carry insurance,<sup>318</sup> to avoid the adverse publicity that may accompany financial irresponsibility,<sup>319</sup> or merely to satisfy a felt moral obligation. Minimal levels of liability insurance coverage might well persist in a world where judgments could not be enforced.

The basic point of the economists is, nevertheless, well taken. 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.

Initially, debtors who wish to drop their liability insurance coverage may not be able to do so. Those who contract with debtors today often require that the debtors carry insurance to protect third parties.<sup>320</sup> Whether contracting parties will continue to do so once they are under competitive pressure is another matter. The contract between A and B that B carry insurance to pay liability to C is in part for the benefit of A as well as C. Liability can disrupt the business relationship between A and B, as, for example, where B is unable to perform its building construction contract with A because B's assets have

316. See, e.g., Easterbrook & Fischel, *supra* note 185, at 107 ("[I]nvestors should not be willing to pay insurers to reduce risk. Why buy something you already have for free?"); Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1361 (1994) ("Individuals who are entirely judgment proof, for example, have no reason to purchase insurance at all—it is irrational to insure against loss if you have nothing to lose.").

317. It is not entirely clear that liability insurance will help. On the one hand, a policy of liability insurance may pay an obligation that otherwise would push the debtor into bankruptcy. On the other, the existence of the policy may attract litigation that otherwise would not be filed; the resulting judgments may exceed the policy limit, pushing the debtor into bankruptcy. Which tendency would predominate probably is a question that can be answered only empirically, if at all.

318. See, e.g., Gilbert, *supra* note 201, at 1 ("[W]ith 'lender liability' under the Comprehensive Environmental Response and Compensation Liability Act (CERCLA) still a source of potential exposure, lenders may require borrowers to obtain [environmental impairment] insurance . . ." (footnote omitted)).

319. See, e.g., Stephen Keating, *Taxis Still on the Road Strapped Yellow Cab Pays Liability Insurance*, DENVER POST, May 11, 1994, at C1 (describing incident in which Colorado Department of Revenue attempted to shut down self-insured Yellow Cab Company for inability to pay tort claims and Yellow Cab executive responded by displaying check that would pay for insurance and asserting that "[e]veryone that travels in a Yellow Cab is protected").

320. For example, building contractors sometimes require that subcontractors working on the job carry liability insurance and hospitals sometimes require that affiliated doctors carry medical malpractice insurance.

been seized by C for a tort judgment. Liability can also embarrass a contracting partner and indirectly harm the contracting partner's business. For example, a hospital may lose patients when an affiliated doctor is featured in newspaper stories as practicing "bare." From the viewpoint of A, however, both of these problems may be resolved without the purchase of insurance. Provided that the building construction contract is well drafted, B can discharge its liability to C in bankruptcy without B losing a day's work on A's construction site.<sup>321</sup> Affiliation with an uninsured doctor is embarrassing only when one's competitors are not themselves affiliated with uninsured doctors. If there is money to be saved by doctors going bare, the solution from the standpoint of the hospitals as a group is for none of them to require insurance beyond that necessary to protect themselves. Nothing prevents the market from reaching that result. Malpractice insurance costs money, and ultimately that cost is passed along to a patient who probably does not want it because he or she can purchase first-party insurance more economically. Hospitals can better compete for patients by assuring them quality medical care than by assuring them compensation for bad medical care. All that really prevents doctors from going bare is our cultural preference for financial responsibility.<sup>322</sup> Considering that cultural preference ultimately may serve neither the financial interests of the hospital nor the patient, there is little reason to expect it to survive. Once liability insurance is no longer the norm, even those who would like to carry it to protect the public may find that competitive pressures from uninsured firms make the cost prohibitive.

The controversy over "occurrence" and "claims-made" insurance provides an excellent example of economic incentives riding roughshod over cultural preferences for the payment of liabilities. Prior to 1984, commercial general liability insurance was written only on an "occurrence" basis. That is, the insurer agreed to pay claims, whenever made, if they arose from an occurrence during the policy period. Beginning in 1984, insurers began offering commercial general liability insurance on a "claims-made" basis.<sup>323</sup> That is,

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321. During Chapter 11 bankruptcy, the debtor can choose which of its contracts it wishes to perform. See 11 U.S.C. § 365(a) (1994). It can affirm those contracts and reject the rest, converting the latter to liability for breach which will, in all likelihood, be dischargeable. See *id.* §§ 365(g), 502(1). The drafting problem is merely to make sure that the debtor has sufficient incentives to choose to perform the construction contract.

322. Illustrating this cultural preference, Professor James J. White wrote in response to an earlier draft of this Article that "no one will do surgery with your physician who has taken all his assets offshore and who has 'gone naked.' In fact, a surgeon without insurance will probably not be allowed to operate." Letter from James J. White, Robert A. Sullivan Professor of Law, University of Michigan Law School, to Lynn M. LoPucki 3 (Nov. 10, 1995) (on file with author).

323. See Eugene R. Anderson et al., *Liability Insurance: A Primer for Corporate Counsel*, 49 *BUS. LAW.* 259, 265 (1993) (describing how old "occurrence" policy was effectively withdrawn from U.S. market and replaced with new policy offered in two mutually "exclusive forms"—"occurrence" and "claims-made").

the insurer agreed to pay only claims made during the policy period.<sup>324</sup>

The practical difference between occurrence and claims-made policies shows up in delayed disaster situations such as asbestos, toxic waste, or cigarettes. Under an occurrence policy, the insurer pays for the disaster when the claims are finally made. Under a claims-made policy, as soon as the insurer sees that massive numbers of claims will be filed over the coming years, the insurer declines to write the next year's policy,<sup>325</sup> the debtor discharges its liability in bankruptcy, and the losses are externalized to the tort victims. The debtor actually profits along with the insurer, because, as one might expect, claims-made insurance is cheaper than occurrence insurance.

Despite its economic advantage to both seller and buyer, claims-made insurance was slow to catch on.<sup>326</sup> The managers who purchased insurance preferred a liability policy that would actually pay the claims. But the insurance industry was persistent and claims-made policies now dominate the fields of environmental and professional liability.<sup>327</sup>

As the levels of voluntary insurance in various industries decline, there will be increasing pressure to make insurance compulsory.<sup>328</sup> Insurance is

324. See *Alan Corp. v. International Surplus Lines Ins.*, 22 F.3d 339 (1st Cir. 1994) (upholding insurer's denial of coverage under "claims-made" pollution liability policy because government did not initiate environmental enforcement action during policy period even though insured notified insurer of environmental damage during policy period). See generally *In re Insurance Antitrust Litig.*, 938 F.2d 919, 923 (9th Cir. 1991) (holding primary insurers and reinsurers may have violated antitrust laws in pressuring Insurance Service Office to eliminate accidental pollution coverage from its market dominant Commercial General Liability Insurance form and to issue second, "claims-made," form), *aff'd in part, rev'd in part on other grounds and remanded sub nom. Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993).

325. See Abraham, *supra* note 311, at 980 (noting that, with reference to claims-made coverage, "only liabilities developing during the first few years after the policy is sold need to be predicted"); Andrew Reidy & Robert Carter, *Insurance Helps Breathe Life into Tobacco Litigation*, CONN. L. TRIB., Apr. 17, 1995, at 24 (reporting that tobacco industry insurers are expected to raise "trigger of coverage" issue created by issuance of claims-made policies with respect to cigarette litigation).

326. See, e.g., DONALD S. MALECKI & ARTHUR L. FLITNER, COMMERCIAL GENERAL LIABILITY 3 (1994) ("Contrary to expectations, the claims-made form has seen only limited use since its introduction, due perhaps to the 'soft market' conditions that set in during the late-1980s."); Abraham, *supra* note 311, at 965 n.73 ("The effort to introduce a claims-made [commercial general liability], however, has not met with success. Some state regulators have been reluctant to approve the new policy for general use, and the consuming public has not reacted favorably to its introduction.").

327. See, e.g., Leslie Cheek III, *Risk-Spreaders or Risk Eliminators? An Insurer's Perspective on the Liability and Financial Responsibility Provisions of RCRA and CERCLA*, 2 VA. J. NAT'L RES. L. 149, 159 (1982) (quoting "basic principle developed by the American Insurance Association that '[c]laims-made insurance policies should be acceptable alternatives to the standard occurrence-based contracts'" (citation omitted)); Gilbert, *supra* note 201, at 6 ("Regardless of the specific coverage provided, today's [environmental impairment] insurance nearly always is written on a 'claims-made' or 'discovery' basis . . . [I]t is nearly impossible to find [environmental impairment] coverage on an 'occurrence' basis."); John Sherlock, *Legal Malpractice Insurance Competitive; A Guide to Choosing a Carrier in a Crowded Marketplace*, LEGAL INTELLIGENCER, June 2, 1995, at 3 ("All lawyers' professional liability policies are written on 'claims-made' policy forms. This means coverage under the policy does not trigger until the claim is made.").

328. See, e.g., Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 54 (1986) (suggesting compulsory insurance as possible response to problem of judgment-proof tortfeasors); Note, *Designer Genes that Don't Fit: A Tort Regime for Commercial Releases of Genetic Engineering Products*, 100 HARV. L. REV. 1086, 1099-100 (1987) (advocating financial responsibility requirements such as mandatory insurance to deal with problem of judgment-proof firms).

already compulsory in many sectors of the U.S. economy. Laws in most states require owners and drivers of automobiles to carry some minimal amount of liability insurance.<sup>329</sup> Laws in all states require employers of more than some minimal numbers of workers to carry workers' compensation insurance.<sup>330</sup> The federal government requires the purchase of liability insurance as a prerequisite to engage in the operation of a nuclear facility,<sup>331</sup> a commercial airline,<sup>332</sup> a hazardous waste disposal facility,<sup>333</sup> and a variety of other commercial enterprises.<sup>334</sup> Laws providing for limited liability sometimes couple the privilege with the obligation to insure or maintain reserves.<sup>335</sup> As voluntary insurance declines in other high risk industries, the government can require insurance as a condition of doing business in those industries as well. The next Subsection explains why that strategy nevertheless will be inadequate to save liability.

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329. Liability insurance is compulsory in about 40 American jurisdictions. See 1992 SUMMARY OF SELECTED STATE LAWS AND REGULATIONS RELATING TO AUTOMOBILE INSURANCE 18-27 (1992) (showing that 39 states have "compulsory liability insurance"); ROBERT H. JOOST, AUTOMOBILE INSURANCE AND NO-FAULT LAW 2D § 1:8 (Supp. 1995) ("In 1995, 40 American jurisdictions required all motorists to maintain BI liability insurance or its equivalent."). According to Joost, 11 other American jurisdictions have "financial responsibility" laws that give drivers the option of buying insurance or otherwise providing for their own financial responsibility. See *id.* But the limits of insurance or financial responsibility are modest. Only three states require insurance in an amount greater than \$25,000 for one victim, and only three require insurance in an amount greater than \$50,000 for all victims in a single accident. See *id.* at §§ 4-34, 5-18 & 6:31 (1992) (containing tables from which this conclusion can be derived). In states where liability insurance is compulsory, a substantial portion of all drivers do not carry insurance. See *infra* note 360.

330. See U.S. CHAMBER OF COMMERCE, 1995 ANALYSIS OF WORKERS' COMPENSATION LAWS 1, 3-5 (1995) (showing workers' compensation statutes of all 50 states as "compulsory" with insurance "required"); Worker's Comp. L. Rep. (CCH) 5011-14 (1993) (showing state-by-state requirements for workers' compensation insurance).

331. See 42 U.S.C. § 2210(b) (1988 & Supp. V 1993) (requiring, as condition of licensing nuclear power plant, that operator prove financial responsibility in amount set by Nuclear Regulatory Commission) As of 1989, the Commission had set the amount at approximately seven billion dollars. See John F. McNett, *Nuclear Indemnity for Government Contractors Under the Price-Anderson Amendments*, 19 PUB. CONT. L.J. 1 (1989).

332. See Federal Aviation Act, 49 U.S.C. §§ 1301-1542, revised, codified and reenacted without substantive change at 49 U.S.C.A. § 40101-41741 (West Supp. 1995). Section 41112 specifically addresses financial responsibility requirements, and regulations have been promulgated pursuant thereto. See 14 C.F.R. § 205.5(b) (1995) (requiring that commercial airlines maintain liability insurance totaling \$20 million plus \$300,000 times 75% of number of passenger seats installed in aircraft).

333. See Resources Conservation and Recovery Act of 1976 § 3004, 42 U.S.C. § 6924(a) (1988) (mandating promulgation of regulations for financial responsibility requirements for operators of facilities for treatment, storage, and disposal of hazardous waste); Hazardous and Solid Waste Amendments of 1984 § 205, 42 U.S.C. § 6924(t) (listing insurance coverage as one means of satisfying financial responsibility requirements).

334. E.g., 49 U.S.C.A. § 31138 (1994), amended by ICC Termination Act of 1995, Pub. L. No. 104-88, §104(d), 109 Stat. 803, 919 (1995) (commercial transportation of passengers by motor vehicle), 49 U.S.C.A. § 31139, amended by ICC Termination Act of 1995, Pub. L. No. 104-88, § 104(e), 109 Stat. 803, 919 (1995) (same); 49 U.S.C.A. § 70112 (commercial space launch activities).

335. See, e.g., DEL. CODE ANN. tit. 6, § 1546 (1993) (requiring \$1,000,000 in liability insurance or reserves for limited liability partnership).



### 3. *The Limitations of Compulsory Liability Insurance*

Consider now a world of the future in which all persons and firms are judgment proof except insurers,<sup>336</sup> firms in other industries where financial responsibility is required by regulation,<sup>337</sup> and firms in the business of providing guarantees.<sup>338</sup> Protected by their judgment-proof status, other firms would have only one direct economic incentive to purchase liability insurance—to avoid whatever penalties the system imposed on the uninsured. Insureds would tend to seek the lowest cost policy that would enable them to do business. Insurers, seeking to compete on the basis of price, would tend to offer the minimum coverage permitted by law. Insurer and insured would have a common interest in reducing the recoveries of injured third parties. The less injured persons recovered from insurers, the lower the insurance premiums.

In those parts of the economy where insurance is compulsory today, insurer and judgment-proof insureds already have this common interest to varying degrees. The interest manifests itself in a number of strategies pursued by insurers and insureds, and in strategic responses by the compulsory liability insurance system. The net result has been a sharp increase in the burden of regulation and a diminution of the effectiveness of liability insurance. Four strategies pursued by insurers and insureds suggest the nature and magnitude of the problem.

First, in a compulsory liability insurance system, competition will focus on price. The optimal strategy for insurers to reduce their prices may be to reduce their costs by externalizing the risk they contract to assume. They would accomplish this by operating with the minimum assets at the maximum risk of bankruptcy permitted by the state insurance regulator. Unscrupulous insurers might trade off enforcement of expensive loss prevention rules for minor increases in the premium;<sup>339</sup> it would be up to the insurance regulators to

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336. I assume that insurance commissioners will continue to require that insurance companies demonstrate their solvency in order to continue to be licensed to write policies. *But see* Gilbert, *supra* note 201, at 7 (referring to existence in private insurance market of "'cut through' endorsements, which require an insurer's parent company to guarantee the coverage in the event of the insurer's insolvency"). The existence of these endorsements suggests that: (1) insurance companies are compartmentalizing their operations in separate corporations to limit their liability (that is, soft-judgment proofing); and (2) the impact is great enough that sophisticated persons who deal with insurers insist on nullifying the strategy by requiring that the parent company guarantee payment.

337. *See supra* notes 331–34 and accompanying text.

338. The ability to assure a third party of the payment of a debt is itself a valuable asset. The debtor would not want to own sufficient assets for its own assurance to be adequate; that would expose the assets to the liability system. Instead, the debtor would itself remain judgment proof, but purchase a third-party guarantee of obligations for which it chose to assure payment. The technique is no different than that employed by many, if not most, owners of small businesses today. They incorporate their business so that they will not be personally liable for tort claims, and they induce banks to lend to their corporations by personally guaranteeing corporate repayment of the loans. *See* RONALD J. MANN, PAYMENT AND CREDIT SYSTEMS Assignment 24 (1996).

339. *See* Cheek, *supra* note 327, at 175 ("Just as an automobile owner can find a mechanic willing to dismantle the vehicle's air pollution control equipment, so a hazardous waste facility operator would be

catch them. In a system of voluntary insurance where insureds count on their insurers to protect them by paying losses, insureds must concern themselves with the solvency of their insurers. In a system of compulsory insurance and judgment-proof insureds, insureds have no economic incentive to concern themselves with whether their insurers will pay claims. The market no longer assists in assuring the solvency of insurers, so the entire burden of doing so falls on regulators.<sup>340</sup>

Second, today's market-generated<sup>341</sup> insurance policy forms contain numerous exclusions and exceptions from coverage.<sup>342</sup> Insurers do not offer, and businesses do not demand, types of coverages that the insurers cannot provide on a cost-effective basis. The result is a market-generated pattern of exclusions and exceptions in the insurance policy that in at least a rough sense reflects the strengths and weaknesses of insurance. One such exclusion, that for intentional torts, has already been discussed.<sup>343</sup> In a compulsory insurance system with judgment-proof insureds, it is in the common interests of insurers and insureds to minimize coverage to the extent permitted by law. That is, both insurer and insured would prefer completely ineffective coverage if it would satisfy the requirement to have insurance, because such insurance would be *very* cheap. As a result, in a compulsory insurance system with judgment-proof insureds, the market for insurance coverage would no longer function to identify the coverages insurers can provide on a cost-effective basis. The insurance regulatory system would have to determine the minimum terms of coverage, as it does where insurance is compulsory today.<sup>344</sup>

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able to find an insurer willing to waive enforcement of expensive loss prevention rules for a minor increase in the premium.”).

340. See, e.g., P.R. Newswire Ass'n, Inc., *Uninsured Taxicabs May Put Public At Risk, 'Play It Straight,' Long Warns Insurance Agents*, Dec. 16, 1993 (reporting possibly widespread practice of selling taxicab drivers inexpensive personal automobile policies rather than much more expensive commercial coverage required by law).

341. The market in which the commercial liability insurance forms are generated is not entirely free. See *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993) (holding that primary insurers and reinsurers may have violated antitrust laws in compelling Insurance Service Office to eliminate accidental pollution coverage from its market dominant Commercial General Liability Insurance form and to compel issuance of second, “claims-made” form); see also *In re Insurance Antitrust Litig.*, 938 F.2d 919, 923 (9th Cir. 1991), *aff'd in part, rev'd in part on other grounds and remanded sub nom. Hartford Fire Ins. v. California*, 509 U.S. 764 (1993). Nevertheless, there is a market process at work that produces an evolution in policy provisions.

342. See, e.g., Anderson et al., *supra* note 323, at 280 (“In addition to the ‘expected or intended’ exclusion, Coverage A [of the commercial general liability policy] contains twelve other exclusions”), Gilbert, *supra* note 201, at 6 (describing numerous exclusions contained in environmental impairment insurance policies); Kirk A. Pasich, *The Breadth of Insurance Coverage for Environmental Claims*, 52 OHIO ST. L.J. 1131, 1131–32 (1991) (“Most insurance carriers . . . deny that they have any duty to pay the costs of cleaning up the environment or to pay damage claims against their insureds. Thus, insureds and insurance carriers are now litigating over myriad issues with respect to insurance carriers’ obligations to defend and indemnify their insureds against claims relating to environmental contamination”). Reidy & Carter, *supra* note 325, at 24 (suggesting that “[t]he main defense the insurance industry is likely to litigate is whether the tobacco-related suits constitute an ‘accident’ or ‘occurrence’ so as to be covered under liability insurance” and that other likely issues include trigger date for coverage and pollution exclusion).

343. See *supra* notes 301–15 and accompanying text.

344. See *supra* notes 331–34 and accompanying text.

Third, in a system of voluntary insurance and solvent insureds, the process of determining insurability and rating the risk is greatly facilitated by information supplied by the applicant. Fear that at the time of loss the insurer will deny coverage for fraud in the insurance application or for failure to comply with conditions of coverage is an important incentive for the applicant to cooperate.<sup>345</sup> In a compulsory insurance system with judgment-proof insureds, this incentive disappears because the insured no longer cares whether the insurer pays the loss. Some insureds will find it to their advantage to defraud their insurers, even if they are certain to be caught later. The system cannot permit insurers to deny coverage for fraud in the insurance application, or the insurer would have an interest in being defrauded that would coincide dangerously with the interest of insureds in defrauding. That is, both would benefit from the issuance of a policy that the insurer could void for fraud when a claim was finally made. The insurance regulatory system has already responded to this problem in other contexts by limiting the ability of insurers to void compulsory coverage for fraud. That is, coverage obtained by fraud is enforceable.<sup>346</sup> The net effect is that in a compulsory system, insurers are no longer assured of the cooperation of their insureds in determining insurability and rating the risk.

Fourth, liability insurers need the cooperation of their insureds in processing claims and defending litigation. In a system of voluntary insurance and solvent insureds, the threat that the insurer will deny coverage pursuant to policy provisions provides an important incentive to cooperate.<sup>347</sup> In a compulsory insurance system with judgment-proof insureds, this incentive also disappears, and insureds may be reluctant to cooperate.<sup>348</sup> This problem has

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345. See ABRAHAM, *supra* note 306, at 60 ("Once coverage has been provided . . . policy defenses are perhaps the most workable tool for enforcing compliance with the insurer's risk management standards."); L. William Caraccio, Comment, *Void Ab Initio: Application Fraud as Grounds for Avoiding Directors' and Officers' Liability Insurance Coverage*, 74 CAL. L. REV. 929, 991-98 (1986) (discussing alternatives to insurers' current use of preexisting knowledge clause as basis for coverage).

346. See *supra* note 313.

347. See, e.g., N.Y. INS. LAW § 3420(c) (McKinney 1985) (providing that burden of proof shall be on insurer when insurer defends against liability on ground that insured failed or refused to cooperate with insurer in violation of any provision in policy); see also *Cohen & Co. v. North River Ins. Co.*, No. 93-1680, 1994 U.S. Dist. LEXIS 3646 (E.D. Pa. Mar. 25, 1994) (holding that failure of accounting firm, sued by writ of summons, to notify its insurer of claim within one-year duration of "claims-made" policy or within 60 days thereafter resulted in forfeiture of insurance), *aff'd*, 39 F.3d 1168 (3d Cir. 1994). *But see* Bousquet, *supra* note 5, at 17 ("[M]any lawyers know of a potential claim but fail to disclose it because of their reluctance to accept responsibility for their acts—thereby creating another potential roadblock to compensation for clients who are harmed.").

348. See Cheek, *supra* note 327, at 159; Steven A. Kunzman, *The Insurer as Surrogate Regulator of the Hazardous Waste Industry: Solution or Perversion?*, 20 FORUM 469, 483-84 (1985) (arguing that direct liability under CERCLA effectively strips insurer of its ability to deny coverage for failure to comply with terms of policy and thereby strips insurer of much of its control over insured's conduct). Kunzman bases his arguments on those developed by Cheek, *supra* note 327. See also ABRAHAM, *supra* note 306, at 61-62 (suggesting that insurers in compulsory liability insurance system control policy holders by compelling them to indemnify insurers against their own wrongdoing). Of course, the technique no longer works when insureds are judgment proof.

been severe enough in the current system to prompt courts and legislatures in most states to adopt "reach and apply" rules to prevent post-loss actions of insureds from voiding coverage or preventing recovery from insurers.<sup>349</sup> The reach and apply problem would be magnified in a system of compulsory insurance with judgment-proof insureds.

#### 4. *Designing a Compulsory Liability Insurance System*

The liability system attempts to provide injured persons with remedies across the entire spectrum of wrongful acts, from the purely accidental to the deliberate infliction of injury. For compulsory liability insurance to be a complete substitute, it would have to do the same.

Such a system is not inconceivable. It would, however, give insurance companies a very different role from the one they play today. The primary function of the liability insurance system as it operates today is to reduce total risk through transfer and offset of risks against other similar risks.<sup>350</sup> Insurance companies deal with the risks of deliberate infliction of injury principally by excluding them from coverage.<sup>351</sup> Insurance companies do sometimes monitor the activities of insureds for the purpose of controlling losses, but only in a manner ancillary to the insurance companies' primary function. They do so in cooperation with an insured whose interest in controlling losses largely coincides with their own.

Making compulsory liability insurance a complete substitute for liability would require that liability insurers take on a much broader role than the one they now play. Insurers would not be able to rely on the cooperation of their insureds in attempting to control the risk that the insured will deliberately inflict losses; insurers will have to control those risks through some kind of monitoring or deterrence. The monitor's task will be to prevent assault and

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349. See, e.g., MO. REV. STAT. § 379.195 (West Supp. 1996) (providing that no contract of liability insurance shall be "cancelled or annulled by any agreement between the insurance company and the assured after the said assured has become responsible for such loss or damage"); PA. STAT ANN tit 40, § 117 (West 1988) (requiring that policies provide that insolvency or bankruptcy of insured shall not release insurer and permitting direct actions against insurers); *Mandeville v Shelby Mut. Plate Glass & Casualty Co.*, 5 Conn. Supp. 306, 309 (C.P. 1937) ("The statute, to effectuate its manifest purpose to safeguard the rights of the injured person, prohibits any cancellation or annulment of the policy by any agreement between the insurance company and the assured after the injury" (quoting *Guern v Indemnity Ins Co.*, 107 Conn. 649, 653 (1928))); *Storm v. Nationwide Mut. Ins. Co.*, 97 S.E.2d 759, 762 (Va. 1957) (finding that "an injured party is a beneficiary under the policy from the moment of injury" regardless of subsequent judgments, agreements, or releases between the policy holder and the insurer). *But see MacArthur Co v Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988) (upholding Manville's ability to settle with its insurer during bankruptcy case and thereby cut off rights of subsequent injured parties).

350. The system permits liability insurance, nevertheless, because liability insurance does more than simply transfer risk; liability insurance reduces total risk by offsetting particular risks against similar ones. The reduction of total risk by aggregation in the hands of an insurance company creates net wealth.

351. That is, where losses are most difficult to control because they are largely within the control of the insured, insurers refuse coverage because such risks are not "insurable." See GREENE ET AL., *supra* note 200, at 45.

battery; patent infringement; race, sex, or religious discrimination;<sup>352</sup> or the midnight dumping of toxic waste—all by people with little to lose and perhaps much to gain by their wrongful acts. To have any hope of success at all, the insurer will need agents or employees on the shop floor, in the board room, on the bridge of the Exxon Valdez, and perhaps even in the bedroom.<sup>353</sup> The insurer will be cast in the unaccustomed role of surrogate regulator,<sup>354</sup> with the conduct to be regulated the vast array currently affected by civil liability. By choosing to issue or refuse to issue policies, insurers in a compulsory liability insurance system would decide who could or could not go into business.

An alternative way for compulsory liability insurers to deal with highly reactive risk would be to insure only those who demonstrate financial responsibility. Presumably, any system of compulsory insurance would provide for policy limits.<sup>355</sup> By requiring financial responsibility, perhaps in the form of a bank letter of credit for the policy limits, and contracting for subrogation against its own policy holder for all sums the insurer may be required to pay, an insurer would completely eliminate moral hazard and, with it, reactivity of risk. By so limiting its insureds, insurers would in essence reconstruct tort liability by contract. The new system would have far greater capacity for deterrence than any system existing today.<sup>356</sup>

352. See, e.g., *Boston Hous. Auth. v. Atlanta Int'l Ins. Co.*, 781 F. Supp. 80, 83 (D. Mass. 1992) (explaining that Massachusetts public policy bars insurance coverage for indemnity and defense where policyholder intentionally committed racial discrimination in housing); *Ranger Ins. Co. v. Ba' Harbour Club, Inc.*, 549 So. 2d 1005 (Fla. 1989), *aff'd*, 570 So. 2d 1043 (Fla. Dist. Ct. App. 1990) (finding Florida public policy prohibits indemnification for loss resulting from intentional act of religious discrimination).

353. See, e.g., ABRAHAM, *supra* note 306, at 62 (“[A]ppointing the [insurance] industry as a frontline risk manager would require it to play an authoritative role—perhaps even an authoritarian one—in making decisions about the way other businesses conduct their operations.”).

354. See, e.g., Abraham, *supra* note 311, at 954–55 (describing “surrogate regulation” by insurance companies as device for controlling incentives of insureds). *But see* ABRAHAM, *supra* note 306, at 57 (noting that compensation funds would make insurers “surrogate regulators,” that role “would be a new one and would place unconventional demands on insurers,” and that he was “not necessarily advocating such a role”); *id.* at 62–63 (referring to surrogate regulator as “insurer’s new role” and arguing that direct regulation would be preferable). Cheek has argued that:

Insurers can function as an important adjunct to public regulation of safety if they are left free to do what they are in business to do: *spread* the economic consequences of the risks they have contracted to assume. Any attempt to enlist insurers to *control* or *eliminate* these risks will inevitably impair their willingness and ability to perform their appropriate function in society and undermine the efficacy of public safety regulation.

Cheek, *supra* note 327, at 177–78.

355. All existing systems do. See, e.g., *supra* notes 331–33 and accompanying text. Whether they should is an issue that goes beyond the scope of this Article. Theory as to the reasons for the existence of policy limits is sparse. For some speculation as to the reasons for the existence of policy limits, see Alan O. Sykes, “Bad Faith” Refusal to Settle by Liability Insurers: Some Implications of the Judgment-Proof Problem, 23 J. LEGAL STUD. 77, 86 (1994) (“[T]he fact that insureds have finite assets affords a standard explanation.”). Other possible explanations include adverse selection, moral hazard, and the pricing of insurance higher than is “actuarially fair.” *Id.* at 86 n.25.

356. The system would have a greater capacity for deterrence because no participant would be judgment proof. Today, most individuals and small businesses are judgment proof or capable of becoming so before a judgment could be entered against them. See *supra* note 5 and accompanying text.

The obvious problem with this alternative is that it would provide insurance only to those with the financial capacity to pay claims in the full amount of the policy limits. If the compulsory policy limits were set high, few businesses could qualify for insurance. If, as seems more likely, the policy limits were set low enough that most businesses could prove financial responsibility,<sup>357</sup> the great bulk of liability would be in excess of policy limits. Debtors would externalize that great bulk to tort victims, and deterrence would fail. The system would have sacrificed adequate coverage of risks to obtain universal coverage of risks.

More likely, in a world where everyone was judgment proof, designers of a compulsory insurance system intended to substitute for liability would elect to cover fewer kinds of risks. Risks of intentional wrongdoing would be excluded from coverage; the system would rely on direct regulation backed by the threat of incarceration to control them. In a world where everyone was judgment proof, the liability system might remain in place with respect to intentional torts—just as it remains in place today with regard to violent crimes—symbolically active, but ineffective in transferring economic losses. Across a wide spectrum of civil wrongs, the liability system would be dead.

##### 5. *The Political Limits of Compulsory Liability Insurance*

Compulsory liability insurance will raise political as well as economic issues. The purpose of compulsory liability insurance would be to assure compensation and loss spreading. To achieve that purpose, uninsured persons would be barred from engaging in the activity.<sup>358</sup> Compulsory insurance laws stand as an economic barrier to entry into a few businesses today; the compulsory insurance contemplated here would expand that barrier to substantially all businesses. Denial of insurance would be denial of the opportunity to go into business. The barrier would be greatest in newly developing industries such as biotechnology where the risks are both high and difficult for insurers to assess.<sup>359</sup> The system also would strike particularly hard at professional persons whose human capital could not be easily transferred to another business for which they could get insurance. Efforts at evasion would be persistent and frequently successful.<sup>360</sup>

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357. See *infra* note 365 and accompanying text.

358. See, e.g., Patricia D. Gugin, Note, *Conditioning Access to the Public Forum on the Purchase of Insurance*, 17 GA. L. REV. 815, 836 (1983) (suggesting that "mandatory insurance may function as a form of censorship").

359. See JOEL S. MOSKOWITZ, ENVIRONMENTAL LIABILITY AND REAL PROPERTY TRANSACTIONS 338 (2d ed. 1995) ("Although a limited market exists now for environmental liability coverage, premiums and deductibles are high, and coverage is restricted."); *supra* note 315 (discussing availability of insurance in biotechnology field).

360. The California Department of Insurance has reported

Experience under other financial responsibility and compulsory insurance systems suggests that the socially irresponsible will remain financially irresponsible with or without a financial

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 are not easily accepted. Eleven American jurisdictions have declined to make auto insurance compulsory, instead enacting "financial responsibility" laws that require a driver to purchase insurance only after the driver has a specified accident or violation.<sup>361</sup> Even in the majority of states where the law requires the purchase of insurance, the system may not provide effective means for enforcement. At least in some states, this failure of the legislature to provide effective means of enforcement is actually intended by the legislature to enable people of moderate means to drive without insurance.<sup>362</sup> Also to minimize the number of people denied the right to drive, these laws establish "assigned risk" plans requiring insurance companies to write policies for high risk drivers at regulated rates lower than the market rates. The effect is to subsidize the highest risk drivers.<sup>363</sup> All companies writing insurance in the state are required to insure their proportion of assigned risks, so the companies can pass

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responsibility law. Evasion of compulsory automobile insurance requirements is widespread in the twenty-six states that replaced their [financial responsibility] statutes with such requirements, and the percentage of insured motorists in these jurisdictions has stabilized at levels prevalent before these laws were enacted.

CALIFORNIA DEP'T OF INS., REPORT ON AUTOMOBILE LIABILITY INSURANCE (1995) (reporting that 27.5% of California drivers do not have insurance as required by state law); *see also* OHIO DEP'T OF PUB. SAFETY, 1994 OHIO TRAFFIC CRASH FACTS 34 (reporting that 83% of drivers involved in automobile accidents in Ohio in 1994 were insured, 6% were uninsured, and for 11% insurance status was not stated); STANFORD RESEARCH INSTITUTE, THE ROLE OF RISK CLASSIFICATION IN PROPERTY AND CASUALTY INSURANCE: FINAL REPORT 27 (1976) (estimating that 17.5% of all drivers in United States have no automobile insurance); Brian Ford, *Lawmakers Consider No-Fault Insurance*, TULSA WORLD, Oct. 25, 1995, at B1 ("The state Department of Public Safety estimates that between 15 percent and 17 percent of accidents involve uninsured motorists."); Fannie Weinstein, *Bane of the Highways: Uninsured Motorists*, INS. REV., Nov. 1991, at 32 (estimating number of uninsured motorists nationwide at 17 million in 1991).

361. *See* JOOST, *supra* note 329, at § 1:8 (Supp. 1995).

362. In California, for example, approximately 30% of all drivers are uninsured. CALIFORNIA DEP'T OF INS., COMMISSIONER'S REPORT ON UNDERSERVED COMMUNITIES at ca-1 (1995) (describing large number of uninsured motorists as indicative of failure of system to serve poor). In April, 1996, California voters defeated Proposition 200, which aimed at combatting high rates of uninsurance, by a three to two margin. *See* Victoria Slind-Flor, *Tort Revision 'Lost Cause' in California?*, NAT'L L.J., Apr. 8, 1996, at B1. The proposition would have established a no-fault automobile insurance system and required owners to show proof of insurance when they registered their cars. *See* Proposition 200 § 12801 (1996) ("No motor vehicle registration shall be issued or renewed unless the owner of that vehicle furnishes proof, in a form satisfactory to the Department of Motor Vehicles, that the vehicle is insured as required by this chapter."). In 1990 a California vehicle code requiring drivers to provide evidence of financial responsibility on traffic stops and in accident investigation was repealed. *See* CAL. VEH. CODE § 16028 (West Supp. 1996) (repealed 1990).

363. *See* Cheek, *supra* note 327, at 153 (arguing that states undermine financial responsibility laws by requiring insurers to provide coverage to any licensed driver and requiring good drivers to subsidize those in high risk pool). As Keeton and Kwerel point out:

[Assigned-risk] rates must be approved by the state insurance commission before they can go into effect and are often held below break-even levels. The resulting losses are then spread among insurance companies in proportion to the volume of voluntary business they do in the state, so that drivers who buy insurance in the voluntary market end up paying prices above expected cost.

William R. Keeton & Evan Kwerel, *Externalities in Automobile Insurance and the Underinsured Driver Problem*, 27 J.L. & ECON. 149, 171 (1984).

the cost of the subsidy along in the form of higher premiums for lower risk drivers. For the state to operate an assigned risk plan rather than permitting those drivers to drive uninsured is nevertheless economically efficient; the plan enables them to externalize some of the risk they generate, but driving without insurance would enable them to externalize all of the risk they generate.<sup>364</sup>

The problems of implementation of compulsory automobile liability insurance are likely to be repeated in the context of compulsory business liability insurance. We can expect that a compulsory business liability insurance system would require insurance only to low policy limits,<sup>365</sup> would demand that insurance companies write policies for assigned risks in at least some circumstances, would force other policy holders to subsidize the assigned risks, and would engage only in lax enforcement.<sup>366</sup> All but the last of these characteristics will render the system more effective in compensating injured persons and spreading losses, but all four will render it even less effective in deterring wrongful conduct.<sup>367</sup>

Fixing the limits of compulsory general liability insurance would be a complex undertaking. Some businesses generate risks of high losses, necessitating coverage in amounts not necessary for others. Political pressures to establish separate classifications and different insurance based on the type

364. See Keeton & Kwerel, *supra* note 363 (arguing that subsidizing liability insurance for financially irresponsible drivers is Pareto superior when those providing subsidy benefit from increased coverage of low-asset drivers); see also GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* 59 (1970) (suggesting compulsory insurance to correct distortion in decisions to bear risk)

365. See, e.g., Jeffrey Kehne, Note, *Encouraging Safety Through Insurance-Based Incentives: Financial Responsibility for Hazardous Wastes*, 96 *YALE L.J.* 403, 417 (1986) ("[R]equired levels of coverage [under the Resource Conservation and Recovery Act of 1976] fall far short of potential third-party damages. Current regulations also allow facilities to operate with third-party liability coverage that applies only to claims filed during a specified policy period—typically one year." (footnote omitted))

Furthermore, "[i]n 1982, twenty-eight states had compulsory liability insurance laws. However, none of these states required more than \$25,000 coverage per person injured, and sixteen required \$15,000 or less." Keeton & Kwerel, *supra* note 363, at 151; see, e.g., ALA. CODE § 32-7-6 (1975) (requiring automobile liability insurance to limit of not less than \$20,000 because of bodily injury to or death to one person in any one accident, and \$40,000 because of bodily injury to or death of two or more persons in any one accident); DEL. CODE ANN. tit. 21, § 2118(a)(2)(b) (1995) (requiring liability insurance coverage of not less than \$15,000 for one person and \$30,000 for all persons injured in any one accident)

366. Experience in the enforcement of California's mandatory automobile liability insurance law demonstrates that it is a political hot potato. About 30% of California's drivers violate the law by driving without insurance. The state could drastically reduce that number by requiring proof of insurance to register an automobile, as some other states do. Instead, the California Insurance Commissioner reports data showing that it is minorities and poor who drive without insurance. The report refers to the communities in which they live as "underserved" by the insurance industry, implying that it is the insurance industry rather than the uninsured drivers who are to blame. See CALIFORNIA DEP'T OF INS. STATISTICAL ANALYSIS BUREAU, COMMISSIONER'S REPORT ON UNDERSERVED COMMUNITIES (Feb 1995)

367. See Cheek, *supra* note 327, at 159 ("To the extent that the states give guaranteed insurance availability a higher priority than loss prevention through active regulation, the ability of [financial responsibility] insurers to advance the public interest in environmental safety will be diminished"), *id.* at 159-60 (quoting "basic principle" developed by American Insurance Association that "[m]andatory residual markets (i.e., assigned risk plans) should be avoided, in order to prevent subversion of safety regulation and subsidization of uninsurable facilities by the owners of responsibly managed risks") *But see* Keeton & Kwerel, *supra* note 363, at 151 (arguing that subsidizing liability insurance for financially irresponsible drivers may be Pareto optimal when those providing subsidy would otherwise go uncompensated)



of business,<sup>368</sup> the size of the business, and the wealth or poverty of the owners would be pervasive. The resulting system of regulation probably would rival in complexity the systems recently proposed to deal with health care.<sup>369</sup>

It is conceivable that a liability insurance system based on the model presented here might preserve the liability system. But it is clear that it would, in the process, transform the liability system almost beyond recognition.

### G. *Financial Responsibility Requirements*

As an alternative to mandatory insurance, the system might permit would-be entrepreneurs to demonstrate financial responsibility either by posting a bond or by proving their financial condition. The bond probably would be required in the same amount as the limits of the liability insurance policy for which it would substitute. A debtor who had the money could post it in cash.

As an alternative, debtors would be permitted to purchase a bond from an insurance company. A bond is a commitment to pay a fixed amount of money in a specified circumstance. Here, that circumstance probably would be the entry and nonpayment of a money judgment against the debtor. Insurers who sell financial responsibility bonds today generally do so in return for a minimal-risk premium of one percent of the bond. The insurer's obligation carries minimal risk because the insurer: (1) requires that the applicant agree to indemnify the insurer against any payment the insurer must make; and (2) requires that the applicant either prove that its financial condition is adequate to assure payment of the indemnity obligation or provide the insurance company with collateral. In other words, only a well-capitalized debtor can obtain a bond.

The third alternative for demonstrating financial responsibility would be to prove one's financial condition directly to the regulator. A variety of regulatory systems would be possible, ranging from the elaborate examination currently used to determine the financial condition of banks and insurance companies, to the mere requirement that debtors file and swear to the truth of financial statements showing some specified net worth. The cost of the premiums payable and the regulation required in such a system would be substantial.

Whatever the method of enforcement, if the system worked, it would bar persons not wealthy enough to demonstrate financial responsibility by any of these three means from engaging in liability-generating economic activity. To return to the metaphor with which this Article began, those without the means to ante up could not stay in the game. This frames a central tension in the

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368. For a frightening analogy, see 13 C.F.R. § 121.601 (1995), which classifies businesses into about 800 SIC categories as part of an effort to define a "small business."

369. See, e.g., Health Security Act, H.R. 3600, 103d Cong. (1993) (totalling 1342 printed pages in length).

struggle over liability: Americans do not want judgment-proof businesses to be able to operate, but neither do they want to exclude persons of moderate means from participation in the economy. The system currently accommodates that conflict by permitting persons who cannot demonstrate financial responsibility to participate in all but a few industries, and by excusing nonpayment of liabilities when they exceed the debtor's ability to pay.

To limit participation in the economy to those who could prove financial responsibility adequate for the role they chose would drastically reduce economic opportunity for all but the wealthiest segment of society. Not only would the reduction injure those barred from businesses and occupations because they could not demonstrate financial responsibility, but their absence would also reduce competition in the businesses and occupations that they could not enter. Economic activity would slow, prices would increase, and the gap between rich and poor would widen.

If an economy-wide requirement of financial responsibility were adopted, there would be strong pressures to relax the standards for persons of modest means. The issue would be how to separate the wealthy from the not-so-wealthy so that the system could favor the latter. But that brings the inquiry full circle. The liability system, as currently conceived, is a system for determining "what wealth particular judgment creditors should be able to reach."<sup>370</sup> The problem is that the system's schemes for making that determination have consistently been defeated by strategy. What we need, and currently do not have, are meaningful definitions of a "wealthy person" and of that person's "wealth."

## V. CONCLUSION

Strategies for defeating liability are readily available. Among individuals and small firms, they already protect the vast bulk of all assets against liability. Not all individuals and small firms are currently judgment proof, but that may be only because they do not need to be. They are close enough to being judgment proof that, if a sizable lawsuit were filed against them, they could become judgment proof before any judgment could be enforced against them. Large firms have only begun to tap the judgment-proofing strategies available to them. For most large firms, the costs of judgment proofing still exceed the benefits. But computerization already has reduced the clerical costs sharply, and cultural deterrents are in decline as well. The publication of strategies for "asset protection"—a euphemism for judgment proofing—already has become a cottage industry.<sup>371</sup> Trends already established soon will tip the balance of

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370. See *supra* text accompanying notes 10, 20-36

371. See, e.g., SOLOMON & SARET, *supra* note 148; SPERO, *supra* note 142

costs in favor of judgment proofing for most large firms and pull down the remaining cultural barriers.

Judgment proofing need not spread to every industry to kill the liability system. Once substantial numbers of large companies judgment proof substantial portions of their operations, the inequity of the system will be apparent. The system will force businesses that expose themselves to liability to pay large judgments, but will be unable to reach those who resist. Such glaring inequity will lead to action. Unless the resisters can be brought under control, it is likely that the system will be dismantled.

Strategies by which the system can attempt to postpone liability's day of reckoning are plentiful. But they are drastic measures that would require traumatic change. Ultimately, nearly all are vulnerable to counterstrategies. General financial responsibility requirements could provide a long term solution, but only at a political cost that the system may be unwilling to pay. Given a choice between having to be financially responsible to participate in the economy and the death of liability, the American people may well choose the latter.

Throughout this Article, the assumption has been made that the system can make whatever rules it chooses. In fact, the system has far less flexibility than has been assumed. Participants in the liability system, including large corporations and insurance companies, undoubtedly exert enormous political influence over proposed changes in the system. Even if the system had ways of saving itself, those in charge might not allow the system to pursue them.

Returning to the assumption of complete system flexibility on which this Article is based, the question remains why a system with such power would still be unable to defeat the strategists. Part of the answer is that the system must coordinate the actions of millions of participants. The rules by which the system operates<sup>372</sup> must be widely known, easy to understand, and stable over time. For the liability system to survive, it must command players to risk whatever wealth they have by putting it into the pot. But the system has no words with which to say that. In both the popular and the legal culture, the words we use to describe the system relate only to form. We take concepts such as "ownership," "entity," "property," and "secured creditor" seriously. We assume they identify real things of importance, when they do not. The judgment-proof debtor who still sails on the yacht, drives the Mercedes, and lives in the house on the hill remains wealthy, whether those items are fully encumbered, owned by the debtor's spouse, or titled to a Cook Islands trust. But neither popular nor legal language describes such a debtor as "wealthy." There may be viable stopping points for enterprise or trading partner liability,

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372. The rules expressed in written law can be almost infinitely complex. But, as I have explained elsewhere, the rules expressed in written law are not the rules by which the system operates. See LoPucki, *The Law in Lawyers' Heads*, *supra* note 12, at 1517-21.

but we have neither the vocabulary nor the public consciousness necessary to make those stopping points the foundation for a modified system. Our legal culture is failing us, and, for liability at least, there probably is not time to develop a new one.<sup>373</sup>

If we had such a culture, how might it define "wealth?" One possibility would be to define a person's wealth as the resources that person could commit to the payment of a debt if the person wished to pay it. That would include the money the person could borrow from friends and relatives, money the person could earn in the future, nonproperty assets such as celebrity or education that the person could exploit, or job perks the person might reassign. These concepts are, of course, not well defined, but that can be said of any system that has not yet been implemented and therefore has not generated practices. It is the practice which completes a legal culture and gives meaning to its rules.<sup>374</sup> Whether wealth could be redefined meaningfully and a viable liability system built on that new definition is purely academic. For the liability system to pursue such a fundamental redefinition is unthinkable. The choice the system makes will be evolutionary, not revolutionary.

Legal culture is not the only limit on the system. The United States must compete with nations whose liability systems are less ambitious. If the U.S. system manages to save liability, but other nations do not, economic actors in those other nations may have a competitive advantage over those in the United States. Liability-generating economic activity (is there any other kind?) may move to those nations, with the products being shipped back into the U.S. markets,<sup>375</sup> or the assets of U.S. generators of liability may flee to nations that will protect them against U.S. liability.<sup>376</sup>

One more possibility is worthy of mention. It is that the death of liability might not be such a bad thing. Scholars have argued, with some persuasive force, that liability has had minimal deterrent effect.<sup>377</sup> Possibly some more

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373. For a description of a nation's conscious effort to create a legal culture, see Frances H. Foster, *Parental Law, Harmful Speech, and the Development of Russian Legal Culture: Russian Judicial Chamber Discourse and Narrative*, 22 *YALE J. INT'L L.* (forthcoming 1997) (describing efforts to create a legal culture in post-Soviet Russia).

374. See Stanley Fish, *Fish v. Fiss*, 36 *STAN. L. REV.* 1325, 1327-30 (1984) (attributing agreement on what a rule "is" to constraints of context in which it is applied because knowledge "informs rules rather than follows from them").

375. See generally Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 *YALE L.J.* 2039 (1993) (arguing that U.S. environmental liability may put U.S. producers at disadvantage in international trade).

376. See *supra* Section II.D.

377. See generally GEORGE EADS & PETER REUTER, *DESIGNING SAFER PRODUCTS: CORPORATE RESPONSES TO PRODUCT LIABILITY LAW AND REGULATION* vii (1983) (arguing that product liability sends "indistinct signal"); Gary T. Schwartz, *Reality in the Economic Analysis of Tort Law: Does Tort Law Really Deter?*, 42 *UCLA L. REV.* 377 (1994) (examining empirical evidence from variety of sources and concluding that tort law probably provides sufficient deterrent to warrant cost of system); John A. Siliciano, *Corporate Behavior and the Social Efficiency of Tort Law*, 85 *MICH. L. REV.* 1820, 1864 (1987) (arguing that "tort law does not necessarily push producers towards a socially efficient level of product safety"); Stephen D. Sugarman, *Doing Away with Tort Law*, 73 *CAL. L. REV.* 558, 559-609 (1985) (arguing that tort

direct form of coercion could provide the basis for a system that would replace liability after it is gone.

Sophisticated information systems seem the most likely substitute for liability.<sup>378</sup> It is not difficult to imagine a world in which the only deterrent to nonpayment of debt is a bad credit rating and the only deterrent to medical malpractice is the publication of notice of its occurrence. Systems that deliver these kinds of information already exist, and their deterrent effect supplements that of liability. Because these systems act against persons rather than property, they do not suffer the metaphysical difficulties that plague the future of liability. In part because these system are potentially so powerful, they are tightly constrained by a web of legal and quasi-legal burdens.<sup>379</sup> But in the post-liability world, we might choose to unleash their power. It is not too soon to start thinking about it.

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law has failed to deter wrongful conduct, failed to compensate at acceptable costs, and failed to do meaningful justice).

378. Theoretically, sophisticated information systems might rescue the liability system by advising the public of companies' judgment proofing efforts and thus raising the publicity cost of those efforts. In practice, however, the public would be better served by information about the risks of loss companies are imposing on them than by information about the public's ability to recover damages in the unlikely event losses occur.

379. See 15 U.S.C. § 1681b (1994) (restricting reasons for which credit reports may be issued); Joel Brinkley, *The Furor Over Data on Doctors*, N.Y. TIMES, May 29, 1994, § 4, at 4 (reporting that, in response to complaints from American Medical Association, federal government declined to offer public access to its database of 62,183 doctors, dentists, nurses and other medical professionals who have been sued, sanctioned, or otherwise penalized for crimes, mistakes, or incompetence); Amy Stevens, *A List of Bad Lawyers to Go On Line*, WALL ST. J., Aug. 26, 1994, at B1 (reporting that American Bar Association's National Discipline Data Bank, listing "names, addresses, aliases and violations" of 25,000 lawyers, will be made available on Westlaw, but only to disciplinary authorities).