PIERCING THE CORPORATE VEIL

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INTRODUCTION

According to firmly established legal principles, the corporation is recognized as a legal entity, separate and distinct from its shareholders. The obligations of the corporation are the responsibility of the corporate entity, not the shareholders, who are liable only for the amount they voluntarily put "at risk" in the business venture.[1] The insulation of shareholders is known as "limited liability."[2] The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting all of their personal wealth to the risks of the business.[3] This incentive to business investment has been called the most

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1. *See, e.g.*, Amoco Chemical Corp. v. Bach, 222 Kan. 589, 593, 567 P.2d 1337, 1341 (1977), which states: "We start with the basic premise that a corporation and its stockholders are presumed separate and distinct, whether the corporation has many shareholders or only one. Debts of the corporation are not the individual indebtedness of its stockholders."

See also 18 AM. JUR. 2d *Corporations*, §§ 14-16 (1965); 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 41-46 (1974).

2. 13A W. FLETCHER, *supra* note 1, at § 6213.

3. N. LATTIN, THE LAW OF CORPORATIONS 11-12 (2d ed. 1971). *See also* Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929).

In Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941), the general creditors of a bankrupt corporation attempted to set aside a deed of trust against the corporation's physical facilities, which had been executed in favor of the president (and sole shareholder) of the corporation four years before bankruptcy was declared. The court upheld the validity of the deed of trust and refused to set aside the foreclosure sale in which the sole shareholder was the purchaser. The court concluded:

> We do not think a case is presented where the corporate entity ought to be disregarded as being a sham, a mere obstacle to justice, or instrument of fraud. It is not denied that a corporation, owned by one man save for qualifying shares, is lawful . . . . That it was created to shield the owners from liability beyond the capital set up by the charter does not show an unlawful or fraudulent intent, for that is the main purpose of every corporation. It becomes an evidence of fraud only when the capital is unsubstantial and the risk of loss great, or the contributions to capital are greatly over-valued and the like.

Id. at 502.

important legal development of the nineteenth century.[4] When the incentive value of limited shareholder liability is outweighed by the competing factor of basic fairness to parties dealing with the corporation, however, courts may "pierce the corporate veil"[5] and hold the shareholders personally liable for the obligations of the corporation.[6] This Article examines the law relating to piercing the corporate veil and suggests how the careful corporate attorney should advise clients to avoid piercing.

I. General Criteria for Piercing the Corporate Veil

In theory, the piercing doctrine applies to publicly held and closely held or family corporations.[7] A review of the decisional law, however, shows no case in which the shareholders of a corporation whose stock was publicly traded or widely held were found personally liable for the obligations of the corporation. Thus, the piercing doctrine applies primarily to closely held corporations.

Closely held corporations typically are financed by one of two methods. One method requires the promoters, who will later manage the corporation, to incorporate and contribute part of their personal assets to the initial capital of the new corporation with the expectation that the corporate veil will shield the remainder of their personal assets from the risks of the business.[8]

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4. Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351 (1948).

5. Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Annot., 63 A.L.R.2d 1042 (1957).

6. Horowitz, *Disregarding the Entity of Private Corporations*, 14 WASH. L. REV. 285, 294 (1939), states the rule as follows:

> While the facts of each case, in which the doctrine of disregarding the corporate entity is applied, vary, there is one situation common to all: a right owed and its corresponding duty owed to the person demanding recognition of his right and the performance of its corresponding duty . . . . When the doctrine of disregard is applied, it is applied because of the necessity of enforcing this right-duty. . . . When expressed, it has usually been expressed in a restricted form, namely by a holding that before a corporate entity is disregarded, some species of fraud, bad faith or other wrong must exist to be obviated, the stockholders of the corporation whose entity is sought to be disregarded being chargeable with the violation of the duty.

In addition, J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 2 (1931) states: "The basis, therefore, for abrogating the normal immunity of stockholders is an abuse of the privilege to do business in corporate form, or in other words, a fraud upon the law."

7. H. HENN, LAW OF CORPORATIONS 252 (2d ed. 1970).

8. 1 W. FLETCHER, *supra* note 1, at § 189.

The other method requires the promoter-managers to contribute only a portion of the initial capital and to raise additional amounts from shareholders who do not expect to manage the business.[9] Theoretically, if the corporate veil is later pierced, only those shareholders actively involved in managing the corporation will be personally liable. Although this selective liability among shareholders makes sense in light of the rationale for limiting shareholder liability, the only judicial support is dicta in a few cases.[10]

In addition to closely held corporations, courts have pierced the corporate veil in the parent-subsidiary corporation context when a plaintiff contracts with the subsidiary, for example, and, upon default, attempts to hold the parent corporation liable.[11]

Given the purpose of promoting commerce by providing limited liability for shareholders in state corporation laws, courts have been reluctant to pierce the corporate veil, even when the express purpose of incorporation was to limit the liability of the incorporators.[12] Indeed, courts of every jurisdiction have recognized the legitimacy of incorporating to avoid personal liability.[13] Consequently, something more than the shareholders' desire to avoid personal liability must exist to justify piercing the corporate veil. The precise requirements, however, rarely have been articulated clearly.[14] The suit in which a party seeks to dis-

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9. *Id.*

10. *See, e.g.*, Sutton v. Reagan & Gee, 405 S.W.2d 828, 837 (Tex. Civ. App. 1966), in which the court expressed the rule as follows:

> Whether or not a shareholder will be insulated from personal liability should depend on the use, or misuse, which *that* shareholder is making of the corporate form. The only shareholders who should be held personally liable are those who have used the corporation to bring about results which are condemned by the general statements of public policy which are enunciated by the courts as "rules" which determine whether the courts will recognize their own child.

11. *See* notes 72-95 and accompanying text *infra*.

12. *See, e.g.*, Burns v. Norwesco Marine, Inc., 13 Wash. App. 414, 418, 535 P.2d 860, 862 (1975), in which the court indicated that: "The corporate form is of course, frequently utilized to limit the personal liability of its officers, directors and shareholders. And as a general rule, the corporate entity will be respected by the courts." *See also* Dietal v. Day, 16 Ariz. App. 206, 492 P.2d 455 (1972).

13. Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929); Horowitz, *Disregarding the Entity of Private Corporations*, 14 WASH. L. REV. 285 (1939).

14. Professor Hamilton, a leading authority on corporate law, states this point clearly:

> This language is inherently unsatisfactory since it merely states the conclusion

regard the corporate entity is an equitable one; the trial court generally is granted wide latitude in determining whether grounds for piercing exist.[15]

A "totality of the circumstances" rule allows the courts to deal with each case on its own facts but fails to provide entrepreneurs with firm guidelines for avoiding personal liability. An analysis of the piercing doctrine begins with a list of factors courts consider important in determining whether to pierce the corporate veil. A review of the case law reveals that one or more of the following factors was present in each instance of piercing:[16]

(1) commingling of funds and other assets of the corporation with those of the individual shareholders (Corporation *XYZ* holds no separate bank account but deposits the receipts from its business transactions in the personal account of *A*, its sole shareholder);

(2) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholders);

(3) failure to maintain the corporate formalities necessary for the issuance or subscription to the corporation's stock, such as formal approval of the stock issue by an independent board of directors;

(4) an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation;

(5) failure to maintain corporate minutes or adequate corporate records;

(6) identical equitable ownership in two entities (Corporation *A* is owned by the same shareholders and in the same proportions as Corporation *B*);

(7) identity of the directors and officers of two entities who are responsible for supervision and management (a partnership

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> and gives no guide to the considerations that lead a court to decide that a particular case should be considered an exception to the general principle of nonliability. A systematic analysis, moreover, is not readily discernible in the cases, and many courts continue to rely on metaphors to explain their results.

Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 979 (1971).

15. Creditors Protective Ass'n v. Balcom, 248 Or. 38, 432 P.2d 319 (1967); Bennett v. Minott, 28 Or. 339, 44 P. 288 (1896).

16. *See* Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962) and cases cited therein.

or sole proprietorship and a corporation owned and managed by the same parties);

(8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking;

(9) absence of separately held corporate assets;

(10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation;

(11) sole ownership of all the stock by one individual or members of a single family;

(12) use of the same office or business location by the corporation and its individual shareholder(s);

(13) employment of the same employees or attorney by the corporation and its shareholder(s);

(14) concealment or misrepresentation of the identity of the ownership, management, or financial interests in the corporation, and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security);

(15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities;

(16) use of a corporate entity as a conduit to procure labor, services, or merchandise for another person or entity;

(17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another;

(18) contracting by the corporation with another person with the intent to avoid the risk of nonperformance by use of the corporate entity, or the use of a corporation as a subterfuge for illegal transactions;

(19) the formation and use of the corporation to assume the existing liabilities of another person or entity.

In determining which of these factors will overcome the presumption of legitimacy in the use of the corporate entity, the policies behind insulating shareholders from personal liability must be balanced against the policies justifying piercing.[17]

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17. Mull v. Colt Co., 31 F.R.D. 154, 166 (S.D.N.Y. 1962), states the balancing test

II. The Two-Prong Test

A. General Rule

In locating the point where encouragement of business development is overshadowed by the public interest in protecting those who deal with the corporation, the courts have required that the party seeking to pierce the corporate veil satisfy a two prong test: "(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual [shareholders] no longer exist; and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow."[18] The first prong often is termed the "formalities requirement." The second prong of the test may be called the "fairness requirement."

While the courts regularly have cited the two prong test in piercing cases, they have applied the rule in a tremendously diverse manner. For example, some cases suggest that despite observation of corporate formalities, it is unfair to protect the shareholders behind the corporate veil when the corporation is severely undercapitalized for reasonably anticipated business risks.[19]

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as follows:

> The sanctity of a separate corporate identity is upheld only insofar as the entity is consonant with the underlying policies which give it life. The separate personality of a corporation is a privilege granted by the legislature where an artificial person is created by the compliance with various forms and procedures. Certainly a concomitant of the favor of the sovereign in permitting a corporate form of doing business is that the conduct of the entity be compatible with the public interest. The corporate fiction is but a matter of commercial convenience; the concept is not to be extended beyond reason and policy . . . . When the statutory privilege of doing business in the corporate form is employed as a cloak for the evasion of obligations as a mask, behind which to do injustice, or invoked to subvert equity, the separate personality of the corporation will be disregarded.

18. Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 796, 306 P.2d 1, 3 (1957). In Grayson v. Nordic Constr. Co., 22 Wash. App. 143, 148, 589 P.2d 283, 286 (1978), the court stated:

> The law is that when the shareholders of a corporation, who are also the corporation's officers and directors, conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity shall be mandated.

19. *E.g.*, Anderson v. Abbott, 321 U.S. 349 (1944), has been cited as indicating that undercapitalization—a factor fulfilling the "unfairness" prong of the test—alone may be enough to pierce the veil. This case, however, involved a violation of a state banking statute which imposed double liability on the bank for failure to return depositors'

Other cases suggest that, even when both prongs of the test are met, the corporate veil should be pierced only on a "showing of *actual* fraud."[20] The use of the term fraud, however, probably should not be interpreted in its full legal sense. The cases indicate that this additional prong is satisfied if there is evidence of fraud, intent to defraud, bad faith, or a showing that injustice may result if the veil is not pierced.[21] This actually is nothing more than satisfaction of the "unfairness" prong of the test.

B. Rationale for the Corporate Formalities Prong of the Piercing Test

Courts nearly always cite disregard of corporate formalities as one prong of the test used to determine when the veil should be pierced.[22] That is, the corporate formalities of keeping separate corporate records, issuing stock, and avoiding commingling of funds, must be followed to establish the corporation as a separate entity. This requirement is given various names. For example, when the sole shareholder controls the corporation, the corporation may constitute the sole shareholder's "alter ego,"[23] or a total "unity of ownership and interest"[24] may exist between the shareholders and the corporation, or the corporation may have become the "mere instrumentality"[25] of the shareholder.

While disregard of corporate formalities is frequently men-

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funds, so the "gross undercapitalization" of the corporation was not the sole factor in the court's decision to pierce the veil.

20. *See, e.g.*, Rockford Equip. Co. v. J.R. Simplot Co., 92 Idaho 218, 440 P.2d 338 (1968); Herman v. Mobile Homes Corp., 317 Mich. 233, 26 N.W.2d 757 (1947).

21. For example, the court in Associated Meat Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 838, 26 Cal. Rptr. 806, 813 (1962), stated it this way:

> It should be noted that, while the doctrine does not depend on the presence of actual fraud, it is designed to prevent what would be fraud or injustice, if accomplished. Accordingly, bad faith in one form or another is an underlying consideration and will be found in some form or another in those cases wherein the trial court was justified in disregarding the corporate entity.

Accord, Maley v. Carroll, 381 F.2d 147 (5th Cir. 1967); Contractors Heating & Supply v. Scherb, 163 Colo. 584, 432 P.2d 237 (1967); Action Plumbing & Heating Co. v. Jared Builders, Inc., 368 Mich. 626, 118 N.W.2d 956 (1962).

22. *E.g.*, Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962).

23. Kird v. H.G.P. Corp., 208 Kan. 777, 494 P.2d 1087 (1972); Emrich v. Emery, 216 Or. 88, 337 P.2d 972 (1959); Hyde v. Hyde, 78 S.D. 176, 99 N.W.2d 788 (1959).

24. Burns v. Norwesco Marine, Inc., 13 Wash. App. 414, 418, 535 P.2d 860, 863 (1975).

25. Henderson v. Security Mortgage & Fin. Co., 273 N.C. 253, 160 S.E.2d 39 (1968).

tioned, the rationale for this element of the test is seldom discussed. When there is one or a few shareholders, practically speaking, the shareholder-owners control and direct the affairs of the corporation for their own personal interests by controlling shareholder meetings and acting as directors and officers of the corporation. Hence, a unity of interest usually will exist between the closely held corporation and its shareholder-owners. The intent behind the formalities prong of the piercing test, however, is to prevent shareholder-owners from impairing the interests of other parties by carrying this unity of interest too far.[26] For example, even though the same people may perform various corporate roles required by statute, the law still distinguishes the rights and responsibilities of each.[27] Moreover, state law intends that each of these roles be carried out with sensitivity to the interests of all of the parties affected by the corporation, including owners, directors, officers, employees, creditors, government entities, and the public at large.[28] For example, traditional corporate law requires that board members, who are charged with the overall responsibility for the corporation's management, must act independently of the shareholders for the good of the corporation as a whole.[29] If a sole shareholder dominates the corporation such that the board of directors never meets and the concerns of other interested parties are never considered, he or she violates this legislative intent.

How does breach of the formalities requirement justify piercing? First, a court may believe that failure to observe a certain corporate formality directly impaired the interests of the plaintiffs in a particular case. For example, failure to keep the shareholder-owner's assets separate and distinct from those of the corporation may result in inadequate corporate resources to satisfy plaintiff's claim.[30] Similarly, failure to hold directors' meetings may prevent the board from assuring that the corpora-

26. 1 W. FLETCHER, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.10 (1958 & Supp. 1980).

27. *E.g.*, ORS 57.180-.241 (1979).

28. 3 W. FLETCHER, *supra* note 1, at § 990.

29. Burg v. Horn, 380 F.2d 897 (2d Cir. 1967); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Roche v. Golden Sky Lands, Inc., 107 Ariz. 335, 487 P.2d 756 (1971); L.E. Fosgate Co. v. Boston Market Terminal Co., 275 Mass. 99, 175 N.E. 86 (1931); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

30. *E.g.*, Holland v. Joy Candy Mfg. Corp., 14 Ill. App. 2d 531, 145 N.E.2d 101 (1957).

tion possesses adequate financial resources to insure against the risks of the business.

Few courts, however, specifically address the effect of neglected formalities on plaintiff's damages.[31] Therefore, a second and more general rationale is that when unfairness otherwise exists, if the shareholder-owner has disregarded corporate formalities, then the court, too, will disregard the distinction and hold the shareholder liable without inquiring into whether the failure of formalities actually caused the plaintiff's injury.[32]

It is also possible that all that is involved is a "makeweight argument"—if the shareholder-owner disregarded the entity, what prevents the court from doing the same?[33] This suggests, of

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31. One case in which the court did relate the disregard of corporate formalities to plaintiff's specific prejudice is Harrison v. Puga, 4 Wash. App. 52, 480 P.2d 247 (1971). There the court explained:

> The court must do so, however, for an adequate reason. Often the reason given is public advantage, requirements of justice, alter ego, fraud, bad faith, or other wrong. Such cases often mean nothing more than that the violation of duty will result if the entity is not disregarded. . . . First, when the corporate stockholder himself by his overt acts in dealing with the corporation disregards the separate entity of the corporation to the prejudice of such third person, he can scarcely complain if the court judges him by his conduct and likewise disregards the corporate entity in order to enforce the right owed to the person dealing with that corporation . . . . In the instant case, the defendant's overt intention to disregard the entity of Cascade Cablevision, Inc., is evidenced by the fact that he stripped the corporation of all its assets and took substantial assets in his own name for which he refuses to account to the corporation. He could scarcely have disregarded the corporation more.

Id. at 62-64, 480 P.2d at 254. Of course, in this case the formalities disregarded and the fraud perpetrated were essentially the same factors—commingling of personal and corporate assets. *Accord,* Wakeman v. Paulson, 257 Or. 542, 480 P.2d 434 (1971); Block v. Olympic Health Spa, Inc., 24 Wash. App. 938, 604 P.2d 1317 (1979).

32. Dillman v. Nobles, 351 So. 2d 210 (La. App. 1977) (bar owner-shareholder held personally liable for negligently causing injury since the corporation was deemed his mere alter ego; no board meetings were held, no minutes, records, bylaws or separate bank accounts; there was constant commingling of corporate and personal funds; all permits, leases and licenses were in the name of the owner personally, or in his name jointly with the corporation). *See also* Smith-Hearron v. Frazier, Inc., 352 So. 2d 263 (La. App. 1977).

33. *See, e.g.,* Zubik v. Zubik, 384 F.2d 267 (3d Cir. 1967). This was a suit in tort for damage caused by defendant's barges. The corporation was formed when Zubik was too ill to continue operating the barge business and wanted his children to run it. It borrowed heavily from Zubik, and the great bulk of the "assets" were leased from him. Payments to Zubik were credited on the company's books to his account, which was used for payment of his personal expenses. There was evidence of informal meetings—but no records were kept—and informal lessor-lessee relations. But no evidence existed that funds oscillated at will between the corporation and Zubik. Although the trial court pierced the corporate veil, the circuit court reversed, saying in part:

course, that the actual test is unfairness alone, and the formalities element is irrelevant—since only "makeweight formalities" have been disregarded. The disturbing part of this possibility is that other cases may occur in which the same unfairness is present, but all the formalities (even the makeweight ones) have been kept, with the court mechanically applying the two-prong test and ruling out piercing.[34]

In addition to the nature of the failed formalities, two other important issues arise with respect to the formalities prong. The first issue is whether to pierce the corporate veil when corporate formalities have not been kept, but those dealing with the corporation knew or should have known that they were dealing with a corporation rather than with an individual shareholder, and there is no other unfairness. The second issue is whether to pierce when corporate formalities have been kept but unfairness such as undercapitalization is present. These issues are discussed below.

C. *Contract Versus Tort Cases*

Consider the following illustrations:

1. *XYZ* Corporation, which is closely held by *X*, *Y* and *Z*, hires employee *B*. While driving a vehicle owned by the corporation and acting within the scope of employment, *B* hits *A*, causing extensive personal injuries. The issue, upon failure of the corporation to satisfy *A*'s claim for negligence, is whether the court will pierce the corporate veil and hold *X*, *Y* and *Z* individually liable for the duty owed to *A* under tort liability of *XYZ* Corporation.

> Once fraud or injustice demand piercing the corporate veil, then the intertwining of personal affairs with a family corporation can provide additional grounds for arguing that the defendant cannot be heard to complain. . . . But in the case of an old (71 at the time of trial), illiterate, ill man, the conduct of personal affairs through a family corporation not only has its separate justification unrelated to fraud or injustice but it fails as a "make weight" argument for ignoring the corporate entity.

Id. at 274.

34. *See* Grayson v. Nordic Constr. Co., 92 Wash. 2d 548, 599 P.2d 1271 (1979). The trial court had pierced because of unfairness, but the court of appeals reversed, holding that the corporation should not be pierced because all the formalities were kept, 22 Wash. App. 143, 589 P.2d 283 (1978), despite unfairness to the plaintiff. The Washington Supreme Court later reversed, holding the corporate officer liable because of his personal activity but specifically refusing to pierce the corporate veil. 92 Wash. 2d at 554, 599 P.2d at 1274.

2. *XYZ* Corporation, a closely held corporation with shareholders *X, Y* and *Z*, contracts with *A*. The issue, upon default by the corporation, is whether the court will pierce the corporate veil and hold *X, Y* and *Z* individually liable for the duty owed *A* by the corporation.

One might expect different treatment of these cases, since in contract cases the plaintiffs have a prior opportunity to investigate the corporation to determine adequacy of capitalization and other risks that may impair the corporation's ability to perform. Thus, if the corporation proves to be undercapitalized, the plaintiffs arguably assumed this risk since they had a prior opportunity to ask for personal guarantees from the shareholders and failed to do so. On the other hand, prior opportunity to investigate rarely exists in a tort case. Nevertheless, most courts mechanically apply the two-prong test to both situations.[35]

1. *Tort Cases*

Since the plaintiff in a tort case usually has engaged in no prior dealings with the corporation, it seems illogical in an unfairness case to require disregard of corporate formalities as a prerequisite to piercing. The courts have seldom recognized this point although commentators have advocated this position for several years.[36] The commentators argue that the doctrine of limited liability throws the burden of loss upon plaintiffs, making their recovery dependent upon circumstances such as observance of corporate formalities that are purely fortuitous and unrelated to the tort claim.[37] This result is especially unjust when the corporation is closely held and the shareholders are actively involved in its management, since these shareholders are not only responsible for the operational policies of the corporation giving rise to the tort, but also for its undercapitalization.

Many examples can be found in tort law in which one party attempts to shift liability to another only to have the courts look

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35. *See, e.g.*, Walkovsky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966), a tort case which cites Bartle v. Home Owners Co-op, 309 N.Y. 103, 127 N.E.2d 832 (1955), and Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942) as authority, both of which are contracts cases. *See also* Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations*?, 76 YALE L.J. 1190 (1967).

36. *See, e.g.*, Note, *Should Shareholders be Personally Liable for the Torts of Their Corporations*?, 76 YALE L.J. 1190 (1967).

37. *Id.* at 1195.

through the shifting arrangement and hold the original risk-generating party liable. For example, one who employs an independent contractor generally is not held vicariously liable for the negligent conduct of the latter—even while acting within the scope of the contract.[38] If the employer's duty, however, is nondelegable[39] or if the activity involved is intrinsically dangerous,[40] then the employer cannot avoid liability by hiring an independent contractor. These exceptions are analogous to the instance of an individual unfairly shifting liability to an inadequately capitalized entity for risk-generating activity. Nevertheless, the courts persist in applying the two prong test—unfairness *and* disregard of formalities—to corporate tort cases.[41]

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38. W. PROSSER, LAW OF TORTS § 71 (1971).

39. For example, the duty to keep premises safe for business visitors has been held by some courts to be nondelegable. Thus, a shopping center landlord was held vicariously liable when his independent contractor negligently repaired leased premises, resulting in injuries to the business invitee of the landlord's tenant. Misiulis v. Milbrand Maintenance Corp., 52 Mich. App. 494, 218 N.W.2d 68 (1974).

40. For example: blasting, use of fire to clear land. *See* RESTATEMENT (SECOND) OF TORTS § 416 (1965).

41. For example, Mull v. Colt Co., 178 F. Supp. 720 (S.D.N.Y. 1959), is a New York City cab company case that illustrates the unfair results which the rule of limited liability can lead to when applied to tort claims involving undercapitalized corporations. The case involved a personal injury inflicted through the negligent operation of a taxicab, which was owned by a two-cab corporation operated in conjunction with 99 other two-cab corporations (all owned by the same shareholders). The plaintiff was faced with satisfying a claim for more than $30,000 from one of the corporation's two used cabs and $5000 of liability insurance. The court recognized the inherent inequity in the situation in which the defendant used the corporate form as a device to avoid the financial responsibility normally associated with the operation of a large taxi fleet in a metropolitan area. Nevertheless, it stated:

> [A] very unfortunate situation exists in this great city for which there should be a remedy. . . but it is not of the character which . . . may be reached by judicial action . . . .
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> When all is said and done any notion of mine [Judge Metzner] as to fairness and justice in the circumstances must yield to "justice under law." Any other measuring rod would only create chaos. The state and municipal legislative bodies are the places where remedy must be sought.

Id. at 721-23.

The Colt Company was, at the time of the accident, carrying the minimum allowable insurance for taxicabs. This amount had been fixed by the legislature at $5000 for injury to one person. The stated purpose underlying the enactment of the compulsory insurance provision for taxicabs was to provide a means of recovery to those who suffered from the negligence of insolvent owners and to protect the riding public generally. Therefore, one explanation of the reluctance of the court here to pierce the veil may have been a view that the legislature had already set the standards of adequate capitalization and that the court unilaterally could or should not disturb this standard.

2. *Contract Cases*

In a few contract cases courts have recognized that because

A few courts have questioned this rule. For example, on a later hearing of Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962), the same court indicated:

> The sanctity of a separate corporate identity is upheld only insofar as the entity is consonant with the underlying policies which give it life. The separate personality of a corporation is a privilege granted by the legislature where an artificial person is created by the compliance with various forms and procedures. Certainly a concomitant of the favor of the sovereign in permitting a corporate form of doing business is that the conduct of the entity be compatible with the public interest. The corporate fiction is but a matter of commercial convenience; the concept is not to be extended beyond reason and policy . . . . When the statutory privilege of doing business in the corporate form is employed as a cloak for the evasion of obligations, as a mask behind which to do injustice, or invoked to subvert equity, the separate personality of the corporation will be disregarded.

Id. at 166. The court seems to indicate that a balancing of the interests of society is appropriate between (1) promoting commerce and industry by retaining limited liability of shareholders, as against (2) the public policy which seeks to charge those at fault with the cost of their own negligence. Presumably, this balancing could result in piercing the corporate veil in some situations in which unfairness exists even though the corporate formalities have been adhered to.

While this may be a possible implication of the court's statement in *Mull*, the case itself cannot be conclusively cited for this proposition since the issue in the case concerned the defendant's motion to dismiss for failure to state a cause of action, and the court simply held that the amended pleadings stated a cause of action upon which relief might be granted and remanded for a full trial.

Another limitation inherent in the *Mull* opinion is the basis on which the court found that the pleadings stated a cause of action. The court indicated that the consolidated assets of all of the corporations owned by the same shareholder or group of shareholders and which were found to be operated as a single entity (in substance although not in form) should be made accountable to satisfy the tort liability of any one of the corporations. There was no indication, however, that the personal assets of the shareholders behind these multiple corporations should be made subject to liability by piercing the corporate veil of the accumulated corporations.

Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961), is another case that has been cited as holding that inadequate capitalization (unfairness) by itself is enough to allow piercing of the corporate veil. *See* Note, *Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation*, 45 S. CAL. L. REV. 823 (1972).

In *Minton*, Seminole Hot Springs Corporation, operated a public swimming pool that it had leased from its owner. Seminole held no other assets. Further, though the corporation was duly organized, it never functioned as a corporation. The plaintiff's daughter drowned in the pool and the plaintiffs recovered a $10,000 judgment against the corporation for wrongful death. The judgment being unsatisfied, the plaintiffs brought an action against Cavaney to hold him personally liable for the judgment against the corporation. Cavaney, an attorney, was a director and the secretary-treasurer of the corporation. In the majority opinion, Justice Traynor stated,

> The equitable owners of a corporation . . . are personally liable when they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will; when they hold themselves out as being person-

of their prior opportunity to investigate the corporations with whom they dealt, plaintiffs carry a heavier burden of proof than is required in tort cases.[42] For example, when a reasonable investigation would reveal that the corporation is undercapitalized and the plaintiff, therefore, could require the personal guarantee of the corporation's shareholder(s), little justification remains for piercing the veil. Arguably, the court should assume that the parties to the transaction voluntarily distributed the risks between themselves in negotiating the contract terms.[43] In effect,

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> ally liable for the debts of the corporation; *or when they provide inadequate capitalization and actively participate in the conduct of corporate affairs.*

56 Cal. 2d at 579, 364 P.2d at 475, 15 Cal. Rptr. at 643 (emphasis added). The court went on to state, "No shares were ever issued," and:

> In the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. Seminole never had any substantial assets. It leased the pool that it operated, and the lease was forfeited for failure to pay the rent. Its capital was "trifling compared with the business to be done and the risks of loss. . . ."

Id.

The court held in *Minton* that Cavaney, as a shareholder, could not be held personally liable upon a judgment against the corporation for negligence, without an opportunity to relitigate the issues of the corporation's negligence and amount of damages, since Cavaney was not a party to the previous action against the corporation and did not control the litigation leading to the judgment against the corporation. Thus, the court reversed the trial court which had held Cavaney liable. Therefore, despite the language of the court (which might be read to say that undercapitalization by itself is enough to pierce the veil), it does not appear that *Minton* is good authority for the proposition for which it has sometimes been cited. Furthermore, it appears on the facts that in addition to undercapitalization there was also a disregard of the corporate formalities. (For example, the corporation had been organized but never functioned as such and no stock was issued). In addition, California cases subsequent to *Minton* have not taken the position that inadequate capitalization by itself is enough. For example, in Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 841, 26 Cal. Rptr. 806, 816 (1963), the court stated:

> Evidence of inadequate capitalization is, at best, merely a factor to be considered by the trial court in deciding whether or not to pierce the corporate veil. To be sure, it is an important factor, but no case has been cited, nor have any been found, where it has been held that this factor alone *requires* invoking the equitable doctrine prayed for in the instant case.

42. *See* Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937).

43. An article in the *Duke Law Journal* explains the nature of this assumption and its effect on undercapitalization as an unfairness factor in contract cases:

> While just and equitable limitations must be placed upon the limited liability mechanism, fundamental questions are begged by the literal enforcement of a "rule" that capital reasonably sufficient to meet anticipated obligations must be devoted to the business. Creditors, of course, are free to negotiate the terms upon which they will deal with the corporation. Thus, if a question exists as to the probable success of the venture, the creditors should insist upon an appropriate security for their advances or upon a personal guarantee of pay-

this approach modifies the two prong test for contract cases, requiring plaintiffs to show not only unfairness and disregard of corporate formalities but also that plaintiffs did not assume the risk by going ahead with the transaction.[44] While the commenta-

> ment from shareholders. Because of this contractual freedom and the opportunity for prior investigation into the stability of an enterprise, creditors should not be entitled to a judicial inquiry into the "reasonableness" of the capitalization of the corporation . . . . Consequently, except in cases where a sensible weighing of all the facts indicates a real abuse or perversion of the corporate privilege, courts ought to be constrained by statute from refusing to enforce limited liability principles.

Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525, 554.

44. For example, in United Paperworkers Int'l Union v. Penntech Papers, 439 F. Supp. 610 (N.D. Me. 1977), the court made this distinction in a contract case in which the plaintiff sought to hold the parent corporation liable for the contractual obligations of its subsidiary:

> It is well established that some degree of moral culpability on the part of the parent must be shown to establish liability for a contract of a subsidiary . . . . It is particularly so in contract cases because contracts are private, consensual relationships in which each party has a clear and equal obligation to weigh the potential benefits and risks of the agreement. Unless fraud or misrepresentation is involved, there can be little justification for disregarding corporate entities which the parties obviously expected to remain intact.

Id. at 617-18; *accord*, Bendix Home Systems, Inc. v. Hurston Enterprises, Inc., 566 F.2d 1039 (5th Cir. 1978); Portsmouth Cotton Oil Refinery Corp. v. Fourth Nat'l Bank, 280 F. 879 (M.D. Ala. 1922), *aff'd*, 284 F. 718 (5th Cir. 1922).

Even when the court does not find that the plaintiffs engaged in a conscious weighing of the risk, it may still treat the contractual obligation situation as an assumption of the risk of the corporation's undercapitalization by the creditor who deals with the corporation. For example, the court in Dewitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976), noted this heavier burden of proof:

> The reasoning is that when one extends credit or makes any other contractual arrangement with a corporation, it is to be assumed he acquaints himself with the corporation's capitalization and contracts on such basis, and not on the individual credit of the dominant stockholder.

Id. at 686 n.13. *See also* Note, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441 (1967).

A Massachusetts case, Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937), also has described the standard for piercing the corporate veil when the claimant had prior opportunity to investigate the corporation:

> The right and duty of the courts to look beyond the corporate forms are exercised only for the defeat of fraud or wrong, or the remedying of injustice. In the present case we have a corporation formed without substantial capital, relying on borrowing money to make valuable a hotel that it was buying on credit. The plaintiff dealt with that corporation. There is nothing to show that he was deceived. The fair inference is that he knew the worthlessness of the corporation with which he contracted, and knew that his contract was of no value unless the corporation could borrow money. He must have known that lenders have a habit of demanding security.

Id. at 381, 10 N.E.2d at 264. *See also* Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr.

tors uniformly argue for this distinction, it has not been followed by a majority of the courts.[45]

In evaluating the unfairness prong, the courts also should consider the sophistication of the party contracting with the corporation. If the prior opportunity to investigate is a consideration, then the plaintiffs' lack of sophistication is equally tenable against a presumption that they knowingly assumed the risk of the corporation's undercapitalization. The neophyte who contracts with a sophisticated corporate representative should be permitted to show that the parties did not consider allocation of risk at the time of contracting. No court in a contracts case, however, has considered the sophistication of the claimant as a relevant factor.[46]

D. Undercapitalization Cases

Whether in tort or contract, the essence of any request that the court pierce the corporate veil is the claimants' failure to collect a judgment against a corporation. Therefore, the adequacy of the corporation's capitalization looms large in the court's evaluation of the unfairness prong. A leading commentator on corporate law has emphasized the importance of this element in piercing situations:

> It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.[47]

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614 (1970); Bartle v. Home Owners Co-Op, 309 N.Y. 103, 127 N.E.2d 832 (1955). In Critzer v. Oban, 52 Wash. 2d 446, 326 P.2d 53 (1958), the court mentioned the contract creditor's opportunity to assess the capitalization of the corporation as one basis for not piercing the veil. Another basis cited by the court was that the corporation had complied with state law on minimum capital to begin business operations.

45. Note, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441 (1967).

46. In American Discount Corp. v. Saratoga West, Inc., 13 Wash. App. 890, 537 P.2d 1056 (1975), however, a corporate bankruptcy case in which plaintiff-creditor argued that the founder-sole shareholder's secured debt should be subordinated to plaintiff's claims, the court did mention the financial sophistication of plaintiff (a lawyer) as a factor in refusing to grant the subordination. *Id.* at 894-95, 537 P.2d at 1059.

47. H. BALLANTINE, BALLANTINE ON CORPORATIONS 303 (rev. ed. 1946).

1. *Undercapitalization in Contracts Cases*

An important issue in the context of contractual obligations of an undercapitalized corporation is whether the courts will pierce the veil absent a showing of noncompliance with corporate formalities.[48] While the two-prong test is applied uniformly in such cases, the courts arguably could apply different standards in different factual contexts. First, when corporate formalities have been observed and the plaintiff had an opportunity to investigate prior to contracting, courts should not pierce the corporate veil. A formalistic basis for this result is that corporate formalities have not been disregarded. A more persuasive basis is that the contract creditor has agreed to accept the risk of undercapitalization.[49]

48. Undercapitalization has been held to be *an* important factor, but not in itself conclusive. For example, in Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (1970), the court stated:

> The principal question is whether or not lack of capital contribution to the corporation is sufficient to make the individual shareholders liable, i.e., to pierce the corporate veil.
>
> There is no question that the corporation was underfinanced, a condition not uncommon among new small businesses, including small corporations privately financed. It is common knowledge that many such corporations have been highly successful, that others have prospered but without legendary success, and that still others have failed in part, at least, because of inadequate capital. Such in the story of our American enterprise system.
>
> Appellants would have us declare that, per se, inadequate capitalization renders the shareholders, officers and directors liable for the obligations of the corporation. They cite no case so holding, and we know of none.

Id. at 841, 87 Cal. Rptr. at 617-18.

An interesting Oregon case, Martinson v. Andrews, 219 Or. 280, 347 P.2d 53 (1959), seems at first blush to hold that the corporate veil may be pierced in a contracts situation (not one involving undercapitalization, however) on a showing of unfairness without proof that the formalities have been disregarded. On a close reading, however, the court's comments concerning piercing the veil of the corporation solely owned by the defendant were not necessary to the decision, since the contract itself was between plaintiffs and the defendant as an individual.

See also Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244 (1977), in which the court stated in dictum that the veil of a corporate general partner in a limited partnership may be pierced on the basis of undercapitalization alone.

49. An example of a case of this first type is Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 197 P.2d 167 (1948), in which a corporation with an initial capital of only $1200 had received cash prepayments of more than $19,000 of the plaintiff's money (and total prepayments of several times that from other creditors). In this case the court discussed the opportunity for the creditor to investigate the debtor's financial status prior to entering a transaction as a defense to a claim of undercapitalization. Thus, it is not clear from the opinion whether the court actually held that the corporation was adequately capitalized or not; what is clear is that the court found that even if the corporation was undercapi-

Second, when disregard of corporate formalities misleads contract creditors to assume that they are dealing with individual shareholders rather than with the corporation, the creditors clearly have not assumed the risk of the corporation's undercapitalization, and the individual shareholders should be held liable for what they argue are the corporate obligations.[50]

Third, when corporate formalities have been disregarded, but the contracting party had an opportunity to investigate and knew that the real party in interest is the corporation, the corporate veil should not be pierced. Disregard of corporate formalities is the only factor distinguishing this case from the first example discussed above; assumption of the risk of thin capitalization is the predominant factor in both cases. Nonetheless, some courts have permitted piercing in the third type of case[51] while others have refused to pierce even though both prongs of the traditional test have been met.[52] No logical reason exists to disregard the effect of the creditor's opportunity to investigate the credit of the corporation simply because the corporation disregarded some of the corporate formalities. A normal credit investigation will reveal financial data relating to the capital structure and business transactions of the corporation, but not whether stock has been issued or annual meetings held. Thus, usually no additional unfairness imposed by the corporation's failure to observe corporate formalities results to the

talized, the plaintiff still could not recover since he had assumed the risk of inadequate capitalization in setting the terms of the contract.

50. *See* notes 22-34 and accompanying text *supra.*

51. For example, in Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957), the court found that a $5000 contribution to capital (which may in fact never have been made) was not sufficient to support the corporation's monthly volume of gross sales of between $100,000 and $150,000. There was also a total lack of observance of corporate formalities, including the failure to issue stock, failure to hold directors' and shareholders' meetings, and lack of a separate bank account. The court disregarded the corporate form in spite of the plaintiff's prior opportunity and failure to assure himself of the adequacy of the corporation's financial resources to carry out its contractual undertakings.

52. For example, the veil was not pierced in Bendix Home Systems, Inc. v. Hurston Enterprises, Inc., 566 F.2d 1039 (5th Cir. 1978), in which the initial contribution to capital was also $5000, but in which the corporate formalities were, at least in part, observed. The court found that the plaintiff was undeceived about the defendant's financial position and that a reasonable inquiry would have revealed the need for some form of security. *See also* Plumbers and Fitters, Local 761 v. Matt J. Zaich Constr. Co., 418 F.2d 1054 (9th Cir. 1969); Arnold v. Browne, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972); Amoco Chem. Corp. v. Bach, 222 Kan. 589, 567 P.2d 1337 (1977).

plaintiff who does not inquire into the financial strength of the corporation. Only when the defendant provides misleading information or promises to stand behind the corporation's debts should a distinction be made and the corporate veil pierced.

2. *Subordination of Claims*

An alternative to piercing in contract situations involving an insolvent corporation is to subordinate the shareholders' claims to those of other creditors.[53] Even an unsecured creditor would take prior to a secured shareholder.[54] This remedy, which is much less drastic than piercing, usually arises in the liquidation or reorganization of the corporation pursuant to receivership or bankruptcy proceedings under the federal bankruptcy act, or in state insolvency proceedings.[55] Although the remedy usually has been applied in parent-subsidiary situations, no reason exists to limit its application. Subordination of claims is an equitable remedy granted when the shareholder-creditor has acted in bad faith towards other corporate creditors, or when corporate mismanagement adversely affects the corporation's ability to pay other creditors. It has also been applied in corporate undercapitalization cases.[56]

In the past some courts applied a presumption against shareholder-creditors that their actions were unfair to other creditors, making it difficult for shareholder-creditors to defend

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53. The doctrine was first applied by the United States Supreme Court in Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939), and is known as the "Deep-Rock Doctrine" because of the Deep Rock Oil Corporation, which was the subsidiary involved in the case.

54. *See generally* N. LATTIN, *supra* note 3, at 87-89.

55. *See* Albert Richards Co. v. The Mayfair, 287 Mass. 280, 191 N.E. 430 (1934); American Discount Corp. v. Saratoga West, Inc., 13 Wash. App. 890, 537 P.2d 1056 (1975).

56. For examples of the application of the Deep Rock Doctrine, see Pepper v. Litton, 308 U.S. 295 (1939); Bankers Life & Cas. Co. v. Kirtley, 338 F.2d 1006 (8th Cir. 1964); *In re* Commonwealth Light & Power Co., 141 F.2d 734 (7th Cir. 1944); Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941), *cert. denied*, 313 U.S. 583 (1941). For a comment on the Deep Rock Doctrine, see Israels, *The Implications and Limitations of the "Deep Rock" Doctrine*, 42 COL. L. REV. 376 (1942); Sprecher, *The Conflict of Equities under the "Deep Rock" Doctrine*, 43 COL. L. REV. 336 (1943); Stroia, *Deep Rock—A Post Mortem*, 34 U. DET. L.J. 279 (1957); Note, *"The Deep Rock Doctrine:" Inexorable Command or Equitable Remedy?*, 47 COL. L. REV. 800 (1947); Note, *Subordination of Stockholder Loans on the Ground of Corporate Undercapitalization*, 23 MD. L. REV. 260 (1963). Note that undercapitalization is usually present in the cases in which this doctrine is applied.

against subordination.[57] The rationale supporting this presumption was that the debts owed by the corporation to the shareholders should be treated as if they were invested capital, which is always subordinate to the debts and obligations of the firm. The issue here is not whether a debt exists or whether the shareholder should be ordered to pay the debts of the corporation but whether fairness dictates that nonshareholder creditors should receive priority in the payment of the corporation's debts in insolvency.

3. *Tort Cases*

The two-prong test should not apply to tort victims of an undercapitalized corporation. In these cases, the limited liability of shareholders shifts the burden of the loss to the tort victim and works to thwart the objectives of modern tort law: compensation for the injured party, deterrence of future accidents, and punishment of the personally culpable.[58] This is particularly true in the close corporation context in which the shareholders are also the officers responsible for the operational policies of the corporation which gave rise to the tort, and the failure to provide for sufficient assets or insurance to meet reasonably anticipated risks of the business.

4. *Making a Determination of Adequate Capital*

The task for the lawyer in advising a closely held corporation on what amount of capital is adequate is extremely difficult. It is possible, however, to establish some guidelines for deciding whether sufficient capitalization exists to avoid piercing.

The courts begin with the rule that capitalization must be adequate to cover the reasonably foreseeable risks of the business.[59] This inquiry assumes that, prior to the commencement of

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57. The Second Circuit had embraced the former view in *In re* V. Loewer's Gambrinus Brewery Co., 167 F.2d 318 (2d Cir. 1948), but was forced to abandon it in Gannett Co. v. Larry, 221 F.2d 269, 275 (2d Cir. 1955), because of the Supreme Court's holding in Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948).

58. *See* Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190 (1967); notes 36-41 and accompanying text *supra*.

59. Gounares Bros. & Co. v. United States, 185 F. Supp. 794 (S.D. Ala. 1960); Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Kilpatrick Bros., Inc. v. Poynter, 205 Kan. 787, 473 P.2d 33 (1970). *Contra*, Critzer v. Oban, 52 Wash. 2d 446, 326 P.2d 53 (1958)(adequate capitalization determined by state statute setting forth minimum capital contribution to begin business). For complete discussion, see 1 W.

the corporate undertaking, prudent businessmen consider the amount of capital required to finance the operations of the business. Presumably, start-up costs, near-term cash flow needs, and long-range financing are all considered in this initial financial planning process. Theoretically, after a consideration of these and other factors, if the operation shows the promise of generating a favorable return on investment, the incorporators will proceed with the venture. If not, the project will be aborted.

After deciding to proceed, the incorporators must next determine an appropriate capital structure. Two sources of investment capital are available: debt (money from outside sources, such as banks) and equity (permanent capital such as common stock, contributed by the principals or shareholders of the corporation).[60] The inability of a new corporation to borrow money without an equity base or the personal guarantee of the incorporators often determines the blend of debt capital and equity capital. As the corporation matures, the mixture of debt and equity is determined by the relative risk and return possibilities associated with the two forms of capital.[61] Debt financing carries a higher degree of risk to the corporation than equity capital since the payment of interest is a fixed obligation and must be paid out of operating revenues. Dividends paid on equity are discretionary.[62] On the other hand, borrowing when the corporation can earn a return greater than the interest rate adds to corporate profits.

Undercapitalization may exist in at least two forms: (1) the total investment in the corporation in the form of debt and equity is adequate for the reasonably foreseeable risks associated with the business, but the debt is excessive when compared to the capital supplied by the shareholders; and (2) the total investment in the corporation in all forms is inadequate to run the business.[63]

No general rule has been articulated by the courts for determining adequate capital. A variety of different conceptual ap-

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FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 44.1 (1974).

60. *See generally* 1 F. O'NEAL, CLOSE CORPORATIONS §§ 2.08-.13 (2d ed. 1971 & Supp. 1980).

61. *Id.*

62. N. LATTIN, *supra* note 3, at 533.

63. Note, of course, that even if capital were inadequate to cover the reasonably foreseeable risks of the business, these risks might be appropriately covered by insurance.

proaches, with a comparison of their relative merits, are considered.

a. *The Financial Analysis Approach*

One test for adequate capital often mentioned by the courts is the comparison of the capitalization of companies in the same industry.[64] The underlying concept is that the current financial condition of the company should be assessed by looking at the company's balance sheet and projected operations to determine, in light of the risks of the business, whether the capitalization is adequate. Such an analysis provides some indication of whether the contractual obligations of the company are reasonably covered. A bank examines certain specific financial data in making

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64. For example, the *Symposium on the Close Corporation*, 52 Nw. U.L. Rev. 345 (1957), identifies the following factors which have been applied by the court in piercing situations:

> [a] [E]xamination of the capital needs of a soundly financed company of a size and nature similar to the one being formed. The fact that a comparable company has capital equal to or less than the corporation in question would tend to indicate that the suspect corporation is not undercapitalized.

Id. at 369.

Two difficulties should be noted with this test: (1) It may be difficult to find a firm which is really comparable; (2) the financial success of an enterprise is in part dependent on factors other than the amount of available capital, such as the ability of management or general trends in the economy.

> [b] [Inquiry into] whether a non-stockholder would have loaned the corporation money at the time when the stockholders made their loans. If an outsider would not have, . . . the corporation did not have sufficient capital represented by stock.

Id.

This test overlooks that capital may not be available to the corporation, not because of the financial condition of the company, but because of factors in the money market which make loans difficult to obtain. Proof of the facts may also be difficult after several years of operation in the corporate form.

> [c] One court [separated] advances by the stockholders during the first year [from] later advances, [holding those made in the first year to be capital contributions while those made later were bona fide debt]. *See* Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1947), *cert. denied*, 313 U.S. 583 (1947). This test is applicable where the shareholders seek to share in the division of assets of the bankrupt corporation along with other secured creditors.

Id.

> [d] [E]xamination of the purpose for which the loan was made. [Where] the stockholder makes a loan for a purpose which is continued and of uncertain duration, the loan is treated as a contribution to capital rather than as a legitimate debt.

Id. at 370. The court is faced with the difficulty of determining what constitutes a "continual purpose" under this test.

loans to businesses,[65] and informed investors perform a similar

65. The most useful of the many financial ratios which might be considered in evaluating the adequacy of capital would be those which are concerned with the existing or present financial condition of the corporation. These include:

(1) *Current Ratio* - gives a rough indication of the firm's ability to meet its current obligations. If current assets exceed current liabilities by a comfortable margin, the firm should be able to pay its current bills. This ratio also measures the margin of safety that management maintains in order to allow for unevenness in the flow of funds through the current asset and liability accounts.

(2) *Acid-Test Ratio* - measures the extent to which liquid resources are readily available to meet current obligations. If this ratio is not at least 1:1, for example, then the corporation can be expected to have difficulty meeting its current obligations.

(3) *Debt/Equity Ratios* - gives an indication of the solvency of the corporation or its ability to meet the interest costs and repayment schedules associated with its long-term obligations. Debt capital carries a greater risk to the corporation because bondholders and creditors can take legal action if they are not paid promptly. This can ultimately force a business into bankruptcy. The corporation while it would prefer to finance its operations with equity capital, must pay a higher overall cost for obtaining its capital in this manner.

(a) *Debt/Capitalization Ratio* - a variation of the debt/equity ratio which shows the percentage of invested capital accounted for by debt.

(4) *Times Interest Earned* - a measure of the level to which income can decline without impairing the company's ability to meet interest payments on its liabilities. If preferred stock is outstanding, a similar ratio can be worked out for the dividends on the preferred shares. Other fixed charges may be dealt with in a similar manner, creating a ratio known as "Fixed Charges Coverages" or "Time Fixed Charges Earned."

Many sources contain average ratios of companies in the same industry or of a similar size. The best known of these is prepared by Dunn & Bradstreet, Inc., which publishes 14 ratios for each of 125 industry groups. A variety of ratios is also found in *Moody's Manual of Investments, Standard and Poor's Corporation Records*, and other publications prepared for investors.

Use of industry-wide ratios or those of just one other corporation for comparison involve difficulties which may be hidden by the apparent objectivity of the figures (i.e., sometimes a higher number does not mean better performance; there may be differences in the situations being compared, dollar values change over a period of time, differences may be found in the way terms are defined, short-run changes may be hidden, and the past may not be an accurate indication of what will occur in the future), but the analysis of these ratios could provide additional evidence on the question of whether capitalization is adequate. Corporations with an operating history would provide a greater range of figures for comparison since the change in ratios over time could be observed, as well as comparisons with the performance of other corporations.

The analysis of financial data could very well require the use of an expert witness since, as is pointed out above, the figures by themselves may be misleading. It is recognized that one of the most useful skills of business analysts is the experience they gain only after numerous examinations of balance sheets and income statements. After a time, the seasoned investment counselor achieves an intuitive feel for what is a "good" current ratio or debt to equity ratio. He or she can sense an imbalance among ratios which leads to more detailed analysis of a given area. The need for expert testimony in analysis in deciding whether to purchase a corporation's stock. A court could look at the same or similar factors to make a reasonably sophisticated decision on whether the capitalization of a business was adequate for the associated risks.

Counsel should advise new closely held corporations to assess probable business risks and reflect the assessment in the corporate minutes. Most good business plans used in the formation of new companies adopt this approach, although the business plan and its financial projections are not made expressly for the purpose of dealing with the piercing problem.

Despite the ready application of business concepts and methodology, most courts have made little or no effort to explain the basis upon which they find adequacy of capital. As a result, the opinions give little guidance to those attempting to assure themselves that this issue would not be decided against them if challenged.[66]

b. *The Insurance Approach*

To cover reasonably anticipated risks of the business, it has been suggested that a corporation should be required either to maintain a sufficient quantity of realizable assets or to purchase liability insurance of specified limits.[67] This is much simpler

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development of evidence relating to capitalization would not present a problem which has not been resolved by the use of experts in other specialized areas. A large body of qualified "experts," including CPA's, financial and business planners, securities analysts and investment counselors, is readily available to serve the court in evaluating the corporate financial structure.

66. For example, in Automatriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957), the court found that an original contribution to capital of $5000 was inadequate to operate a business with gross sales of between $100,000 and $150,000 a month. After simply stating these figures, the court concludes that the capitalization is inadequate—without any discussion of cash flow, the capital structure of other comparable businesses or any other factor which would be considered by an informed investor or a bank considering a loan to the corporation.

In Claremont Press Publishing Co. v. Barksdale, 187 Cal. App. 2d 813, 10 Cal. Rptr. 214 (1960), the court found that when the plaintiff, a printer, had advised the defendant that he should have at least $10,000 of initial capital to fund the publication of a newspaper, a contribution of $500 was inadequate. The plaintiff's advice is accepted as though it is unquestionably a reasonable amount and no further inquiry is made into the matter. This approach is not only unsophisticated, but also fails to consider that the plaintiff with knowledge of defendant's undercapitalization (since he was the one who gave the advice) continued to accept the publisher's notes for more than two years without any security. Some courts would hold, under such circumstances, that the unfairness prong of the two prong test had not been satisfied.

67. The article cited at note 51 *supra*, discusses these alternatives in some detail,

than making periodic financial projections, and since the principles of risk analysis for insurance purposes are relatively well established in the financial community, it is probable that the insurance approach provides more assurance to the closely held corporation's shareholders that business risks are covered adequately and that piercing will not occur.

Under the insurance approach, the issue is how much insurance is required. The task is not to assure that *all* tort victims will have a remedy, but rather than the corporation is adequately capitalized for the reasonably foreseeable risks of the business. Of course, the potential for tort losses cannot be calculated precisely, but actuarial studies can provide a range of reasonably anticipated losses based on the risks associated with a given class of business. Catastrophic losses might not be covered if their frequency is so low that they can be eliminated as a reasonably foreseeable risk. If the frequency is not low, however, then even high value losses probably should be included in the risk calculation. The determination of "reasonably anticipated losses" is based on the principles of probability, and data has been gathered for all major industries for insurance purposes. These figures could provide a basis to determine whether capitalization is adequate for potential tort liability of the corporation.[68]

c. *Statutory Solution—Minimum Capital*

An extension of the insurance theory would be to enact special statutes for closely held corporations, requiring the entity to carry liability insurance of specified limits as a prerequisite to limited liability for the shareholders. The corporate veil of corporations failing to carry the minimum amount required would be disregarded and the shareholders would be personally liable as a matter of law for the torts of the corporation. The inflexibility of treating all corporations the same, however, militates against the adoption of this approach.

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suggesting a revision of state corporation statutes treating closely held corporations (defined as those corporations with 25 or fewer shareholders) differently from publicly held corporations. The author would remove limited liability from the closely held corporation unless the shareholders met a requirement of carrying some specified limit of insurance against liability for tort injuries.

68. R. Mehr & B. Hedges, Risk Management in the Business Enterprise 207-92 (1963).

d. *Abolish Corporate Veil for New Companies*

A final approach is to eliminate completely the limited liability of shareholders in closely held corporations. In light of modern business practices, including the personal guarantee that lenders normally require from shareholders in closely held corporations, abolishment of limited liability might not be a serious impediment to the development of commerce and industry. The shareholders would be forced to purchase liability insurance with realistically established limits to protect their personal wealth not committed to the business. This approach may be more in tune with modern tort concepts than the uncertain and sometimes arbitrary results of the piercing cases.

5. *When Adequacy of Capital Must Be Determined*

In considering adequacy of capital, the initial capitalization is not as important as the amount of capital available to satisfy claims either on the date of entering into a contractual agreement or on the date when tort liability is incurred. While the notion of continuous ability to satisfy claims has been implicitly recognized in a number of decisions,[69] it has been explicitly stated by very few.[70] Thus, although the better position is that measurement should be made when the claim against the corporation is made or when the contractual agreement which gives rise to a claim is undertaken, initially adequate capitalization is all that courts require.[71]

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69. *E.g.*, Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (1970). *See generally* 1 F. O'NEAL, *supra* note 60, at §1.10, n.6.

70. One of the few judicial opinions to give explicit recognition to this idea is DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976), which contains a discussion of both initial and ongoing financial responsibility as factors for determining when the corporate form is to be disregarded:

> One fact which all of the authorities considered significant in the inquiry, and particularly so in the case of the one-man or closely-held corporation, is whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking. [Citations omitted.] And "[t]he obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter—during the corporation's operations."

Id. at 685.

71. *See* Dix, *Adequate Risk Capital*, 53 NW. U.L. REV. 478 (1958).

III. Piercing the Veil Between Parent and Subsidiary Corporations

In addition to the closely held corporation context, the corporate veil may be pierced when a plaintiff who has contracted with a subsidiary corporation seeks to hold the parent corporation liable as the shareholder-owner of the subsidiary.

One would expect to find no differences in the legal theories applied in these two contexts. While in some cases courts have treated the two forms identically,[72] in others special rules have been applied to the parent-subsidiary context.[73]

A. *The Two-Prong Test*

In the parent-subsidiary context, the piercing test is the same—disregard of formalities and unfairness.[74]

As in the close corporation context, disregard of the formalities prong is stated in several ways. It may be labelled the "alter ego" theory,[75] or the "instrumentality rule,"[76] or the "mere agent" or "adjunct" theory.[77] However expressed, the substance of this part of the test is the degree of control that the parent exercises over the subsidiary and the extent to which the corporate formalities of the subsidiary are observed.

This formalities requirement is recognized in all jurisdictions.[78] The problem, therefore, is to determine the circumstances that render the subsidiary an "instrumentality." Although one alone may suffice, more typically a combination of the following factors may constitute the necessary control:[79]

72. *E.g.*, Brown v. Margrande Compania Naviera, 281 F. Supp. 1004 (E.D.Va. 1968). *See generally* H. Henn, *supra* note 7, at 258.

73. *Id.*

74. *See* New York Trust Co. v. Carpenter, 259 F. 668 (6th Cir. 1918).

75. Fisser v. International Bank, 282 F.2d 231 (2d Cir. 1960); Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Serv. 217 Cal. 124, 17 P.2d 709 (1932); Howco Leasing Corp. v. Oregon Lumber Export Co., 283 Or. 225, 582 P.2d 4 (1978).

76. Brown v. Margrande Compania Naviera, 281 F. Supp. 1004 (D.C. Va. 1968); Lowendahl v. Baltimore & Ohio R.R. Co., 247 A.D. 144, 287 N.Y.S. 62, *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936); Keuckelhan v. Federal Old Line Ins. Co. (Mut.), 69 Wash. 2d 392, 418 P.2d 443 (1966).

77. Fitz-Patrick v. Commonwealth Oil Co., 285 F.2d 726 (5th Cir. 1960); Tennessee Consol. Coal v. Home Ice & Coal Co., 25 Tenn. App. 316, 136 S.W.2d 454 (1941); H.E. Briggs & Co. v. Harper Clay Products Co., 150 Wash. 235, 272 P. 962 (1928). *See also* Annot., 38 A.L.R.3d 1102 (1971).

78. J. Powell, Parent and Subsidiary Corporations 76 (1931).

79. Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

(1) the parent corporation owns all or most of the capital stock of the subsidiary;
(2) the parent and subsidiary corporations employ common directors or officers;
(3) the parent corporation finances the subsidiary;
(4) the parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation;
(5) the subsidiary has grossly inadequate capital;
(6) the parent corporation pays the salaries and other expenses or losses of the subsidiary;
(7) the subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation;
(8) in the papers of the parent corporation or in the statement of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own;
(9) the directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest;
(10) the formal legal requirements of the subsidiary are not observed;
(11) the parent corporation uses the property of the subsidiary as its own.

Parent-subsidiary relationships usually result from carefully planned acquisitions or from the creation of a new corporate entity specifically intended to shield its parent from liability for some risk inherent in the parent's operations. Therefore, in contrast to the sole shareholder-close corporation context, it is unusual to find a parent that ignores corporate formalities in its dealings with its subsidiary. As a result, the degree of control exercised by the parent over its subsidiary is of relatively greater importance in the court's decision whether to pierce the corporate veil.

Some cases indicate that the veil between parent and subsidiary will be pierced if the subsidiary is the mere instrumentality of the parent, even though the unfairness prong of the test is not met.[80] Many other courts,[81] and the commentators in gen-

80. *E.g.*, Platt v. Bradner Co., 131 Wash. 573, 230 P. 633 (1924). A later and more often cited Washington case, Pittsburgh Reflector Co. v. Dwyer & Rhodes Co., 173 Wash. 552, 555, 23 P.2d 1114, 1115 (1933), states the rule this way:

eral,[82] indicate that both control and unfairness must be established to pierce the subsidiary's veil. In most if not all of the cases that advocate the control test alone, either the element of fraud or other unfairness is mentioned in the opinion,[83] fraud or unfairness exists on the facts,[84] or the expression of a requirement that fraud or other wrong exists is hidden in the judicial expression that the "instrumentality rule" will be applied only in "a proper case."[85]

Besides the traditional two-prong piercing theory, two other prominent theories are applied in cases finding the parent corporation liable for obligations of the subsidiary. One is the estoppel theory, the other is the agency theory; both are based on well-developed legal principles outside the field of corporate law.

> In order to justify the judicial disregard of corporate identities, one, at least, of two things must clearly appear. Either the dominant corporation must control and use the other as a mere tool or instrument in carrying out its own plans and purposes so that justice requires that it be held liable for the results, or there must be such a confusion of identities and acts as to work a fraud upon third persons. In most, if not all, of the Washington decisions in which corporate entities have been disregarded, both elements have appeared, and there is strong authority for the rule that both elements (if there be two) must appear in order to warrant relief.

81. *E.g.*, New York Trust Co. v. Carpenter, 250 F. 668 (6th Cir. 1918); E.A. Schlecht v. Equitable Builders, Inc., 272 Or. 92, 535 P.2d 86 (1975).

82. *E.g.*, J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 76 (1931).

83. *Id.* at 46-47.

84. *Id.*

85. *E.g.*, United States v. Reading Co., 253 U.S. 26 (1920); Chilean Nitrate Sales Corp. v. The Nortuna, 128 F. Supp. 938 (S.D.N.Y. 1955); *see In re* Watertown Paper Co., 169 F. 252 (2d Cir. 1909). In *Watertown Paper Co.*, the court stated:

> Unless, therefore, it can be shown that some exception to the general rule of separate corporate existence and liability applies in this case, it must follow that the claim of the Pulp Company should have been allowed. The only exceptions to that rule possibly applicable here are: (1) The legal fiction of distinct corporate existence will be disregarded, when necessary to circumvent fraud. (2) It may also be disregarded in a case where a corporation is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality or adjunct of another corporation.

Id. at 256.

Note that in the second exception mentioned by the court in this case, nothing is said about any other requirement than control. On the facts before the court, however, no fraud was established, the separate corporation's formalities were observed, insufficient control was exercised by the parent to make the subsidiary a mere instrumentality, and the court did not pierce the veil of the subsidiary. Thus, at best, the court's statement is dictum.

B. *The Estoppel Theory*

In a number of parent-subsidiary cases,[86] "estoppel" is used as the basis of the decision. In some instances, the facts make the case analogous to a technical common law estoppel.[87] For example, the parent states to the party doing business with the subsidiary that it guarantees the obligations of the subsidiary, and the third party relies on that representation to its detriment. In other situations estoppel is simply another term describing the situation in which the parent has so controlled the subsidiary that the latter is a mere instrumentality and the parent is "estopped" to claim the corporate shield.[88] Facts establishing estoppel may also satisfy the two-prong test for piercing the veil. Dominance by the parent may be shown by stock ownership of the subsidiary and the representations of the parent; unfairness may also be based on the representations made by the parent, as when the subsidiary actually does business using the name of the parent.

C. *The Agency Theory*

Sometimes in parent-subsidiary cases the relationship is described as that of principal and agent.[89] Many cases use the term agent as the equivalent of instrumentality in the piercing test.[90] In other instances, the courts imply that two distinct types of cases exist: cases of agency, and cases of piercing the corporate veil.[91]

To illustrate, Corporation *A*, by written contract, expressly makes Corporation *B* its agent; according to agency law, this

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86. *E.g.*, Almirall & Co. Inc. v. Vic Clement, 207 A.D. 320, 202 N.Y.S. 139 (1923); Quaid v. Ratkowsky, 183 A.D. 428, 170 N.Y.S. 812 (1918), *aff'd without opinion*, 224 N.Y. 624, 121 N.E. 887 (1918).

87. *See* Quaid v. Ratkowsky, 183 A.D. 428, 170 N.Y.S. 812 (1918), *aff'd without opinion*, 224 N.Y. 624, 121 N.E. 887 (1918).

88. *See* J. Powell, Parent and Subsidiary Corporations 66 (1931).

89. *E.g.*, Wyoming Construction Co. v. Western Cas. & Surety Co., 275 F.2d 97 (10th Cir. 1960), *cert. denied*, 362 U.S. 976 (1960). *See generally* H. Henn, *supra* note 7, at 259.

90. Radio-Craft Co. v. Westinghouse Elec. & Mfg. Co., 7 F.2d 432 (3d Cir. 1925); Platt v. Bradner, 131 Wash. 573, 230 P. 633 (1924).

91. Thus, the court in New York Trust Co. v. Carpenter, 250 F. 668 (6th Cir. 1918) stated: "[I]n all the decisions we have examined, in which corporate entity has been disregarded, the reasons were principles of agency, or estoppel, or because justice required it." *Id.* at 677. *See also* Evalsons v. Industrial Covers, Inc., 269 Or. 441, 525 P.2d 105 (1974).

makes *A* liable for obligations of *B* incurred within the scope of the agency. In this situation, Corporation *A* may or may not be the parent corporation of *B*. With respect to *A*'s liability, it makes no difference whether *B* is the mere instrumentality of *A*; the result is the same whether the agency is established by written agreement or express oral agreement.[92] Actually, if an express agency exists, a person contracting with Corporation *B* and attempting to hold Corporation *A* liable might not argue the piercing doctrine at all, since unfairness must be proved to recover.

The difficulty in squaring agency theory with traditional piercing theory arises when an agency is implied from conduct of the parent and its subsidiary. The problem is that the facts used to establish control for the instrumentality prong of the piercing test are the same facts that would imply agency. Thus, the parent corporation may be liable under an implied agency theory when no liability would exist under the piercing test.

Numerous situations exist in which this problem can arise. For example, many subsidiary corporations are wholly owned by parent corporations, they employ the same executives, the same directors, and the subsidiary is run solely for the interest of the parent. Under common principles of agency, the subsidiary in this situation is the agent of the parent corporation, since a similar degree of control between two individuals would result in an implied agency.[93] In these situations, the courts have refused to employ logic and instead apply agency law; they hold the parent liable only when the piercing test has been met, requiring *both* control *and* unfairness.[94] If they held otherwise, the rules of agency would largely destroy the protection afforded shareholders by incorporation.

This problem with application of agency law has not been extensively discussed in the close corporation-shareholder context,[95] although it does not appear that any reason exists why

92. W. SEAVEY, LAW OF AGENCY 32-33 (1964).

93. *Id.* at 13.

94. H. HENN, *supra* note 7, at 258.

95. *See* Mull v. Colt Co., 178 F. Supp. 720 (S.D.N.Y. 1959), which states:

The theory of agency is used in intercorporate dealings. It is inappropriate if the purpose of piercing the corporate veil is to reach the individual stockholder, because, as is pointed out above, the very purpose of doing business in the corporate form is to relieve the stockholder of liability absent extraordinary circumstances such as fraud or illegality.

the agency theory should apply in one context and not in the other.

IV. Conclusion: Advice to Closely Held Corporations

While the piercing doctrine is uncertain in many respects, the prudent businessperson can take certain measures to protect the shareholders from personal liability. The following recommendations for insuring limited liability are offered:

1. *Formalities Element*

a. At the time of incorporation:
   (1) file articles of incorporation with the proper state and local authorities;
   (2) issue stock, providing certificates to all shareholders of record;
   (3) provide at least the minimum capital required by law and make sure that all subscribed shares are actually paid for;
   (4) establish a separate bank account in the corporation's name.

b. After incorporation:
   (1) hold the annual shareholders' meetings;
   (2) hold regular meetings of the board of directors (also include a nonshareholder on the board);
   (3) keep accurate records of all such meetings;
   (4) do not commingle corporate and personal funds;
   (5) document all loans to the corporation by the shareholders—show the purpose for the loan and the reason that funds were not obtained from outsiders;
   (6) if possible, pay regular dividends which represent a reasonable return on investment;
   (7) always use the corporation's name in dealing with the public and require that authorized parties sign all documents as agents for the corporation, stating their relationship to the corporation.

2. *The Fairness Prong*

Id. at 722.

Note also that Ballantine stated that most of the cases on piercing the veil in the close corporation context can "be explained by a liberal interpretation of the ordinary agency rules." He did not explain what a "liberal" interpretation meant. *See* Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CAL. L. REV. 12, 21 (1925).

a. *Capitalization:*
(1) document the reason for selecting a given capital structure, including any comparable businesses studied (and past operating experience, if the entity was established prior to incorporation);
(2) provide a fixed maturity date and reasonable interest rate for any loan made to the corporation by a shareholder;
(3) prior to incorporation, discuss the range of contemplated activities and specifically evaluate the reasonable risks of torts liability associated with the business, document reasons for selection of the amount of liability insurance, and consult a competent insurance broker for advice in assessing the risks and getting insurance;
(4) provide all contracting parties with accurate financial data prior to any contractual agreements;
(5) maintain a balance between debt and equity which is in line with the debt-equity ratio of other businesses of the same type.

b. *Other factors:*
(1) avoid diversion of corporate assets or funds to shareholders, parent corporations, or related entities for other than corporate uses;
(2) do not allow any shareholders or agents of the corporation to represent that they will be personally responsible for the obligations of the corporation;
(3) do not establish a separate corporation for conducting a single business venture (particularly one with high risk) unless adequate capital or insurance is provided for the venture;
(4) make the names of all shareholders available to those who deal with the corporation.

3. *The Agency Theory*

a. Observe corporate formalities and avoid unfairness.

b. Avoid domination by the parent or sole-shareholder(s):
(1) maintain separate management groups in parent and subsidiary corporations, vesting management in the subsidiary with decision-making authority appropriate to their position;
(2) make all transactions between parent and subsidiary or corporation and control person(s) arm's-length bargains in which customary profits are included;

> (3) avoid ratification of the subsidiary's or corporation's acts by the parent or shareholders to assure that agency does not arise through estoppel;
> (4) establish and expressly state policies which indicate that the corporation or subsidiary must operate to the benefit of the entity, not to serve purely the interests of the controlling shareholder(s) or parent corporation.

Although historically the law on piercing the corporate veil moved slowly in the direction of permitting piercing in more and more situations, if the economic climate in the 1980s remains as difficult and chaotic as in the latter part of the 1970s, this trend may reverse. To encourage business, courts may begin to pierce the veil only in extreme circumstances.