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CORPORATE VEIL PIERCING: A PROPOSAL FOR MEXICO

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Abstract. *This article uses an Economic Analysis of Law approach to propose the adoption of the doctrine of corporate veil piercing in Mexico. This study not only recognizes the economic benefits of limited liability for society, but also identifies the incentives it creates for shareholders to abuse of the corporate form by using the corporation to unduly appropriate a corporation's assets at the expense of the corporation's creditors. On this basis, the article describes the American equity doctrine of veil piercing that courts apply in order to reach shareholders' assets in cases of fraud or misconduct against the corporation's creditors. Finally, the paper describes the current legal framework in Mexico and proposes the adoption of corporate veil piercing in the Mexican legal system.*

Key Words: *Corporation, legal personality, limited liability, corporate veil piercing, economic analysis of law.*

Resumen. *Este artículo propone la adopción de la desestimación de la personalidad jurídica en México, empleando como método el análisis económico del derecho. Este estudio no sólo reconoce los beneficios económicos que se derivan de la responsabilidad limitada para la sociedad, sino que también identifica los incentivos que ésta crea en los accionistas para apropiarse indebidamente de los bienes de la sociedad anónima en detrimento de los acreedores de ésta. Sobre esta base, el artículo describe la doctrina americana de la desestimación de la personalidad jurídica que los jueces aplican para alcanzar los bienes de los accionistas en casos de fraude o de actos ilícitos cometidos en contra de los acreedores de la sociedad anónima. Finalmente, el artículo describe el marco jurídico actual en México para hacer frente al abuso de la forma societaria como resultado de la responsabilidad limitada y propone la adopción de la desestimación de la personalidad jurídica en México.*

Palabras clave: *Sociedad anónima, personalidad legal, responsabilidad limitada, desestimación de la personalidad jurídica, análisis económico del derecho.*

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I. Introduction

In the 19th century, new challenges posed by the industrial revolution forced entrepreneurs to find innovative ways to organize their business activities and limit their exposure to liability.[1] Although industrial enterprise at that time required increased capital investment and risk, the rule of unlimited liability made raising capital ex- tremely difficult, as few investors were willing to risk all their assets on a single investment. For this reason, laws regarding limited liability and modern corporate structure were enacted to help large enterprises acquire working capital. As a by-product, these rules also helped boost the economic role played by small entrepreneurs.[2]

Since then, limited liability has facilitated investment in large, complex enterprises as well as a wide range of risky activity.[3] From an economic perspective, limited liability has become "the most efficient system of allocation of business risks and costs";[4] as it has benefited not only individuals and legal entities but also enhanced the growth of companies and corporate conglomerates. Limited liability has also played a key role in industrial R&D, as it

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[1] In the beginning, corporate charters were granted by the state and were viewed as a privilege for corporations engaged in activities related to public functions. *See* Philip I. Blumberg, *Limited Liability and Corporate Groups. Procedural Law*, 11 J. Corp. L. 573 (1986), reprinted in Franklin A. Gevurtz, Corporate Law Anthology, 14, 17 (1997). This is true for corporations in common law countries. The origins of corporations in Roman Law countries is older; it can be traced back to the 17th century. *See* Jorge Barrera Graf, *Las sociedades en derecho mexicano*, 3 (1983).

[2] *See* Stephen B. Presser, Piercing the Corporate Veil 1-15 (1991).

[3] *Id.*

[4] *See* José Engracia Antunes, *Liability of Corporate Groups* 127 (Studies in Transnational Economic Law, Vol. 10, Kluwer Law and Taxation Publishers, 1994).

creates incentives for shareholders to invest in risky but potentially high value-added activity.

Unfortunately, limited liability has also created incentives for shareholders to abuse the corporate form by using the corporation to commit fraud and other unlawful acts at the expense of creditors. Although many arguments may be made against the abuse of limited liability, Economic Analysis provides a useful insight into the effects of such behavior. From this point of view, the abuse of limited liability creates economic inefficiencies, as corporations transfers improperly the cost of their activities to creditors; as a result, the "corporation engages in socially-excessive risk taking."[5] Put differently, the company's managers are incentivized to take excessive risk, often involving activities that promise little real value.[6] As a consequence, the company does not properly internalize the real costs involved.

The abuse of limited liability is closely related to corporate structure and types of investors. When the company has only a few shareholders, the problem of socially excessive risk is exacerbated. [7] When shareholders participate in company management, they are more likely to engage the enterprise in risky activity —at the expense of creditors— in order to obtain a higher return on their investment. Cost transfer to creditors is exacerbated when the creditors cannot negotiate adequate compensation because; (a) they are unable to sign agreements with the corporation (e.g. tort creditors); or (b) despite having signed an agreement, the interest rate charged is based on deceptive information about the company's finances.

Given these potential side effects, several provisions in the Ley General de Sociedades Mercantiles [hereinafter LGSM] and the Código Civil Federal [hereinafter CCF] have been implemented in Mexico to protect creditors against corporate insolvency *despite* limited liability, including minimum capitalization requirements,[8] restrictions on dividend payments[9] and fraudulent

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[5] *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 109 (1985).

[6] For the purposes of this paper, value-creating activity means that the total value of such activity increases the value for both the corporation's shareholders and creditors. Conversely, an activity is not value-creating when the total value is negative because the cost it imposes on creditors is greater than the benefits obtained by shareholders.

[7] This statement includes subsidiaries controlled by its parent; this paper, however, will not analyze the treatment of parents and their subsidiaries in the context of veil-piercing due to time and space constraints.

[8] Minimum capitalization requirements are based on the concept of capital as an expression of a minimum amount of assets that are available to creditors during the life span of the corporation, and which consist in shareholder's equity contributions. Shareholders are free to determine that amount in the charter, but in any case it cannot be less than $50,000 pesos. *See* LGSM, Articles 6, V and 89, II.

[9] The LGSM imposes restrictions on dividend payments as well. The payment of dividends is determined by shareholders in the annual meeting. Just as statutory reserves, restrictions on dividend payments are based on the notion of capital; they arise from net earnings, after

conveyance law.[10] Although these rules help protect creditors, they have proven to be impracticable and fairly easy to circumvent.

In the United States, a special provision known as "piercing the corporate veil" or "veil piercing" is used to challenge limited liability in cases of shareholder fraud or misconduct. Under this doctrine, "a court determines that the debt in question is not really a debt of the corporation, but ought, in fairness, to be viewed as a debt of the individual or corporate shareholder or shareholders."[11] Despite this law's effectiveness in dealing with the abuse of limited liability, it has a "rare, severe and unprincipled" nature.[12]

The purpose of this article is to analyze the rules of veil piercing in the United States and formulate a proposal for its enactment in Mexico. Since a full analysis of limited liability cannot be presented here due to space constraints, this article is offered as an introduction.

Although veil piercing may be applied to diverse business structures, including limited liability partnerships (LLPs) and limited liability companies (LLCs), this article shall only consider the corporate form in its analysis. Although veil piercing is commonly applied to parent-subsidiary relationships —as the incentives to abuse limited liability and corporate structure is exacerbated in these situations— I shall only look at the general rules of veil piercing, as these principles also apply to parent-subsidiary relationships. A deeper analysis of these types of relationships, in particular corporate groups, is beyond the scope of this work.[13]

The content is structured as follows: Part II discusses definitions of the corporation and limited liability. Part III explains the legal and economic rationale of limited liability. Part IV analyses the inefficiencies and incentives that limited liability creates for shareholders and managers to make the corporation engage in excessively risky activity. Part V describes the rules of limited liability as well as legal measures used to deal with its abuse under Mexican Corporate Law. Part VI describes the equitable doctrine of veil piercing in

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the amount of capital has been covered and the assets for the statutory reserve have been separated. *See id.* Article 18. The statute sanctions shareholders and managers making them liable for the amounts distributed in violation of the statutory requirement to cover capital and reserves, and for the dividends declared and distributed despite of the lack of earnings. *See id.* Articles 172, 173 and 181.

[10] The CCF regulates the *acción contra la simulación*, the *acción pauliana* and the *acción oblicua*. The two first remedies are similar to the American fraudulent conveyance law. *See* CCF, Articles 2180-2182 and 2163-2169.

[11] Presser, *supra* note 2, 1-6.

[12] *Id.* at 89.

[13] The justification for piercing the corporate veil of a corporation is not that different from the justification of veil-piercing corporate groups. In fact, in the context of corporate groups the problems of limited liability are exacerbated, which makes the piercing of the corporate veil of a subsidiary even more evident. Discussion of corporate groups focuses on whether the whole group or just the parent should be held liable for the subsidiary's debts. Given space and time constraints, such analysis is beyond this study.

the U.S., including its advantages and disadvantages for both debtors and creditors. Part VII explains previous attempts to adopt veil piercing legislation in Mexico. Part VIII presents ways to implement veil piercing in Mexico. Part IX offers conclusions.

II. Definitions of Legal Personality and Limited Liability

1. *Legal Personality*

The corporation is a legal person; an autonomous entity with its own legal personality distinct from those of its shareholders.

The legal personality of the corporation has been explained by Hansmann and Kraakman as a way to partition assets. In their view, legal personality facilitates "the separation between the firm's bonding assets and the personal assets of the firm's owners and managers."[14] According to these authors, legal personality is an "affirmative asset partitioning" that results in "the designation of a separate pool of assets that are associated with the firm and are distinct from the personal assets of the firm's owners and managers."[15]

Legal personality plays a key role in activities performed by every business. Benefits of legal personality to corporations include: property acquisition in the name of the company rather than the shareholders; perpetual life for the entity; preservation of the business's going-concern value; and a reduction of monitoring costs.[16]

2. *Limited Liability*

Frank Easterbrook and Daniel Fischel define limited liability as "a complex set of contracts among managers, workers and contributors of capital" that "means that the investors in the corporation are not liable for more than the amount they invest."[17]

Hansmann and Kraakman explain the concept of limited liability based on asset partitioning. These authors claim that limited liability, as opposed to legal personality, is a defensive form of asset partitioning "in which creditors of the firm have no claim upon the personal assets of the firm's shareholders, which are pledged exclusively as a security to the personal creditors of the individual shareholders."[18]

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[14] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387, 393 (2000).

[15] *Id.*

[16] *See* Robert Charles Clark, *Corporate Law*, §1.2 (1986).

[17] *See* Easterbrook & Fischel, *supra* note 5, at 89.

[18] *See* Hansmann & Kraakman, *supra* note 14, at 395.

III. Legal and Economic Rationale of Limited Liability

The main justification of limited liability is its efficient allocation of risks and costs.[19] In this way, limited liability has been explained in the context of both the entity's structure and the relationships between shareholders, managers and creditors.

1. *Corporate Structure and Types of Creditors*

The number of shareholders, their role in corporate management and the types of creditors involved in the enterprise also strongly influence the incentives created by limited liability.

A. *Types of Corporations*

Regarding corporate structure, commentators have identified two types of entities: publicly-held and closely-held corporations.

a. Publicly-Held Corporations

The main features of publicly-held corporations are: *a)* the free transferability of investor's interests; and *b)* the separation of management from ownership.

Melvin Aaron Eisenberg defines this type of corporation as one with "a large number of shareholders, most of whom neither participate in the management of the corporation nor directly monitor corporate management."[20]

Publicly-held corporations are generally large enterprises requiring large amounts of capital and many investors to engage effectively in business.

In a publicly-held corporation, shareholders are so numerous that no single party owns enough shares "to have the incentive, or the ability, either individually, or by creating coalitions with other shareholders, to exercise control over the operational or strategic decisions of the firm."[21] This type of corporation is most suitable for passive shareholders whose sole interest is investment. Minority shareholders often do get involved in the affairs of corporations, especially if their interests are considered "strategic." The main point is that nothing prevents any shareholders, even those who own a small minority, from getting involved in corporate affairs, to a certain extent. Con-

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[19] *See* Engracia, *supra* note 4, at 127.

[20] *See* Melvin Aaron Eisenberg, *Contractual Freedom in Corporate Law: Articles and Comments; The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1471 (1989).

[21] *See* William A. Klein & John C. Coffee, Jr., Business Organizations and Finance Legal Economic Principles, 107 (8th ed., 2002).

trol is instead exercised by professional managers as it "eliminates the risk that a lone shareholder could take action in the firm's name that would effectively bind the others."[22]

The free transferability of shareholders' equity interests reinforces the passive attitude of many shareholders. Free trade makes it easy for shareholders to enter and exit the corporation at any time. The corporate form is a model contract that reduces transaction costs because its terms are so complete that investors have no need to negotiate with other shareholders or the corporation's creditors.[23]

b. Closely-Held Corporations

Closely-held corporations are typically small enterprises with "a small number of shareholders, most of whom either participate in or directly monitor corporate management."[24]

Unlike publicly-held corporations, the structure of closely-held corporations does not allow the free transferability of shares and the separation of ownership and control.[25] Closely-held corporations function as like partnerships.[26] Since there are fewer shareholders, most participate in corporate management. By participating in the decision-making process, shareholders ensure that the corporation generates profit. Shareholders limit the free transferability of shares in these types of enterprises in order to capture benefits for themselves.

B. *Types of Creditors*

In economic terms, creditors can be classified into two types: voluntary and involuntary. The main difference between them is their respective abilities to negotiate the allocation of risks and costs.

Whereas voluntary creditors normally enter into contracts with debtors after negotiating terms based on risk, involuntary creditors do not enter into contracts because of excessive transaction costs.[27]

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[22] *Id.* at 109.

[23] *Id.* at 108.

[24] *See* Eisenberg, *supra* note 17, at 1463.

[25] *See* Clark, *supra* note 13, at §18.1.

[26] Under the Uniform Partnership Act §101 (6), a partnership "means an association of two or more persons to carry on as co-owners a business for profit." The difference between a partnership and a corporation is that partners are not protected with limited liability whereas corporate shareholders are protected with limited liability. The lack of limited liability protection for partners creates incentives for them to take part actively in the management of the partnership.

[27] Transaction cost is "the cost of effecting an exchange or other economic transaction.

Voluntary creditors generally know more about the risks involved and can better negotiate contractual terms with debtors. For example, as credit specialists, financial creditors are in a better position to negotiate contract terms; conversely, employees enter into agreements with employers but generally have less information about the business and significantly less bargaining power.[28] With respect to involuntary creditors, a classic example is tort creditors.

2. *Benefits of Limited Liability*

As mentioned above, the economic reality and structure of corporations as well as the types of creditors involved determine the advantages and disadvantages of limited liability. In this way, publicly-held corporations and financial creditors in general have been used as the premises to justify the limited liability principle for corporations.

A. *Posner*

In an article published in the 1970's, Richard Posner analyzed the benefits of limited liability.[29] For Posner, the principle of limited liability is so basic to investment that even in the absence of legal statutes, the parties would invariably contract to limit their respective liabilities. The main reason is that investors would be rarely if ever willing to put at risk more than the amount of their total investment. As a result, the risk assumed becomes part of negotiations and helps define the terms between borrowers and investors.

Posner holds that creditors are risk averse; and that if not for a limit on liability, they would be much less willing to invest. Creditors set an interest rate according to the risk assumed, making them indifferent between a risky and a "riskless" credit. Moreover, creditors are better positioned to bear risk; they can assess risks more easily and economically than shareholders, who only seek to invest and know little about the actual affairs of the business. Many creditors specialize in lending, so they have enough information to determine the level of risk to which they are exposed and then can set the appropriate interest rate. If an increase in risk of default can be foreseen, creditors can raise interest rates accordingly; if this increase is unknowable, however, then another feasible option would be amortized loans. In case the risk of default during the life of the loan decreases, the borrower can always negotiate an

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These costs, which vary in magnitude from one economic system to another, include those of negotiating and drafting contracts and the subsequent costs of adjusting for misalignments." See Donald Rutherford, Routledge Dictionary of Economics, 569 (2nd ed., 2002).

[28] *See* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 505 (1976).

[29] *See id.*

interest rate reduction. In order to protect themselves, lenders usually include restrictions on corporate activity in the loan agreement.

For Posner, limited liability is necessary because it helps to minimize the overall social cost of capital.[30] When statutes establish limited liability for certain types of business enterprise, the parties involved no longer need to bargain every term and condition; as a result, the costs and times associated with transactions have been significantly reduced.

B. *Easterbrook and Fischel*

Easterbrook and Fischel identify two basic principles for limited liability in a corporation (a) reduced separation cost and specialization; and (b) reduced capital costs.[31]

a. Separation cost and specialization

i) Limited Liability Reduces the Costs of Monitoring other Shareholders and Managers

When corporate liability is unlimited, shareholders are liable for the debts of the corporation; thus all their assets are at stake. The exposure of shareholders' assets to creditors creates incentives for shareholders to transfer assets from the corporation to themselves at the expense of other shareholders. In these circumstances, shareholders have to monitor other shareholders in order to prevent this from occurring. Limited liability eliminates the need for asset transfer.

This principle also applies to monitoring corporate managers. In an agency relationship, the agent has incentives to act in a way that can harm the principal. This holds true for the agency relationship between shareholders and managers. Shareholders must monitor managers in order to keep them from transferring the corporation's assets to themselves. When liability is limited, the "cost of precaution" equals the expected "cost of harm"[32] (which

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[30] *See id*. at 501. Posner considers that despite risks faced by creditors, unlimited liability or prohibition on dividend payments would be uneconomical, an "efficient corporate law is not one that maximizes creditor protection on the one hand or corporate freedom on the other, but one that mediates between these goals in a way that minimizes the costs of raising money for investment." *Id*. at 509.

[31] *See* Easterbrook & Fischel, *supra* note 5, at 98-101.

[32] According to the Economic Analysis of Law, "when each individual bears the full benefits and costs of his precaution, economists say that social value is internalized. When an individual bears part of the benefits or part of the costs of his precaution, economists say that some social value is externalized. The advantage of internalization is that the individual sweeps all of the values affected by his actions into his calculus of self-interest, so that self-interest

equals the amount of their investment); beyond this point, the value of monitoring is significantly reduced.

ii) Limited Liability Allows the Free Transfer of Stock and a Reduced Purchase Price

When liability is unlimited, value equals "the present value of future cash flows and the wealth of shareholders."[33] Share transfers to new investors necessarily involve negotiations with shareholders; as a result, investors interested in acquiring stock must invest time and money in obtaining information about pricing.

On the contrary, limited liability makes shares fungible, because their value "is determined by the present value of the income stream generated by a corporation's assets."[34]

As a consequence, share value reflects how well the company executives are managing the enterprise. When the share prices fall, it is generally a signal of poor managerial performance. Outsiders are likely to purchase a large volume of shares in order to assert control of the corporation and achieve more efficient management. This creates incentives for managers to administer the corporation efficiently.

iii) Limited Liability Facilitates the Diversification of Risks to Shareholders

When corporate liability is unlimited, shareholders lack incentives to diversify their investments because it increases their risk of loss. As a result, it becomes more difficult to raise capital from new investors. Conversely, limited liability permits shareholders to diversify their investments in order to reduce risk.

iv) Limited Liability Facilitates Investment in Risky Activities

When corporate liability is limited, shareholders have incentives to invest not only in positive net-present value activities but also risky projects that could otherwise make them lose their entire assets.

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compels him to balance all the costs and benefits of his actions. According to the marginal principle, social efficiency is achieved by balancing all costs and benefits […] In situations when both the injurer and the victim take precaution against the harm, the internalization of costs requires both parties to bear full cost of the harm." See Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, Economic Analysis of Law: Selected Readings 42 (Donald A. Wittman ed., 2008).

33 *Id.* at 96.

34 *Id.* at 98.

b. Capital Costs

Markets thus provide valuable information to creditors and shareholders about the risks of any specific investment, thereby lowering search and due diligence costs.

As the costs of corporate monitoring are financed by both shareholders and creditors, the incentive to monitor excessively is generally reduced.

According to Easterbrook and Fischel, share price "reflects the value of the firm as affected by decisions of specialized agents,"[35] *i.e.*, it generally reflects how well a corporation is managed. Since investors have only a residual claim if the corporation becomes insolvent, they are motivated to monitor only to the extent that such cost does not exceed the total amount of their investment. Shareholders' monitoring of activities benefit the corporation's creditors. The creditors' incentive to monitor the corporation, especially when their interests are secured, does not generally exceed their respective interest; as a result, their monitoring cost is reduced. Notably, creditors have a comparative advantage in monitoring management. This is especially true for sophisticated creditors who specialize in lending. This type of creditor has industry-specific information that permits negotiation of contractual terms in return for partial protection from risk.

C. *Hansmann and Kraakman*

Hansmann and Kraakman have developed arguments that complement the ideas explained above.[36]

For these scholars, limited liability reduces monitoring costs not only for the company's creditors but also for the shareholders' personal creditors. Under limited liability, shareholders' personal creditors solely monitor assets belonging to their debtors rather than the corporation in which their debtors have made investments.

Limited liability also helps reduce so-called governance costs. Firstly, it permits shareholders to participate in the company's gains and losses as well as exercise control over the enterprise, regardless of their identities and holdings. Secondly, it shifts the burden of monitoring from the shareholders to creditors. This is desirable, since many creditors are better informed about the corporation's financial condition.

Finally, under unlimited liability, creditors collect from shareholders' personal property when the corporation is insolvent; however, collection efforts imply costs for both creditors and shareholders, thus a significant amount collected from shareholders' personal property is wasted in collecting.

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[35] *Id.* at 95.

[36] Despite the fact that Hansmann & Kraakman offer diverse arguments, I will only cite those which I believe contain new elements.

IV. Inefficient Incentives Created by Limited Liability

As it was explained, limited liability has both positive and negative effects. The negative effects are closely related to corporate structure, types of creditors and asymmetrical information.

1. *Involuntary Creditors and Uninformed Creditors*

Limited liability allocates risks to competent risk-bearers. Creditors are deemed to be better risk-bearers than shareholders because they usually have more and better information to evaluate risks. They can also negotiate compensation packages in a contract that more accurately reflect the risks involved, including protective covenants to minimize increases in the risk of default (voluntary creditors). There are, however, exceptions to this assumption because there are creditors that, for different reasons, cannot enter into a contract to protect themselves against the risk of default (involuntary creditors).

Some involuntary creditors do not enter into a contract with the debtor because it is prohibitively expensive for them to negotiate the terms of the contract. Some involuntary creditors do not enter into a contract with the debtor because the probability of loss or default is too low, thus negotiating protection against such loss turns wasteful.

It should be noticed that the problem of allocation of the risk is not exclusive for involuntary creditors (who do not enter into a contract to allocate the risk of loss); the allocation of the risk is a problem for many voluntary creditors too, specifically for uniformed voluntary creditors. Many voluntary creditors —despite being in a contractual relationship with the debtor— lack the bargaining power to adequately allocate costs and protect their credit upon entering into a contract. Lastly, the elevated cost of information often prevents creditors from adequately assessing the risks involved; as a result, these investors often fail to negotiate a proper compensation and protection package.[37]

When the corporation "misrepresents the nature of its activities, its ability to perform or its financial condition,"[38] creditors cannot accurately assess risks and, as a result, are unable to formulate adequate compensation packages. When creditors are not adequately compensated for their risk of loss, the corporation is forced to externalize these costs, resulting in harmful inefficiencies.

This problem is exacerbated when there is an asymmetry of information,[39] which confers an advantage on informed parties at the expense of unin-

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[37] Posner defines unsophisticated creditors as those "to whom the costs of ascertaining the true corporate status of the real estate company would be substantial." Posner, *supra* note 23, at 521.

[38] *See* Easterbrook & Fischel, *supra* note 5, at 112.

[39] Asymmetric information is not by itself inefficient; in fact, it can have an efficient result

formed parties. Asymmetric information is problematic because it usually results in a redistribution of wealth. Creditors are forced to spend money to learn the real financial situation of the corporation, a completely unnecessary expense.[40]

Insurance has played an important role in this area, mainly in tort liability. Insurance functions as a private system of liability in which insurers charge premiums based on the risks of each activity. Debtors also have incentives to protect their assets by insuring against liability; this does not mean, however, that all debtors purchase insurance. Furthermore, for some types of harm it is better to deter the harmful party; insurance only allows the insured party to continue engaging in risky and socially undesirable activities in exchange for a certain amount of money. One alternative is to post bond in the amount of the expected liability; even though this solution is usually only available when the debtor is well capitalized.[41]

As for voluntary creditors with no bargaining power or insufficient information to negotiate effectively, Easterbrook and Fischel hold that the corporation can have optimal incentives to take precautions, as long as the creditors are well-represented and organized. This is usually the case with bondholders and employees, who can be represented by a trustee or labor union that negotiates compensation as well as other terms and conditions.[42]

2. *Closely-Held Corporations*

Aside from the structure and function of closely-held corporations, other elements must be taken into account when analyzing the negative effects of limited liability.

In general, as long as the corporation is solvent, its managers' main fiduciary duty is to maximize shareholders' interests. Shareholders participate in corporate profits in the form of dividends but are also among the first to lose their investments when the corporation goes belly-up; for this reason, shareholders prefer projects which involve higher-than-expected returns. Activities with higher-than-expected returns imply a higher risk of loss that may hurt creditors as the corporation may become insolvent.

In publicly-held corporations, shareholders generally cannot make corporations engage in excessively risky activity because their ownership interests are too small to influence managerial decisions. In fact, managers at most publicly-held corporations risk losing their jobs if shareholders become un-

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when it contributes to create a link between knowledge and the control of resources at minimal cost. *See* Robert Cooter, Law and Economics, 282 (4th ed., 2003).

[40] *See* Posner, *supra* note 22, at 521.

[41] For a deep analysis of the problems related to limited liability and liability insurance *see* M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1 (1996-1997) at 71-369.

[42] *See* Easterbrook & Fischel, *supra* note 5, at 105.

satisfied with corporate performance. The risk of job loss gives managers incentives to make efficient decisions at the expense of the business's creditors.[43]

In closely-held corporations, however, there is rarely a separation between ownership and management; shareholders usually play active roles in the company's affairs, acting as managers or exercising control over management to engage in high-risk activities to the detriment of creditors.[44] In addition, shareholders in closely-held corporations often have incentives to enter into self-dealing transactions with the enterprise, which may leave it with insufficient assets to pay creditors. It should be noted that these incentives increase when the corporation is under financial distress.

V. Limited Liability and Rules to Protect Creditors in Mexico

1. *The Corporate Form in Mexico*

The origins of the corporate form in Mexico go back to the eighteenth century in the *Ordenanzas de Minas* that established the basis for the creation of enterprises by dividing capital contributions into freely transferred units and granting owners the right to vote.[45]

The first statute to properly regulate corporations was the *Código de Comercio* of 1854 (Commercial Code of 1854) which recognized certain types of business enterprises as legal persons and allowed limited liability for their shareholders. Although the 1883 and 1889 codes regulated corporations and other business organizations, it wasn't until 1934 that the national Congress issued a specialized law, the *Ley General de Sociedades Mercantiles*[46] (General Law of Corporations).

Despite the controversy surrounding the nature of corporations, the Mexican legal system treats the construct of the corporation as a contract among investors for the fulfilment of a common goal.[47]

A single shareholder, for example cannot establish a corporation under the LGSM, which requires a minimum of two shareholders.[48] There are two rationales for this rule: *a)* the corporation is an exercise of the constitutional right to assemble;[49] and *b)* the corporation is a contract between investors and, as such, requires at least two parties.[50]

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[43] *See* Frank H. Easterbrook, *Two Agency- Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650, 652 (1984).

[44] *See* Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 Colum L. Rev. 1203, 1247-1259 (2002).

[45] *See* Joaquín Rodríguez Rodríguez, *Tratado de sociedades mercantiles*, 5 (7th ed. 2001).

[46] *Hereinafter* called LGSM.

[47] *See* Código Civil Federal [CCF] Article 2688 (Méx.).

[48] *See* Ley General de Sociedades Mercantiles [LGSM] Article 89 (Méx.).

[49] *See* Constitución Política de los Estados Unidos Mexicanos [CPEUM] Article 9 (Méx.).

[50] *See* CCF Article 1792.

The legal personality of an entity has to be recognized expressly by law.[51] In general, only business enterprises registered in the public registry are accorded legal personality.[52] The most important consequence of legal personality is the creation of a separate entity or "person" with its own rights, duties and assets distinct from those who created it.

Although no legal provision exists that explicitly allows corporations to invest in other corporations as shareholders, this power is implied in the LGSM, which stipulates that all corporate bylaws must contain the names of shareholders, whether individuals or entities, as long as the latter have legal personality recognized under law.[53]

2. *Current Creditor Protection Measures under Mexican Corporate Law*

As explained earlier, the modern-day corporation is founded upon the rule of limited liability; under this rule, shareholders are only liable for the company's debts up to the amount of their total investment.[54]

When the LGSM was drafted, it was recognized that shareholders have incentives to abuse limited liability by removing corporate assets at the expense of creditors; as a result, the LGSM sets forth certain legal protections to creditors, including: *a)* minimum capitalization requirements; *b)* statutory reserves; and *c)* dividend restrictions.

Other key provisions protecting creditors can also be found in the *Código Civil Federal* (Federal Civil Code)[55] which is used for issues not addressed in the LGSM. The CCF contains provisions that allow creditors to challenge fraudulent conveyances (*acción pauliana* y *acción contra la simulación)*.The same statute also entitles creditors to force debtors to collect against their debtors.

A. *Minimum Capitalization Requirements*

Minimum capitalization requirements are based on the concept of capital as the total of the shareholder's equity contributions, which is a minimum amount of assets available to creditors during the life span of the corporation.[56] Shareholders are free to determine the amount of capitalization in the

[51] In this sense, for our legal system, the enterprise is considered an economic entity but not a legal person.

[52] *See* LGSM Article 2. This provision establishes an exception for those entities which are not registered but function and negotiate with third parties as if they had adopted any form of business organization; notwithstanding, the default in complying with this formality results in personal unlimited liability for the owners.

[53] *See id.* Article 6.

[54] *See* CCF Article 87.

[55] *Hereinafter* called "CCF."

[56] *See* Rodríguez, *supra* note 38, at 229.

articles of incorporation, but in no case can it be less than $50,000 pesos.[57] In principle, any change in capital stock requires an amendment of the articles of incorporation. To avoid unnecessary costs, the LGSM stipulates that under certain circumstances the company's capital stock may be modified without formal amendment.

Based on their ability to modify capital stock, corporations have been classified into "fixed capital" and "variable capital" entities.

a. Fixed Capital

In fixed capital corporations, capital can be reduced either by reducing the outstanding, authorized stock or by modifying the par value of shares; either change requires the shareholders' majority vote.[58]

The LGSM requires corporations to notify publicly creditors when the stock has been repurchased, so that creditors may petition a court of law to grant payment or legal protection. This remedy is unavailable when it can be shown that the remaining assets are sufficient to cover the company's debts.[59]

b. Variable Capital

In variable capital corporations, reducing capital stock is easier. For these types of enterprises, a specific number of shares authorized in the articles of incorporation represent the minimum capital stock amount set by statute. Any change in that amount requires compliance with provisions established for these entities.

Apart from minimum capital, there is also a maximum capital requirement which changes whenever the shareholders issue and retire new shares that vary from the minimum capital stock. The procedure to issue new stock can either be stipulated in the articles of incorporation or established by the shareholders in a special meeting convened especially for this purpose.[60][61] Creditors cannot object to any reduction in such amount.[62]

According to this system, the minimum capital is not necessarily that established by statute but rather determined by shareholders in proportion to the company's size, regardless of whether the stock is issued at par value or no par value.[63]

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57 *See* LGSM Articles 6, V and 89, II.

58 *See* José R. García López & Alejandro Rosillo Martínez, Curso de Derecho Mercantil, 371 (2003).

59 *See* LGSM Article 9.

60 *See id.* Article 213.

61 *See id.* Articles 216 and 219.

62 *See* Jorge Barrera Graf, *supra* note 1, 157.

63 The par value of a share does not determine the amount of capital; on the contrary, the

c. Downsides of Capital Requirements under the LGSM

The disadvantage of a minimum capital stock requirement is that it creates incentives for shareholders to set a low level of capitalization both at the time of incorporation and during the entire life of the company. Moreover, the remedy granted to creditors of fixed-capital corporations is insufficient because creditors can object before a court in order to obtain either the payment of the debt or an adequate protection of their claim, so long a reduction of the capital is the result of the reduction of the shares rather than the result of insolvency. It focuses on cases in which the corporation calls back shares.

B. *Reserve Requirement*

The LGSM requires corporations to create a reserve for unexpected losses. This represents certain assets that, in order to protect the company's creditors, may not be distributed to shareholders.

To form the reserve, the LGSM requires the corporation to allocate at least five percent of the company's annual net earnings until the reserve equals at least twenty percent of capital stock.[64] Based on the articles of incorporation or that determined by the company's managers, the reserve can be reinvested;[65] however, it can never be used to make ordinary business payments.

The reserve can be used only when the corporation is considered to be in financial distress. Although it may be used to cover losses in the company's capital stock, it must always be replenished. The statute penalizes insufficient reserves by imposing unlimited liability on managers for any shortcoming; it should be noted, however, that these payments may be later recovered from shareholders.[66]

Despite sanctions imposed under law, this requirement can be easily circumvented. Reserves are based on a capital stock requirement determined by shareholders, which may be insignificant. Since no provision requires the existence of a special fund to maintain the reserve, it is normally used as an accounting mechanism subject to manipulation by unscrupulous managers.

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amount of capital determines the share's par value. When the corporation issues no par value shares, the amount of capital is divided between par and no par value shares according to that stipulated in the entity's articles of incorporation. The portion not represented by par value shares is divided into the authorized number of no par value shares; the result is the percentage of capital represented by each of these shares. When the corporation solely issues no par value stock, the amount of capital represented by each share is determined by dividing the entire amount of capital into the number of authorized shares.

64 *See* LGSM Articles 20 and 21.

65 *See* Rodríguez, *supra* note 38, at 802.

66 *See* LGSM Article 21.

C. *Restrictions on Dividend Payments*

Although dividend payments are determined by the annual shareholders' meeting, the LGSM also imposes certain restrictions. Just like statutory reserves, restrictions on dividend payments are taken from the corporation's net earnings after the exact amount has been covered and assets for the statutory reserve have been separated. [67]

Company management prepares the annual financial statements for discussion and approval at the annual shareholders' meeting.[68] Once the financial statements are approved, the shareholders —acting on the advice of management— determine whether to distribute dividends or reinvest the earnings.

The statute penalizes shareholders and managers by making them liable for any amounts distributed that violate the statutory capital and reserves requirement, as well as for the distribution of any dividends without earnings.[69] Although creditors can sue shareholders or managers, shareholders are only liable for amounts they actually receive; whereas managers are jointly and severally liable for any distributed amounts.[70]

The effectiveness of this protection is undermined by the fact that asset value can be altered, giving rise to distribution at the expense of the company's creditors.[71]

One of this system's main problems is that shareholders play an active role in both establishing the capital stock requirement and declaring dividend payments. It overlooks the simple fact that:

a) Shareholders expect a return on their investment.
b) Dividend payments create a strong incentive to remove corporate assets at the expense of creditors.

D. *Fraudulent Conveyance Law*

The CCF also includes other provisions to protect creditors, including the *acción contra la simulación*, *acción pauliana* and *acción oblicua*. The two first remedies are equivalent to fraudulent conveyance in the U.S.[72]

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[67] *See id.* Article 18.

[68] *See id.* Articles 172, 173 and 181.

[69] *See id.* Article 19.

[70] *See* Rodríguez, *supra* note 38, at 372.

[71] In fact, this commentator explains that the problem of distribution in the absence of earnings and in violation of capitalization requirements is deepened when the corporation is in financial distress or on the verge of bankruptcy. *See id.* at 371.

[72] The Uniform Fraudulent Conveyance Act of 1918 (UFCA), the Uniform Fraudulent Transfer Act of 1984 (UFTA) and Bankruptcy Code expressly state that fraudulent transfers and obligations are challengeable under these laws. Both of them provide a broad definition

The *acción contra la simulación* (action against the simulation) is the creditor's right to challenge transactions made by the debtor with the intent to hide assets from creditors. According to the CFF article 2180, the *simulación* is an act where the parties to an agreement make untrue statements about it that results in fraud or deceit of one of such parties' creditors.

Based on the text of the statute, Rojina Villegas identified two types of transactions: *a)* concealed transfers (or incurred debt), and *b)* misrepresented transfers.[73]

a. Concealed Transfers or Obligations

In these transactions, no transfer of assets or incurred debt takes place; the parties simulate it.[74]

b. Misrepresented Transfers

Although a real transaction takes place, the debtor and third party misrepresent the transaction to the debtor's creditors.[75] The only way to challenge this type of transaction under law is by showing actual fraud, i.e., the debtor's intention to mislead the plaintiff.[76] If fraud cannot be proven, the transaction is deemed valid.

If the challenge succeeds, then the transaction is voided and the assets are returned.[77] If the assets had been transferred to third parties in good faith for fair consideration, the transaction cannot be voided.[78]

The difficulty in obtaining relief under this provision is that the plaintiffs must prove the parties' intent.[79] An alternative challenge would be the *acción pauliana*.

The *acción pauliana* is the creditors' right to challenge a fraudulent transaction; unlike the *acción contra la simulación, the acción pauliana* is limited only to

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of transfer: "any transaction that effectively transfers property interests." In order to challenge such transaction it is necessary to show fraud, that is to say, the transfer was made with the actual intent to hinder, delay or defraud or transfers in which the debtor does not receive "fair consideration," under the UFCA, or "reasonably equivalent value." See UFCA §§4-7, UFTA §4 and Bankruptcy Code §548.

73 *See* CCF Article 2180.*See* Rafael Rojina Villegas, Derecho Civil Mexicano, 488 (8th ed., 2001).

74 It is considered that there is a secret agreement between parties. *See id*.

75 For example, the debtor made a donation but she tells creditors that the transfer was a sale.

76 The plaintiff must show that the debtor's intention was to deceive creditors.

77 *See* CCF Article 2182.

78 *See id.* Article 2184.

79 In most cases, courts are forced to make presumptions. *See* "Molina de Romero, Elena," XIV-Julio S.F.J., 816 (8a. época, 1988).

creditors who invested before the challenged transaction took place.[80] This remedy covers all transactions which cause or aggravate the debtor's insolvency.[81] Insolvency is important to decide whether there was fraudulent conveyance; however, the statute additionally requires creditors to prove harm. The *acción pauliana* also grants creditors the right to collect from third parties.[82]

The challenged transaction could have been realized either for consideration[83] or without consideration. In cases without consideration, the transaction is presumed to be fraudulent;[84] otherwise, creditors must show that the parties to the transaction acted in bad faith.[85] The purpose of this remedy is to void the transfer up to the amount of the debt owed. When assets have been transferred in good faith to third parties, the transaction cannot be voided; but the first transferee must pay damages.[86]

As in the *acción contra la simulación*, this provision is severely weakened by the difficulty of demonstrating the debtor's intent.[87]

Fraudulent transfers are also regulated by the *Ley de Concursos Mercantiles* (Bankruptcy Act),[88] which empowers the trustee to solicit the bankruptcy court to void transactions made with the intent to defraud creditors.[89] The provisions of the LCM differ from the CCF in two aspects: *(a)* it includes a list of transactions presumed to be fraudulent;[90] and *(b)* once the transaction is voided, the assets become part of the estate which, unlike the CCF, benefits all creditors.

Another unusual but useful protection to creditors is the *acción oblicua*. The *acción oblicua* is the creditors' right to file complaints against debtors of the debtor, when the latter refuses with the intent of avoiding payment to creditors.[91] If successful, the debtor collects from her own debtors, which results in more assets available for the debtor's creditors. Unfortunately, this provision is rarely utilized with success because of restrictions imposed by the rules of civil procedure.[92]

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[80] *See* CCF Article 2163.

[81] The insolvency required is similar to balance sheet insolvency; that is, when the debtor's liabilities exceed its assets. See Article 2166.

[82] *E.g.*, insurers or guarantors. *See* Rojina, *supra* note 64, at 436.

[83] It strictly requires for consideration or without consideration. For this reason, it does not matter whether the transfer was made for fair consideration as long as some value had been given in exchange for the property.

[84] *See id.* Article 2165.

[85] *See* CCF Article 2164.

[86] *See id.* Articles 2167 and 2169.

[87] *See* Rojina, *supra* note 64, at 439.

[88] *Hereinafter* LCM.

[89] See *Ley de Concursos Mercantiles* [LCM] Article 114 (Méx).

[90] *See id.* Article 112

[91] *See* CCF Article 2171.

[92] See Ernesto Gutiérrez y González, Derecho de las obligaciones, 768 (15th ed. 2003).

Finally, it must be mentioned that bankruptcy courts lack equity powers to subordinate claims of insiders or the corporation itself.[93]

As one can see, the existing legal remedies are clearly inadequate, mainly because the concept of capital on which all these provisions are based is determined by the shareholders and can be easily manipulated. Moreover, the mechanisms used to challenge fraudulent transfers require showing the debtor's intent to deceive creditors, making it difficult if not impossible for creditors to win in court.

Given the failure of current Mexican law to address the abuse of limited liability, it is necessary to analyze other legal remedies, in particular "piercing the corporate veil."

VI. Corporate Veil Piercing under U.S. Corporate Law

1. *Origins*

Unlike other forms of creditor protection, the origins of veil piercing are uncertain; and the criteria used to apply this protection are not uniform.[94]

Presser explains that by the end of the 19th century some legal scholars questioned the justification of limited liability.[95] During the early part of the 20th century, corporations functioned as partnerships. During the Great Depression, however, U.S. lawmakers tried to codify the equitable doctrine of piercing the corporate veil as a legal way to protect creditors. The foundations of modern veil piercing were established in three seminal legal texts: Judge Benjamin Cardozo's opinion in *Berkey v. Third Avenue Railway Co.*,[96] Maurice Wormser's article *Piercing the Veil of Corporate Entity* and Frederick J. Powell's book *Parent and Subsidiary Corporations: Liability of a Parent Corporation for the Obligations of Its Subsidiary.*[97]

Cardozo's opinion is relevant as it was one of the first writings to criticize the unprincipled nature of this legal mechanism and proposed a standard to determine the circumstances under which the parent entity should be held liable for the debts of its subsidiaries. According to his approach, veil piercing should be applied not only when there is an agency relationship between the parent and its subsidiary, but when "the attempted separation between parent and subsidiary will work a fraud upon the law."[98]

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93 *See* Duncan N. Darrow et al., *Symposium The New Latin American Debt Regime — Restructuring Strategies for Mexican Eurobond Debt*, 16 NW. J. Int'l L. & Bus. 117, 156 (1995).

94 Wormser's article, written in 1912, precisely discusses several cases from the 19th century in which courts disregarded the corporate form. *See* Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 Colum. L. Rev. 496 (1912).

95 *See* Presser, *supra* note 2, at 1-21.

96 *See Berkey v. Third Avenue Railway Co.*, 244 N.Y. 84 (1926).

97 *See* Presser, *supra* note 2, at 1-21.

98 *See Berkey* 244 N.Y. at 95.

Judge Powell proposed in his book a three-prong test to pierce the veil of a subsidiary. This approach requires: *(a)* that the subsidiary functions as an "alter ego" or "instrumentality"; *(b)* the occurrence of "fraud or wrong" or "injustice"; and *(c)* an "unjust loss or injury."[99]

Since piercing the corporate veil is considered an exception to limited liability, it is generally regarded as the harshest form of creditor protection. Efforts to unify divergent criteria have failed because the basis of this doctrine is the equitable power of American courts;[100] moreover, limited liability is so fundamental to society that courts are reluctant to apply it.

Under this doctrine, "a court determines that the debt in question is not really a debt of the corporation, but ought, in fairness, to be viewed as a debt of the individual or corporate shareholder or shareholders."[101] It is a judicial exception to the principle of limited liability, "by which courts disregard the separateness of the corporation and holds shareholders responsible for the corporation's action as if it were the shareholder's own."[102] Unlike other legal devices, it benefits only creditors who have requested that the court disregard the corporate form.

Since the legal provisions used to protect creditors were established as tools to make debtors internalize unfair costs imposed on creditors, why should piercing the corporate veil —which affects shareholders so severely— be allowed when other alternatives exist such as covenants, minimum capital requirements and fraudulent conveyance laws? The answer is that the harshness of veil piercing has a deterrent effect on investor misconduct, as it strips investors of their right to limit liability for corporate debts.

2. *Corporate Veil Piercing Tests*

There are no clear, consistent rules, but in an attempt to systematize the divergent criteria that courts use to pierce the corporate veil, legal scholars have identified two approaches.

A. *"Instrumentality" or "Alter Ego"*

Based on previous veil piercing cases and focusing on the parent-subsidiary relationships, this test was formulated by Powell in 1931.[103]

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[99] *See* Presser, *supra* note 2, at 1-33.

[100] Under Article III, section 2 of the U.S. Constitution, federal courts' inherent powers include equity. See Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 Am. Bankr. L.J. 1, 12 (2005).

[101] *See* Presser, *supra* note 2, at 1-6.

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

[103] *See* Philip I. Blumberg, The Law of Corporate Groups. Substantive Law § 6.02 (1985); Presser, *supra* note 2, at 1-32.

This approach consists of three elements that must be shown by the plaintiff:

a. "Instrumentality"

The words "instrumentality" and "alter ego" are employed to describe a relationship in which a parent controls the subsidiary in such a manner that the subsidiary functions as a mere instrument to benefit the parent's shareholders at the expense of the subsidiary's creditors.[104] It refers to the relationship between the parent and the subsidiary and requires showing that the parent exercises complete control or domination over the subsidiary.

Powell does not define what should be understood as control and domination, but lists several possible features, including:

a) The parent owns all or most of the subsidiary's stock.
b) The parent's directors and officers take part in the management of the subsidiary.
c) The subsidiary's directors and officers act independently and in the best interests.
d) The parent finances the subsidiary.
e) The parent was involved with the incorporation of the subsidiary.
f) The subsidiary is inadequately capitalized.
g) The parent bears some expenses or losses incurred by the subsidiary.
h) The subsidiary deals exclusively with the parent.
i) The subsidiary owns only the assets conveyed by the parent.
j) The parent uses the subsidiary's assets as its own.
k) The formal legal requirements of the subsidiary are observed but there appears to be "fraud or wrong" or "injustice."

This prong has to do with the relationship between the parent and creditors of the subsidiary and requires showing a kind of misconduct by the parent.

Powell suggests that for this prong, the following factors also be taken into account:

a) Actual fraud detected in the relationship between the parent and the subsidiary.
b) Violation of a statute through the parent's use of the subsidiary.
c) The parent has deprived the subsidiary of its assets.
d) The doctrine of estoppel can be invoked as a result of the parent's use of the subsidiary.
e) The parent has used the subsidiary to commit a tort.

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[104] *See* Debra Cohen-Whelan, *Individual Responsibility in the Wake of Limited Liability*, 32 U.S. F.L. Rev. 335, 348 (1998).

b. "Unjust loss" or "injury"

This prong requires showing harm to the subsidiary's creditors caused by acts of the parent.

Despite the fact that Powell does not list factors for this prong, he distinguishes between contract and tort creditors and asserts that tort creditors always satisfy this prong.

The "instrumentality" or "alter ego" approach was adopted and broadened in *Lowendahl v. Baltimore & O.R. Co.*[105] and requires showing three elements:

a) The parent controls the subsidiary in such a way that it "is said to have no will, mind or existence of its own and to be operated as a mere department of the business of the stockholder."[106]
b) The control exercised by the parent is used to commit fraud, violate a legal duty or commit unjust conduct.
c) The fraud or wrongful act resulted in an unjust loss and injury to the creditor. This decision holds that the parent is liable whenever it "has expressly made a subsidiary its agent or has itself committed the tort in suit."[107]

In addition, the "instrumentality" or "alter ego" approach has a variant established in *Automotriz del Golfo de California S.A. de C.V. v. Resnick*,[108] which holds that the corporate form should be disregarded when it is shown that: *(a)* there is a unity of interest and ownership so that the subsidiary and parent cannot be considered as two separated entities; and *(b)* if parent and subsidiary are treated as separate entities there will be an inequitable result.[109]

As can be observed, although only nuances seem to differentiate these two results —mainly the requirement of an inequitable result— the terminology here suggests a kind of misconduct.

B. *Agency Relationship*

This approach was adopted in *Berkey v. Third Avenue Railway Co.*[110] and is based on the concept of agency relationship.

In an agency relationship "one person —the principal— uses another person —the agent— to act on his behalf";[111] the principal is bound by the acts

[105] *See Lowendahl v. Baltimore & O.R. Co*. 247 A.D. 144 (1936).

[106] *Id.* at 154.

[107] *Id.* at 157.

[108] *See Automotriz del Golfo de California S.A. de C.V. v. Resnick*, 47 Cal. 2d 792 (1957).

[109] *See id*. at 796.

[110] Berkey v. Third Avenue Railway Co., 244 N.Y. 602 (1927).

[111] *See* Eric Rasmusen, *Agency Law and Contract Formation*, 1 (The Harvard John Olin Discussion Paper Series, No. 323, 2001).

of the agent, who "is not entitled to the gains of the enterprise —nor is he expected to carry the risks."[112] The idea of this approach is that the subsidiary has acted on behalf of the parent and therefore the parent is liable for the debts of the subsidiary.

The agency approach proposes a two-prong test, namely:

a) First prong. This refers to the parent-subsidiary agency relationship. In order for this requirement to be satisfied, the parent must be shown to have exercised complete control over the subsidiary.[113] In case the control exercised by the parent does not qualify as "domination," the relationship can be evaluated under the test of honesty and justice.[114]
b) Second prong. This requires showing that the "separation between parent and subsidiary will work a fraud upon the law."[115]

Blumberg mentions that this approach is often confused with the "instrumentality" or "alter ego" approach; given the difficulty to show that consent was given by both parties, the agency theory has been used in few cases.[116]

C. *Key Elements to Pierce the Corporate Veil*

To summarize, regardless of the approach (the "instrumentality or alter ego" approach or the "agency" approach), there are some elements that courts constantly look at to determine whether or not to pierce the corporate veil. These factors include: *a)* control; *b)* undercapitalization; *c)* failure to observe corporate formalities; and *d)* fraud, wrongful or unjust act.

a. Control

In veil piercing cases where both a parent and subsidiary are involved, courts regard control as an essential factor in order to allow the subsidiary's creditors to reach the parent's assets. However, it "more often appears as a conclusory label than as a term with determinate meaning."[117]

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[112] *Id.* at 4.

[113] In *Walkowszky v. Carlton* the court held that "[w]henever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts 'upon the principle of *respondent superior* applicable even where the agent is a natural person.' Such liability, moreover, extends not only to the corporation's commercial dealings, but to its negligent acts as well." *See Walkowszky v. Carlton* 18 N.Y. 2d, 414, 417 (N.Y. 1966).

[114] *See Berkey*, 244 N. Y. at 95.

[115] *Id.*

[116] *See* Blumberg, *supra* note 91, at §6.06.1.

[117] *See* Deborah A. DeMott, *The Mechanisms of Control*, 13 Conn. L. Int'l L. 233, 234 (1999).

It should be noticed that control by itself is not enough to pierce the corporate veil because one of the effects of limited liability is precisely that it separates ownership from control.

As a rule, corporations are managed by professionals; thus shareholders' power is limited to electing directors and deciding a few other issues. In closely-held corporations, shareholders engage actively in corporate management. There is no separation of ownership and control. For this reason, the same directors and officers (*i.e.* control) is not enough by itself to pierce the corporate veil.[118]

For Blumberg, what is relevant in veil piercing is "the manner and extent of control."[119] It is not enough that the parent determines the policies, finances and expenses of the subsidiary; on the contrary, it is necessary to show that the parent has an "intrusive, hands-on, day-to-day control with the parent often leaving no discretion whatsoever to the subsidiary."[120]

Deborah DeMott explains that the kind of control necessary to pierce the corporate veil is different from the kind of control exercised in an agency relationship (courts frequently do not draw a distinction between them, though).

According to DeMott, in an agency relationship, there are two entities perfectly differentiated, so the agent and the principal do not operate as if they were one entity. Given the mutual consent of both parties, one entity can be the agent of the other without any kind of ownership relationship. Conversely, the kind of control that courts consider necessary to pierce the corporate veil implies the nullification of the legal personality of each entity and, as a result, the existence of just one entity. This kind of control is known as "domination." In addition, when there is an agency relationship, there is legal ownership, whereas domination is usually exercised *de facto*.[121]

Courts usually also look at other elements before concluding that one corporation dominates its subsidiary. For example, whether or not the subsidiary is undercapitalized and whether shareholders treat the corporation's assets as if they belonged to them.[122]

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118 *See id.* at 238.

119 *See* Blumberg, *supra* note 91, at §10.02.

120 *See* William J. Rands, *Domination of a Subsidiary by a Pare*nt, 32 IND. L. REV. 421, 437 (1999). In *Krivo Industrial Supp. Co. v. National Distill. & Chem.*, the court explained that veil-piercing control refers to actual, participatory, total control of the corporation's actions. This kind of control is "a total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation;" it implies such a "domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal." The simple active participation of shareholders in the management of the corporation or the mere ownership of the majority or all of the stock of the corporation does not constitute the kind of control required. *See Krivo Industrial Supp. Co. v. National Distill. & Chem.*, 483 F.2d 1098, 1105, 1106 (5th Cir. 1973).

121 *See* DeMott, *supra* note 105, at 239.

122 *See id.* at 239, 241.

b. Undercapitalization

"Adequate capitalization" or "undercapitalization" is frequently taken into account to pierce the corporate veil, but the exact definition of these terms is not clear.

In the U.S., state statutes do not require any specific capitalization level; and even if this were required, capitalization often fails to reflect the company's solvency, as asset value can be easily inflated. In veil piercing cases, courts often look at "the amount of equity furnished by shareholders"[123] in connection to the corporation's activities; as well as the risk of loss that such activity implies.[124] Some courts also take into account the initial and/or current levels of capitalization, as equity contributions made by shareholders are often required only at the time of incorporation and not as an ongoing obligation.[125]

Courts differentiate between contract creditors and tort creditors when evaluating this prong. For tort creditors, courts are particularly concerned about the level of capitalization, as such creditors cannot fairly negotiate compensation. Conversely, for contract creditors —who can investigate the company's financial condition and negotiate an interest rate that compensates for the risk involved— undercapitalization cannot be used to justify veil piercing, unless they have been misled into believing that the corporation had more assets than it does.[126]

Undercapitalization is usually considered helpful but not decisive as an element to pierce the corporate veil, as in some cases it provides courts with evidence of fraudulent or self-dealing transactions;[127] most legal scholars, however, believe that undercapitalization should not be considered an important factor in applying veil piercing.

Firstly, for many start-up businesses, shareholders often cannot contribute large amounts of equity; besides, it is often more convenient to provide

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[123] *See* David Millon, *Piercing the Corporate Veil, Financial Responsibility and the Limits of Limited Liability*, 35 (Washington and & Lee Public Law and Legal Theory Research Paper Series, Working Paper No. 03-13, 2003). Most courts focus only on shareholders' assets, but some include all corporate assets. *See* Franklin A. Gevurtz, *Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 Or. L. Rev. 853, 888 (1997).

[124] *See id.*at 883. For Easterbrook and Fischel adequate capitalization is "an amount of equity that is within the ordinary range for the business in question," which depends on "the kind of business on which the corporation is embarked." Easterbrook & Fischel, *supra* note 5, at 113; *See* also Harvey Gelb, *Piercing the Corporate Veil—The Undercapitalization Factor*, 59 Chi. Kent. L. Rev. 1, 14 (1982); Minton v. Cavaney, 56 Cal. 2d 576, 580 (Cal. 1961) (stating that the capital is adequate when it is consistent with the activities in which the corporation has engaged and the risks implied).

[125] *See* Mark A. Olthoff, *Beyond the Form—Should the Corporate Veil Be Pierced?* 64 UMKC L. Rev. 31, 315 (1995).

[126] *See* Robert W. Hamilton, *The Corporate Entity*, 49 Tex. L. Rev. 979, 987, 988 (1971).

[127] *See* Gevurtz, *supra* note 111, at 883.

resources in the form of debt rather than equity.[128] Secondly, even though shareholders might make adequate contributions at the time of incorporation, it is difficult for the company to maintain the same level of capitalization during its entire business life. Finally, some legal scholars hold that requiring the corporation to keep the same level of capitalization; or requiring that the equity cushion cover all future debts, could be viewed as an imposition of unlimited liability, as shareholders would function as personal guarantors of the corporation.[129]

c. Failure to Observe Corporate Formalities

Lack of formalities refers to corporations' breach of procedures required by statute.[130] Failure to observe corporate formalities by itself is not sufficient to hold shareholders liable for the corporation's debts, but it can help to identify shareholder misconduct.

This element is closely related to control and refers to issues such as:[131]

a) Failure to issue stock. The fact that the corporation has not issued stock certificates indicates that there are no shareholders and the company is probably undercapitalized.[132] This is generally a starting point to detect shareholder misconduct.
b) Failure to convene shareholders' or board of directors' meetings; as well as failure to formally approve or carefully document transactions. Failure to hold meetings and properly document transactions suggests the existence of unfair transactions between the corporation and its shareholders, in which shareholders are removing assets from the corporation at the expense of the corporation's creditors.[133]

In a few cases, the failure to observe corporate formalities has served as the basis to pierce the corporate veil when creditors were misled into believing that they were dealing directly with shareholders rather than the corporation.[134] For some legal scholars, this factor is irrelevant, because it does not

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[128] *See* Millon, *supra* note 111, at 36.

[129] *See id.* at 37.

[130] *See* Russell Lance Miller, *Piercing the Corporate Veil in Kentucky: An Analysis of United Sates v. WRW Corp.*, 221 N. Ky. L. Rev. 541, 548 (1995).

[131] Gevurtz, *supra* note 111, at 867. *See Kinney Shoe Corp. v. Polan* 939 F.2d. 209, 212 (4th Cir. 1991) (holding that "inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil").

[132] *See id.*

[133] *See id.* at 868.

[134] *See* Millon, *supra* note 111, at 33.

have any impact on creditors;[135] even if the creditors have been misled, the transaction can be challenged under other legal devices, such as fraudulent conveyance law.[136]

d. Fraud, Wrongful or Unjust Act

This element encompasses different types of misconduct: *a)* acts which constitute fraud; and, *b)* acts which are considered to be unjust. The former refers to shareholder's wrongful dealings with creditors,[137] while the latter is based on the legislative policy which holds that "it is unfair to allow owners (of the corporation) to avoid debts at the expense of a corporation's creditors."[138]

Three types of misrepresentations have been considered by courts as fraud to pierce the corporate veil: *a)* representations concerning the financial status of the corporation; *b)* statements promising performance; and *c)* representations and other actions which mislead the creditor into believing that someone, other than the corporation, is assuming the debt.[139] In each case, there must be intent to mislead or confuse the creditor.

The second category of transactions usually refers to unfair self-dealing. Protection from unfair self-dealing in contractual relationships is based on the principle that "the controlling shareholder of the corporation will not be free to do whatever he or she wants with corporate assets. Otherwise, the owner could have the corporation borrow money, take all the money out of the corporation, and leave the creditor unpaid."[140]

In tort cases, controlling shareholders have incentives to remove the assets from the corporation in order to avoid compensating tort victims for the loss or harm suffered; therefore measures that prevent shareholders from self-dealing are desirable.[141] Veil piercing has a deterrent effect for shareholders to self-deal with the corporation's assets because if the court finds that shareholders have removed assets from the corporation at the expense of its creditors then grants creditors the right to collect not only from the corporation but also from shareholders with no limits.[142]

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135 *See* Blumberg, *supra* note 91, at §10.09.

136 *See* Millon, *supra* note 111, at 34.

137 *See* Gevurtz, *supra* note 111, at 870.

138 *See* John H. Matheson & Raymond B. Ebyt, *The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test for Waiving Owner's Limited Liability Protection*, 75 Wash. L. Rev. 147, 178 (2000).

139 *See id.* at 871-874.

140 *See id.* at 875.

141 *See id.*

142 *See id.* at 879.

D. *Rationale and Problems of Corporate Veil Piercing*

a. Rationale

Easterbrook and Fischel consider that the legal rationale of this doctrine is "obscure."[143] The economic rationale, however, is clear, based on the moral hazard[144] generated by limited liability.

According to these scholars, courts should pierce the corporate veil when corporations have engaged in excessively risky activities that externalize their costs, as the aim is to "balance the benefits of limited liability against its costs."[145]

Veil piercing offsets the incentives that limited liability creates for shareholders and managers to engage in excessively risky activities at the expense of company creditors, especially in the case of closely-held corporations and tort creditors.

As explained above, shareholders participate in the profits of the corporation in the form of dividends but they are also the first to lose their investments if the corporation becomes insolvent; for this reason, shareholders prefer projects which have a higher expected return. Activities with a higher expected return imply a higher risk of loss. Given limited liability, shareholders are indifferent to such risk of loss because in case of failure, they will only lose their investment.

In a publicly-held corporation, shareholders are unable to influence the management of the corporation because they are generally too numerous and passive to affect the management's decisions. In these situations, there is usually a separation of ownership and management. In closely-held corporations, however, shareholders often play an active role in the company's affairs, serving as managers or causing management to engage in high-risk activities to the detriment of creditors. The lack of separation between ownership and management in closely-held corporations exacerbates the problems of limited liability because shareholders often operate the company to gain higher levels of return even if the net future value is negative.

Veil piercing alters shareholders' incentives to make corporations engage in overly risky activity. Due to veil piercing, the assets of shareholders are exposed to the company's creditors. As a consequence, shareholders have incen-

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[143] *See* Easterbrook & Fischel, *supra* note 5, at 109.

[144] Moral hazard "is an incentive problem that arises in cases where the actions of individuals cannot be observed and contracted upon, creating ASYMMETRIC INFORMATION among individual parties to a transaction […] The nature of transactions characterized by moral hazard is such that individuals do not have incentives to behave in ways that lead to Pareto efficient outcomes." The Blackwell Encyclopedic Dictionary of Managerial Economics 134 (Robert E. McAuliffe ed., Blackwell, 1999).

[145] *See id.*

tives to invest in ventures with a positive net future value; that is to say, even if it involves risky activity, it helps create value. Veil piercing imposes unlimited liability on shareholders for the corporation's debts; as a result, shareholders avoid making the corporation engage in activities likely to create no positive value because shareholder's assets are at stake.

As for tort creditors, limited liability facilitates the externalization of costs that result from risky activities. Since tort creditors are not in a position to negotiate cost allocation, they are not compensated for the risks they bear. Limited liability exacerbates this problem because shareholders lose their investment; as a result, they remain indifferent to the risks assumed by the corporation.

Veil piercing alters shareholders' incentives to make corporations engage in risky activities that can often result in unlawful acts.

b. Problems of Corporate Veil Piercing. Uncertainty

Limited liability is desirable as an efficient system of risk allocation, where risks are borne by better risk-bearers. Limited liability, however, has a downside: it creates moral hazard.

Under limited liability, shareholders are only liable to the extent of their investment; since they have incentives to engage in risky activity, the probability of loss increases accordingly. The consequence of moral hazard is cost externalization, an inefficient result.

Creditors are usually better risk-bearers, as they possess more information to assess risks and are in a better position to negotiate adequate compensation, in effect avoiding cost externalization. The corporation, however, can externalize costs when it isn't possible for creditors to enter into contractual agreement. Even when creditors can negotiate terms to compensate for their risk of loss, the information they possess is usually insufficient or misleading, preventing them from negotiating an adequate interest rate. In these cases, the doctrine of corporate veil piercing helps make the corporation internalize the costs of its activities.

Uncertainty is the main problem faced by creditors when they try to access shareholders' assets through veil piercing. As explained earlier, since this doctrine has few standards, courts tend to adopt either the instrumentality approach or agency approach but follow neither of them strictly. None of the above factors are enough by themselves to lead to veil piercing. Notably, similar facts often result in different outcomes. Uncertainty regarding veil piercing has thus had negative consequences, since it either discourages investment in important activities or induces excessive precaution. In sum, investors are unsure whether they may be held liable without limit for corporate debts.[146]

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146 *See* Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 Iowa J. Corp. L. 479, 514 (2001).

E. *Formality*

Another downside is that when courts focus solely on questions of formality, diminishing the importance of the company's real-world conditions, creditors are even less likely to obtain remedy.

For example, undercapitalization alone does not lead to veil piercing. In general, shareholders have incentives to keep the corporation's capitalization low, doing no harm to creditors as long as the corporation keeps paying its debts. When undercapitalization is taken into account, shareholders guess the amount that needs to be kept as capital in order to avoid veil piercing, thus shareholders have incentives to keep the corporation with a capital that is not adequate to protect the corporation's creditors but that helps them avoid veil piercing, without ensuring protection for creditors.[147]

Another example is when courts require showing control without taking into account that subsidiaries are controlled to a greater or lesser extent by the parent. As long as some formalities are observed, a parent can control a subsidiary and benefit at the expense of the corporation's creditors.

Some authors, such as Stephen Bainbridge, have proposed to eliminate veil piercing. Bainbridge explains that limited liability offers many benefits to society, whereas veil piercing is too confusing. He considers that "the question is not whether the shareholder used the corporation as his or her alter ego, but whether the shareholder personally engaged in conduct for which he or she ought to be held liable."[148] This being said, it is extremely difficult to consider the elimination of veil piercing as a mechanism to protect creditors.

Robert Charles Clark regards it as an alternative to fraudulent conveyance law and other statutes.[149] For this scholar, veil piercing is a good alternative because it does not require careful scrutiny of each individual transaction[150] and, unlike other legal devices, has a strong deterrent effect.[151]

Although clarity is desirable, in my opinion having a flexible framework may be more advantageous than rigid rules. In a general scheme, courts have broader scope for interpretation, adapting rules to the actual necessities of society. This does not mean that efforts to codify veil piercing are pointless and should be applied arbitrarily; on the contrary, it is absolutely necessary to systematize, improve and better implement legal doctrine.

3. *Alternative Creditor-Protection Measures*

Other legal scholars, keeping in mind the problem of moral hazard and the weaknesses of veil piercing as a legal device to protect creditors, have

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147 *See* LoPucki, *supra* note 34, at 22.

148 *See id.* at 516.

149 *See* Clark, *supra* note 13, at §2.4.

150 *See* Gevurtz, *supra* note 111, at 878.

151 *See id.*

proposed alternative solutions such as insurance, management liability and even the imposition of unlimited liability as a rule for any kind of business organization. Due to lack of space and the introductory nature of this analysis, I shall mention only a proposal presented by Henry Hansmann and Renier Kraakman.

Hansmann and Kraakman propose the imposition of pro rata unlimited shareholder liability for corporate torts. According to these authors, regardless of corporate structure, whether publicly- or closely-held, "limited liability in tort cannot be rationalized."[152]

The premise is that hazardous activities imply a higher level of risk, which means for shareholders that if the project is successful, the return will be higher. Since limited liability protects investors from losing all their assets, it also creates incentives to overinvest in hazardous activities. In addition, limited liability creates incentives for investors to underinvest in the corporation in order to reduce exposure to tort claims, which is easy to do if we consider that corporations can raise capital through long term debt instead of equity.[153]

Hansmman and Kraakman's proposal has been criticized for the detrimental effects that it would have on stock markets and the prohibitive collection costs it would imply.[154]

VII. Veil Piercing in Mexico

1. *History of Corporate Veil Piercing in Mexico*

Attempts to adopt the doctrine of piercing the corporate veil in Mexico are not new. In 1939, Mexico's Congress passed the *Ley que Establece los Requisitos para la Venta al Público de Acciones de Sociedades Anónimas*[155] (Law Establishing the Requirements for the Share Sale to the Public Corporations)[156] which included a provision that made shareholders liable for corporate debts. The adoption of this provision was the result of political and social realities at that time, characterized by the government's outsized role in the nation's economic life.

At that time, the stock market was not yet developed; as a result, a corporation composed of numerous shareholders did not yet exist. It was therefore assumed that any type of control exercised by an individual shareholder was, by definition, unfair self-dealing.[157] Based on this reasoning, the statute in-

152 *See id.* at 1880.

153 *See id.* at 1883.

154 *See* LoPucki, *supra* note 34, at 55-61.

155 *See* Ley que Establece los Requisitos para la Venta al Público de Acciones de Sociedades Anónimas [LERVPASA] Article 13 (Méx.).

156 *Hereinafter* "LERVPASA."

157 *See* Diario de Debates de la Cámara de Diputados 5, Dec. 15, 1938 (Méx.).

cluded two provisions that contained the legal basis for piercing the corporate veil. The main provision stipulated the following: "Individuals exercising control over a corporation, regardless of whether they own a majority of stock, shall be secondarily liable for non-contractual debts arising from corporate misconduct."[158]

As can be seen, this provision was addressed to shareholders regardless of whether they were individuals, entities or majority owners; stockholders were held liable only if they exercised control and the debt resulted from corporate misconduct. At that time, the only factor taken into account to pierce the corporate veil was the exercise of corporate control, the meaning of which was left entirely up to the courts.

As a result, shareholders were generally held liable only to the extent that creditors could not recover from the corporation. As a general rule, when secondary liability is imposed, the plaintiff has to sue first; only if the plaintiff is unable to collect from the debtor then creditors can collect from someone else, known as the secondarily liable party. Article 14 of the LERVPASA created an exception to this rule. It makes express reference to Article 24 of the LGSM; under this provision, creditors are entitled to sue both the organization and its owners; amounts due are recoverable from owners only if collection from the company is not possible because of insufficient assets.[159] In either case, there was no requirement to show that the company was insolvent.

The statute was effective for a very short period of time, as most of it was abrogated by subsequent statutes. Nowadays, it is unclear whether the articles that refer to veil piercing are still enforceable.[160] Regardless of this point, only two cases exist in which veil piercing under the LERVPASA was discussed. In both these decisions, the Supreme Court broadly interpreted the provisions, holding that when a controlling shareholder exercised control and the debt arose from a non-contractual relationship, shareholders were not entitled to limited liability.[161] Due to their doubtful enforceability and legal formalism that prevails in Mexican courts, judges have been reluctant to follow the Supreme Court's interpretation.[162]

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[158] D.O.F. December 30, 1939.

[159] *See id*. LGSM Article 24; Rodríguez, *supra* note 96, at 80-82; Proyecto de Ley de Desestimación de la Personalidad Jurídica Societaria [PLDPJS], Sen. Rep., LVIII Leg., 24 (2002).

[160] Despite of the fact that it was abrogated by the Ley de la Comisión Nacional de Valores of 1953 and Ley del Mercado de Valores of 1974, in 1983 the Supreme Court held that the statute was not derogated, some provisions were abrogated except for articles 13 and 14. *See* "Castillo, Ariel Angeles," 175-178 IV S.J.F. 175 (6a. época, 1983). The resolution is not binding because it does not comply with the requirements established in Article 192 of the *Ley de Amparo*.

[161] *See id.*

[162] See Roberto Obando Pérez, *Una vision dual de la doctrina del levantamiento de la persona jurídica* 182, *available at* www.ijf.cjf.gob.mx/publicaciones/revista/25/r25_10.pdf.

2. *2002 Corporate Veil Piercing Bill*

After the 1994 economic crisis in Mexico, when many insolvency cases involved shareholder fraud, lawmakers became concerned about how to deter fraudulent conduct and provide effective remedies to creditors against debtor insolvency. As a result, Congress passed new statutes and amended existing laws, most of them in relation to bankruptcy and financial institutions. The issue of whether the corporate form should be disregarded became an important Congressional issue; in 2002, a bill to adopt corporate veil piercing (*Proyecto* de *Ley de Desestimación de la Personalidad Jurídica Societaria* or Bill on the Rejection of Corporate Legal Personality) was submitted but, unfortunately, legislative debate and approval did not conclude successfully. This project is notable, however, because it illustrates how inadequate Mexican law was in 2002 with regard to piercing the corporate veil.

This project proposed applying veil piercing to all entities with or without legal personality in which owners misrepresent their dealings with a formal entity to third parties.[163] It is also notable that the bill's terms were contradictory, as its provisions addressed all entities with legal personality (partnerships, corporations and any other type of business organization —implying inclusion of enterprises in which unlimited liability was already the rule), as well as entities without formal legal standing. Under this proposal, veil piercing would disregard the legal personality of an entity as well as ignore stockholders' limited liability; as a result, a major shortcoming of this bill was that it included entities in which owners already had unlimited liability as well as entities with no legal personality.

Veil piercing should not be applied to all types of business organizations because the problem is not legal personality but the incentives that limited liability create for business owners and managers to make decisions that harm creditors. Veil piercing should only be applied to corporations and other limited liability business organizations.[164] As for entities without legal personality, if the owners have misrepresented the status of the entity, there is no need to regulate their liability, because owners and managers are already fully liable in such situations under the LGSM.[165]

Under this proposed bill, a remedy was devised to challenge business owners and third persons that exercised control.[166] Based on the proposed bill's text, third parties could be held liable for corporate debts; what is not clear, however, is how third parties would exercise control over the entity. One possible interpretation of this proposal is that third parties include members of the board of directors; but statutes already provide for remedies against the

[163] *See* PDPJS Article 6.

[164] The general rule is contained in Article 2964 of CCF.

[165] *See* LGSM Article 7.

[166] *See id.*

misconduct of managers. Since veil piercing addresses the moral hazard created by limited liability, managers should not be punished; third parties do not enjoy limited liability.

An alternative interpretation is that the proposed bill adopted the enterprise liability approach; that is to say, the "third party" is a corporation belonging to a single enterprise. This interpretation seems logical since most presumptions about control and fraud under the proposed bill were based on the relationships between the individual companies that comprise a corporate group. Since the negation of limited liability is a harsh sanction, however, it is very important that provisions enabling courts to pierce the corporate veil are clear.

Under this proposed bill, the following three elements must be shown by the plaintiff:[167]

A. Objective Element

This element requires showing that control was exercised over the entity to the extent that the entity's acts were the acts of the owners. Control could be presumed where: *a)* the owner or third party determined the strategic policies of the entity; *b)* the owner or third party financed the entity; *c)* all liabilities were allocated to one entity while assets were allocated to the second entity despite both entities belonging to the same corporate group; *d)* the owner or third parties were, either directly or indirectly, major investors in the entity; *e)* the owner, third party and entity shared identical management; *f)* a majority of the owner or third party's assets were obtained from the entity; *g)* a commingling of assets owned by the owner, third party and entity; *h)* any other fact that reasonably indicates the exercise of control.

As can be observed, the proposed bill did not adequately define the meaning of control; instead, it described several situations that constitute presumptions of control. Most of the presumptions were based on the ordinary operation of parents, subsidiaries and closely held corporations, which by themselves cannot be considered unlawful.

B. Subjective Element

This consists in showing that the owner or third party abused its legal personality in order to defraud creditors, commit fraud or violate "imperative laws."[168] For the first two factors, the proposed bill included definitions. Given the difficulty of proving the defendant's intention to commit fraud, the statute provides a list of presumptions.

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[167] *See id*. Articles 9-15.

[168] *See id*. Article 14.

According to the proposal, creditors are defrauded when the entity has benefited by avoiding payments to creditors. Presumptions of intent to defraud creditors included: *a)* in a corporate group, most of the debts were allocated exclusively to one of the constituent entities; *b)* the owner or third party made use of the assets of the corporation as their own; *c)* the owner or third party made a loan to the entity without adequate assurance of payment; *d)* engagement in excessively risky activities; *e)* improper or fraudulent management of the entity; *d)* any fact from which it could be reasonably concluded that the owners and third parties had intended to defraud creditors. Fraud upon the law was defined by the bill as: *a)* evasion of an imperative law; or *b)* the principles' intent to abuse the entity to obtain a benefit.

C. Result

This requires showing that unless the corporate veil is pierced: *a)* creditors who invested in good faith will be harmed; or *b)* fraud upon the law will take place; or *c)* a violation of imperative laws will occur.

This prong has been designed to allow the court to assess the harm caused if the corporate veil is not pierced. The consequences of corporate veil piercing under this rule would be unforeseeable. As a result of legal formalism, Mexican lower courts tend to favor a narrow interpretation of the law.

Lastly, the proposed bill stated that only in exceptional cases was a remedy available.

VIII. An Alternative Proposal for the Adoption of Veil Piercing in Mexico

In previous parts of this paper, I explained how limited liability constitutes the most efficient allocation of risks and, as such, argue for its preservation. On the other hand, since limited liability creates incentives for shareholders to impose excessive risks on creditors without compensation, many have pointed out that it is also necessary to have legal devices that facilitate the internalization of costs imposed on creditors when the corporation engages in activities that put its own solvency at risk.

The dilemma of how to protect creditors without abolishing limited liability has caused a certain extent of uncertainty and weakness in existing legal remedies that protect creditors. The most typical is the doctrine of piercing the corporate veil. On the one hand, it is rarely applied because of its unprincipled nature; this said, it has been a very effective creditor-protection measure.

Through application of this doctrine, courts create an exception to the limited liability rule; as a result, the elements considered by courts to determine whether the corporate form should be disregarded are closely related to justifications for preserving or eliminating limited liability.

In Mexico, several attempts have been made to adopt this doctrine but, for different reasons, all have failed. After the 1994 economic crisis in Mexico, when many insolvency cases involved abuse of the corporate form, implementation became an important issue; as a result, a new bill was proposed. Based on the bill's content and explanations given by its drafters, among its principle motivations was the frequency of fraud in corporate groups during the 1990's.[169] From my point of view, this was an important step to improve the current system of creditor protection; specifically because it showed how undeveloped Mexican doctrine was in this important legal area.[170]

For reasons explained above, corporate veil piercing should be enacted in Mexico. In order to adopt this doctrine, however, clear and well-defined rules must first be included in the LGSM, the statute that regulates corporations and other business organizations. This statute consists of fourteen chapters; the first contains general rules for all business organizations; the next three chapters establish rules for mergers and dissolutions; and the remaining sections contain provisions for diverse business organizations. Given that veil piercing is an exception to limited liability, provisions that regulate it should be included in a new chapter.

A rule should also be adopted that makes shareholders secondarily liable for corporate debts rather than jointly liable. The reason is that when a corporation is solvent, its creditors would be entitled to full debt payment. Corporate veil piercing is a harsh measure that should be reserved only to minimize incentives available for shareholders to exploit the corporate form at the expense of creditors. Joint liability is undesirable, as it exacerbates the problem of uncertainty because it implies that creditors can sue at the same time both the corporation and its shareholders, regardless of whether the corporation is solvent or not. Conversely, secondary liability implies that creditors have to sue the corporation first and so long the corporation has no assets to pay, then creditors are entitled to sue its shareholders.

Taking into account U.S. case law, the following elements should be considered in evaluating whether to pierce the corporate veil under the LGSM:

1. *Undercapitalization or Insolvency*

One of the elements that American courts consider is whether the corporation is undercapitalized. It should be noted that in seven U.S. states,[171]

[169] *See* PLDPJS at 35.

[170] There are recent studies on corporate veil piercing which do a comparative analysis with other systems. For example, *see* Roberto Obando Pérez, *supra* note 162. This article offers a deep analysis of corporate veil-piercing under Spanish Corporate Law.

[171] See John H. Matheson & Raymond B. Eby, *supra* note 138, at 147, 178 (2000).

no minimum capital amount is required; as a result, undercapitalization is determined by the court.

In Mexico, the capitalization requirement under the LGSM is $50,000 pesos, an amount so insignificant that compliance is easy, regardless of the size and risks assumed by the corporation. Despite the legal requirement, many corporations have larger capital stocks in order to appear financially sound to creditors.

Despite capitalization requirements under the LGSM, undercapitalization is an important element that courts need to assess in evaluating whether to pierce the corporate veil. When a company is incorporated for the purpose of misleading creditors, shareholders generally fail to transfer any assets to the corporation at the time of start-up. For this reason, undercapitalization provides a clue whether the corporate structure is being abused at the expense of creditors.

Alternatively, courts should also take into account insolvency in determining whether to pierce the corporate veil. This does not mean, however, that veil piercing should be applied solely in bankruptcy cases; on the contrary, insolvency should be assessed as an alternative to undercapitalization because many insolvent corporations are liquidated outside bankruptcy.

Insolvency is a good way to evaluate whether limited liability and the corporate structure are being abused. When the debtor is solvent, creditors may receive payment in full; when the debtor is insolvent, however, creditors are not entitled to full payment. This problem is exacerbated when there is more than one creditor. Insolvency also creates inefficiencies by providing incentives for the debtor's managers and shareholders to invest in value-diminishing projects and decrease investment in value-adding projects. Value-diminishing projects involve excessively risky activities with a negative net present value[172], so that the expected value of creditor's claims is likely to be reduced by a greater amount than the expected gain generated by the project for shareholders. These projects are nonetheless attractive, however, because the company's managers seek to increase the expected equity value despite their cost to creditors. The managers' main goal is to avoid bankruptcy and losing their jobs.[173] For this reason, insolvency exacerbates incentives to abuse both the corporate form and limited liability.

As for proof of corporate insolvency, a test could be required as the one required by the article 10 of the LCM in a bankruptcy case, which not only refers to the lack of assets but also to the lack of liquidity.

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[172] For the purposes of this text, value diminishing projects are those with a negative net present value, meaning a project that reduces the total amount of value for both the debtor and the other party to the contract. For more information about positive and negative present value transactions see for example Richard Posner, Economic Analysis of the Law (4th ed. 1991).

[173] *See* Jesse M. Fried, *Executory Contracts and Performance Decisions*, 46 Duke L.J. 517, 1821 (1996).

2. *Failure to Observe Corporate Formalities*

Lack of formality refers to corporations' breach of statutory procedures. Failure to observe corporate formalities by itself is not sufficient to hold shareholders liable for corporate debts, but it can be used to help identify shareholder misconduct.

This element is closely related to control and refers to issues such as:

1) Failure to issue stock. The fact that the corporation has not issued stock certificates indicates that there are no shareholders and the company is probably undercapitalized. This is generally a starting point to detect shareholder misconduct.
2) Failure to convene shareholders' or board of directors' meetings; as well as failure to formally approve or carefully document transactions. Failure to hold meetings and properly document transactions suggests the existence of unfair transactions between the corporation and its shareholders, in which shareholders are removing assets from the corporation at the expense of the corporation's creditors.

This is a key element for veil piercing. In insolvency and fraud cases, this element is fairly common.

3. *Control*

In cases in which the shareholder is another corporation (*i.e.* there is a parent-subsidiary relationship), then the element of control must be shown. This refers to the relationship between the parent and subsidiary and requires proof that the parent exercises complete control or domination over the subsidiary. It is not enough that the parent determines the general policies, supervises or controls the finances and expenses of the subsidiary; on the contrary, it must be shown that the parent exercises day-to-day control over the subsidiary, often leaving no discretion to the subsidiary to make independent decisions. Control implies that the parent is so involved in the day-to-day management of the subsidiary that both have become, in essence, one entity.

Some clues given to guide the court include the following:

1) The parent owns all or most of the subsidiary's stock.
2) The parent's directors and officers take part in the management of the subsidiary.
3) The parent finances the subsidiary.
4) The parent bears some expenses or losses incurred by the subsidiary.
5) The subsidiary deals exclusively with the parent.

6) The subsidiary owns only the assets conveyed by the parent.
7) The parent uses the subsidiary's assets as its own.

A. *Misrepresentation*

Plaintiffs should be required to prove misrepresentation as it implies that the corporation was being used by managers and shareholders to deceive creditors.

Proof should be specifically required that the company's shareholders or managers have misled creditors into believing that the entity had more assets than it really did. The key here is that managers or shareholders made the creditor believe there were enough assets to pay the debts. There must be an intention to mislead or confuse creditors.

B. *Tort Creditors*

Corporate veil piercing should be available to tort creditors without the need to prove other elements except undercapitalization or insolvency. In general, a voluntary creditor that enters into a contract with a debtor negotiates the terms and price of the contract based on the risk of loss involved. This is particularly true for sophisticated voluntary creditors who have a significant stake in the transaction; these creditors have the ability to evaluate information about the real costs of the entity's activities. Unlike voluntary creditors, tort creditors are not in contractual relationships with debtors; for this reason, tort creditors cannot negotiate debt terms. As a result, shareholders and managers fail to internalize the costs of the entity's excessively risky activities.

Such criterion was followed by the LERVPAS. Under this statute, shareholders could be held liable for corporate debts based on misconduct

C. *Injury*

This element is closely related to insolvency as it refers that the misrepresentation, that is to say the abuse of the corporate form and limited liability results in an injury to the corporation's creditors because it prevents creditors from collecting their claims; creditors suffer an injury because insolvency makes them lose something they have the right to receive.

The advantages of this proposal are simplicity and directness. Given the harsh nature of veil piercing, the rule should be simple and clear. This proposal addresses corporations and the elements to be considered by courts are those common in most corporate veil piercing cases. Although other options exist, the purpose herein is to stimulate discussion about the adoption of corporate veil piercing in Mexico.

IX. Conclusion

Economic reality makes it hard to imagine the world without limited liability, which has permitted worldwide expansion of business and the development of risky but productive activity. By virtue of limited liability, risks are allocated to the most efficient risk-bearers. Creditors are better at bearing risk because they can negotiate adequate compensation for the risks they assume. There are, however, exceptions to this assertion.

Limited liability creates incentives for shareholders to engage in risky activities without compensating creditors. Problems generated by limited liability are generally related to corporate structure. In corporations that have only a few shareholders, the likelihood of moral hazard is increased. Shareholders often take part in management to make the enterprise engage in risky activities in order to obtain higher returns on their investment at the expense of creditors.

The downsides of limited liability are also determined by the types of creditors involved, especially when these individuals cannot negotiate adequate compensation. Difficulties to negotiate adequate compensation occur either because (a) creditors are unable to enter into agreement with the corporation, *e.g.*, tort creditors; or (b) because the corporation misrepresents its financial condition.

Aware of these problems, lawmakers have developed several legal mechanisms to protect creditors. The harshest remedy is the doctrine of "piercing the corporate veil," under which courts can make an exception to limited liability. Although this doctrine has been criticized, it is arguably the most effective way to internalize costs. A major weakness of this remedy, however, is a lack of clarity. As a result, there are currently few reliable standards; similar circumstances may produce completely different outcomes.

Mexico urgently requires a legal mechanism that permits corporate veil piercing. Any proposal must take into account the need to provide effective protection to creditors and, at the same time, preserve limited liability as the cornerstone of corporate law.

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