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## Corporations—Corporate Entity—Solely Owned Corporations

The concept of the corporate "entity" is accepted generally as the rationale for keeping the corporate rights and liabilities separate from the rights and liabilities of the shareholders.<sup>1</sup> There is authority to the effect that this "separateness" exists even where the corporation has met the statutory requirement for incorporators and directors by the use of "dummy" shareholders.<sup>2</sup> Further, except in Kentucky<sup>3</sup> (at least in this century), it has been held consistently that the acquisition of all the stock by a single shareholder does not *per se* destroy, suspend or impair the corporate entity.<sup>4</sup>

<sup>1</sup> BALLENTINE, CORPORATIONS, § 118 (1946); Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW AND CONTEMPORARY PROBLEMS 473 (1953); Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597 (1936); Machen, *Corporate Personality*, 24 HARV. L. REV. 347 (1911).

See also: Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CALIF. L. REV. 12 (1925); Ballantine, *Disregarding the Corporate Entity as a Regulatory Process*, 31 CALIF. L. REV. 426 (1942); Canfield, *Scope of Corporate Entity Theory*, 17 COL. L. REV. 128 (1917); Radin, *The Endless Problem of Corporate Personality*, 32 COL. L. REV. 643 (1932); Wormser, *Piercing the Veil of Corporate Entity*, 12 COL. L. REV. 496 (1912); Note, *Disregarding Corporate Entity in One-Man Company*, 13 CALIF. L. REV. 235 (1925).

<sup>2</sup> *Irving Co. v. Bond*, 74 Fed. 849, 852 (1896); *Salomon v. A. Salomon & Co.*, L. R. (1897) A. C. 22; cf. *Montgomery v. Forbes*, 148 Mass. 249, 19 N. E. 342 (1899); *Jackson v. Hooper*, 76 N. J. Eq. 592, 75 Atl. 568 (1910).

However, the presumption is that the single shares outstanding in directors are beneficially owned by the principal stockholder or their existence is disregarded as immaterial. This "beneficial ownership" is then used as the basis for the disregard of the corporate entity where equity requires. *Meizlich v. San Francisco Wool Sorting Co.*, 213 Cal. 668, 3 P. 2d 310 (1931); *Montgomery v. Central Nat. Bank & Trust Co.*, 267 Mich. 142, 255 N. W. 274 (1934); *Hanson Sheep Co. v. Farmers' and Traders' State Bank*, 53 Mont. 324, 163 Pac. 1115 (1917); *Stony Brook Lumber Co. v. Blackman*, 286 Pa. 305, 133 Atl. 556 (1926); *Marchman v. McCoy Hotel Operating Co.*, 21 S. W. 2d 552 (Texas Civ. App. 1929); *Western Securities Co. v. Spiro*, 62 Utah 623, 221 Pac. 856 (1923); *Newton v. Tracy Loan and Trust Co.*, 88 Utah 547, 40 P. 2d 204 (1935); *Roberts v. Hinton Land Co.*, 45 Wash. 464, 88 Pac. 946 (1907).

See also: Fuller, *The Incorporated Individual: A Study of the One-Man Corporation*, 51 HARV. L. REV. 1373, 1375 (1938); Masten, "One Man Companies" and Their Controlling Shareholders, 14 CANADIAN BAR REV. 663 (1936); ROHR-LICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES, § 4.06 (1949).

<sup>3</sup> Ownership of all the stock by one person results in "suspension" (but not dissolution) of the corporation until the incoming of new members, *Russell Lumber & Supply Co. v. First Nat. Bank of Russell*, 262 Ky. 388, 90 S. W. 2d 272 (1936).

See also: *Hawley Coal Co. v. Bruce*, 252 Ky. 455, 67 S. W. 2d 703 (1934); *Louisville Banking Co. v. Eisenman*, 94 Ky. 83, 21 S. W. 531 (1893).

Cases in accord with the "suspension" or "abeyance" concept, but *not* in this century are: *Bank of Gadsen v. Winchester*, 119 Ala. 168, 24 So. 351 (1898); *Swift v. Smith*, 65 Md. 428, 5 Atl. 534 (1886). Cf. *Russell v. McLellan*, 14 Pick. 70 (Mass. 1833).

See further: WORMSER, THE DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS, at 78 (1927).

<sup>4</sup> *Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Service, Inc.*, 217 Cal. 124, 17 P. 2d 709 (1932); *Dunham v. Natural Bridge Ranch Co.*, 115 Mont. 579, 147 P. 2d 902 (1944); *Werner v. Hearst*, 177 N. Y. 63, 69 N. E. 221 (1903); *Tilley v. Coykendall*, 172 N. Y. 587, 65 N. E. 574 (1902); *Commonwealth v. Sunbury Converting Works*, 286 Pa. 545, 134 Atl. 438 (1926); *Button v. Hoffman*, 61 Wis. 20, 20 N. W. 667 (1884).

However, since the existence of the separate entity is a statutory privilege, it has been confined judicially to legitimate uses. For example, the corporate entity cannot be used to defeat public convenience, justify wrong, protect fraud, or defend crime.<sup>5</sup> Further, corporateness will be set aside whenever it is asserted for a purpose inconsistent with the policy of the law for which the concept of corporate entity was developed.<sup>6</sup> This power to "disregard the corporate entity" is, therefore, a discretionary or equitable power, used to obtain a just result according to the circumstances of the case and the conflicting rights and liabilities of the parties.<sup>7</sup>

It is true that corporations owned by a single shareholder have been

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In the last case, the sole shareholder was not permitted to pass title to property held in the corporate name, since "the shareholders are not the private and joint owners of its [the corporation's] property." The court also said: ". . . the owner of all the capital stock of a corporation does not own its property, or any of it, and does not himself become the corporation as a natural person, to own its property and do business in his own name."

The fact that one corporation owns all the capital stock of another corporation and that members of the board of directors of both companies are the same is not sufficient to render parent corporation liable for contracts of its subsidiary, in absence of additional circumstances showing fraud, actual or constructive, or agency. *Whitehurst v. FCX Fruit & Vegetable Service*, 224 N. C. 628, 32 S. E. 2d 34 (1944). (Judgment for plaintiff was upheld on the agency theory.)

Sole shareholder cannot sue individually for a wrong to the corporation, *Green v. Victor Talking Machine Co.*, 24 F. 2d 378, *cert. denied* 278 U. S. 602 (1928).

<sup>5</sup> *Mosher v. Salt River Valley Ass'n*, 39 Ariz. 567, 8 P. 2d 1077 (1932) (corporation held the "alter ego of the defendant"); *Mosher v. Lee*, 32 Ariz. 560, 261 Pac. 35 (1927) (incorporated partners); *Rice v. Sanger Bros.*, 27 Ariz. 15, 229 Pac. 397 (1924) (to defraud creditors by illegal act); *Security Bank & Trust Co. v. Warren Light & Water Co.*, 170 Ark. 50, 278 S. W. 643 (1925); *Donovan v. Purtell*, 216 Ill. 629, 75 N. E. 334 (1905) (fraud); *Noble v. Burnett Co.*, 208 Mass. 75, 94 N. E. 289 (1911); *Brassman, Inc. v. Mosson*, 127 Misc. 282, 215 N. Y. S. 766 (1926) (president issued corporate check); *Arnold v. Phillips*, 117 F. 2d 497 (5th Cir. 1941) *cert. denied* 313 U. S. 583 (1941) (inadequate capital); *U. S. v. Milwaukee Refrigerator Transit Co.*, 142 Fed. 247, 255 (1905); *In re Muncie Pulp Co.*, 139 Fed. 546 (1905) (to defraud creditors); *Pepper v. Litton*, 308 U. S. 295 (1939); *Linn and Lane Timber Co. v. U. S.*, 236 U. S. 574 (1915) (fraud in obtaining government land).

<sup>6</sup> *Davis v. Alexander*, 269 U. S. 114, 117 (1925) (dominant company held for injuries due to negligence of subsidiary company); *United States v. Reading Co.*, 253 U. S. 26 (1919); *Chicago, M. & St. P. R. Co. v. Minneapolis Civic & Commerce Ass'n*, 247 U. S. 490 (1917) (for purpose of rate regulation); *U. S. v. Lehigh Valley R. Co.*, 220 U. S. 257 (1911).

*Cardozo, J.*, in *Berkey v. Third Ave. Ry. Co.*, 244 N. Y. 84, 155 N. E. 58 (1926), stated the surrender of limited liability would be made "when the sacrifice is essential to the end that some accepted public policy may be defended or upheld." (However, there the dominant shareholder was held not liable for torts of subsidiary.)

See also: WORMSER, *THE DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS*, at 83, 84 (1927): "Corporate entity will not be ignored at law or equity simply because the number of shareholders is few or even one, unless the circumstances are such as would warrant the same disregard of the entity were there ten thousand shareholders."

See further: Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW AND CONTEMPORARY PROBLEMS 473, 475 (1953).

<sup>7</sup> For a thorough development of this fluid concept, see Cataldo, *op. cit. supra* note 6, at 480.

brought under close scrutiny by the courts,<sup>8</sup> ever ready to apply the above equitable criteria. But it is rare that such corporations have been deemed automatically invalid on the ground that the number of shareholders has fallen below a certain prescribed minimum number.<sup>9</sup> However, that the North Carolina Supreme Court *will* apply this automatic criterion was made clear in the recent case of *Park Terrace, Inc. v. Phoenix Indemnity Company*,<sup>10</sup> which was before the court on a rehearing of the same case reported two years prior.<sup>11</sup>

In the first *Terrace* case, the facts were set out as follows: Terrace, Inc., all the common stock of which was owned by *A, B, C, and D*, contracted for the construction of an apartment house with Builders, Inc., some of the stock of which was owned also by *A, B, C, and D*. Subsequently, these four shareholders sold all the shares of common stock of Terrace, Inc., to McLean, an individual. As part of the consideration for the transaction, McLean signed a contract releasing *A, B, C, D* and Builders, Inc., from liability for defective construction. Two years and ten months later, Terrace, Inc., brought an action for damages for breach of construction contract by Builders, Inc., against the surety on the performance bond. Builders, Inc. was made a party defendant. The defendants alleged: (1) that the construction was in accordance with specifications; (2) that the release, signed by McLean, was a bar to recovery by Terrace, Inc.; and (3) that when McLean signed the agreement, he was acting as agent for Terrace, Inc., and in its behalf, therefore Terrace, Inc., was bound by his contract.

The Supreme Court affirmed an order to strike allegations (2) and (3) from the answer and to deny making McLean a party defendant. BARNHILL, C. J., said: ". . . the refusal of the court to make McLean a party defendant was well advised. The purchase of outstanding common stock from the then owners thereof was by McLean as an individual. He signed the so-called release as an individual. Hence, these defendants may not be permitted to try any action they may have against McLean in this suit."<sup>12</sup> The majority decision then rested on the issue of agency, holding that the contract signed by McLean was not the contract of the corporation.<sup>13</sup> Thus, the corporate entity was regarded as a

<sup>8</sup> *Pepper v. Litton*, 308 U. S. 295, 313 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U. S. 590, 599 (1920); *Twin-Lick Oil Co. v. Marbury*, 91 U. S. 587, 590 (1875).

In *Pepper v. Litton*, the District Court said: ". . . In all the experience of law, there has never been a more prolific breeder of fraud than the one-man corporation."

<sup>9</sup> See note 3 *supra*.

<sup>10</sup> 243 N. C. 595, 91 S. E. 2d 584 (1956).

<sup>11</sup> *Park Terrace, Inc. v. Phoenix Indemnity Co.*, 241 N. C. 473, 85 S. E. 2d 677 (1955).

<sup>12</sup> *Id.* at 477. 85 S. E. 2d at 679.

<sup>13</sup> *Id.* at 478. 85 S. E. 2d at 679. The modern weight of authority supports the holding that contracts of a sole shareholder *will* bind the corporation, although made without the authority of a board of directors. The reason for this rule is that the

legal fact even though the majority opinion was closed with the query: "Since McLean has acquired all the stock of the plaintiff, is it now a corporation? This question is not presented by the record."<sup>14</sup>

A well reasoned dissent by BOBBITT, J., however, indicated that the *substance* of the action was not the agency issue, but ". . . whether McLean can maintain under the guise of a corporation suit an action for his benefit as sole owner of the plaintiff's common stock."<sup>15</sup> The dissent went on to say: ". . . courts and textwriters have been in entire agreement that equity will look behind the corporate entity, and consider who are the real and substantial parties in interest, whenever it becomes necessary to do so to promote justice or obviate inequitable results."<sup>16</sup>

The import of this dissent was adopted in the second *Terrace* case. BARNHILL, C. J., again writing for the majority of the court, held that McLean was, in fact, the necessary party *plaintiff*.<sup>17</sup> In so holding, the court stated the rule that when one person acquires all the stock of a corporation, automatically the corporation becomes dormant or inactive and can no longer act as a corporation.<sup>18</sup> Thus, the court has adopted the view that a one-man<sup>19</sup> corporation is invalid *per se* for all purposes except to hold legal title of the property for the use and benefit of the single stockholder who becomes seized of the beneficial title to the property. Spelled out further, the import of the decision is that the court will apply the equitable criteria when the corporation has met the requisite number of three shareholders; and will apply the automatic criterion below that number.

The ramifications of such a holding are apparent. For example: (1) Is the income of the corporation to be considered the income of the shareholder, thereby making the shareholder taxable on the income without the benefit of corporate deductions or the corporate rates? (2) If the corporation can *hold* title to the property for the use and benefit of the shareholder, could it *transfer* the same property. And what would be the present status of property already transferred by a wholly-owned corporation? (3) Are all the debts of the corporation to be considered

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sole shareholder is the only person beneficially interested aside from corporate creditors. See 5 FLETCHER, *CYC. OF CORPORATIONS*, § 2099, at 442 (perm. ed. 1952).

See also BALLANTINE, *CORPORATIONS*, § 126, at 296 (1946).

<sup>14</sup> *Ibid.*

<sup>15</sup> *Id.* at 479-80. 85 S. E. 2d at 681.

<sup>16</sup> *Id.* at 481. 85 S. E. 2d at 682. By so stating this proposition, Justice Bobbitt placed before the court the very crux of the equitable criteria.

<sup>17</sup> Note that Bobbitt, J., and Johnson, J., concur in the *result* of the case.

<sup>18</sup> 243 N. C. 595, 597, 91 S. E. 2d 586, 587 (1956). The reason for this rule of form was stated to be: ". . . the concept that a corporation is a combination of three or more persons who may operate as a legal entity when chartered so to do threads its way through the cited and practically every other section of our law on corporations. General Statutes, ch. 55. *No lesser number will suffice.*" (Emphasis added.)

<sup>19</sup> *Ibid.* This statement indicates clearly that the same result would obtain in a two-man corporation since this, also, is below the "statutory" minimum.

as debts of the single shareholder? If so, what are the rights of corporate creditors against the individual?

In the light of these complexities, it would seem the proper response of a single shareholder to take immediate curative action by transferring shares to nominal shareholders in order to comply with the requisite for three shareholders. However, for past transactions, this course of action is dubious, at most, in view of dictum in the principal case, to the effect that ". . . it must be understood that if McLean became the *sole beneficial owner* of the assets of the corporation by virtue of the fact he acquired all the stock, *he could not later, and cannot now*, evade the consequences of his act by merely transferring some of the stock to third parties so as to comply with the statute."<sup>20</sup> (Emphasis added.)

Read literally, this dictum would cause legitimate concern for every corporation now beneficially owned by a single shareholder, in that curative action would be impossible once the status had been attained. However, if the language used can be construed to apply to the specific act of McLean and to the circumstances of this case, it will be possible to effect remedial transfer of shares in other situations and avoid troublesome future problems. Of course, even the latter interpretation does not indicate a solution to transactions already having occurred. At best, the language used by the court leaves this retroactive aspect very unsettled and in need of clarification and immediate remedy.

Apparently, the assembly, in passing the new Business Corporation Act,<sup>21</sup> contemplated the situation presented by the principal case. Section 55-8 of this Act states: "Corporate existence is not impaired by the acquisition of all the shares by one person."<sup>22</sup> Further, in section 55-53(e), the Act states: "Except in the case of watered shares, shareholders shall be subject to no assessment or liability thereon other than that arising from the unpaid balance, if any, of the agreed consideration, even if all the shares are owned by one person." However, this Act, if allowed to stand as passed by the 1955 legislature, will not become effective until 1 July, 1957. Accordingly, the need is still urgent for present judicial or legislative remedy.

As to the equitable power of the court to meet situations of this nature, this also has been embodied in the new Business Corporation Act in section 55-53(h), which states: "Nothing in this section shall limit any liability that a shareholder may incur on general principles of law or equity arising from the creation or maintenance of an inadequately

<sup>20</sup> 243 N. C. 595, 599, 91 S. E. 2d 586, 588 (1956).

<sup>21</sup> N. C. GEN. STAT., CH. 55 (Supp. 1955).

<sup>22</sup> The theory of permitting a corporate existence to remain unimpaired when owned by a single shareholder is inconsistent with a requirement for three incorporators. N. C. GEN. STAT. § 55-6 (Supp. 1955). If the law has the former policy there is no need for the latter.

capitalized incorporated enterprise or other abuse of the privilege of achieving limited liability by incorporation."

The equitable criteria has been an adequate test for the existence or non-existence of the corporate entity in any conceivable combination of rights and liabilities of the parties. Therefore, it seems illogical that the court would feel the need of establishing a rule of automatic invalidity. Because of this implication, however, it is clear that the *Terrace* case will have a disturbing impact on the law of this area until a judicial or legislative remedy is presented.

FRANKLIN A. SNYDER.

### Criminal Law—Entrapment in North Carolina

It has been said<sup>1</sup> that the first reported instance of a defense of entrapment is to be found in the decision by the Great Lawgiver, overruling that ancient plea tendered by Eve in Paradise, "The serpent beguiled me and I did eat."<sup>2</sup>

The earliest reported pleas in North Carolina of temptation by others, appear in the cases of *Dodd v. Hamilton*<sup>3</sup> and *State v. Jernagan*<sup>4</sup> in 1817, and since that time the defense has often been interposed in the North Carolina courts. Perhaps the most enlightening approach to a presentation of the position of the North Carolina court on the doctrine of entrapment is an examination of the cases against a background of the subject generally.

The classic, and most frequently cited definition of entrapment is that of Mr. Justice Roberts, in *Sorrells v. United States*.<sup>5</sup> "Entrapment is the conception and planning of an offense by an officer and his procurement of its commission by one who would not have done so except for the trickery, persuasion, or fraud of the officer."<sup>6</sup>

The basis for the doctrine of entrapment seems to be ethical rather than legal considerations.<sup>7</sup> The judicial approach to the problem does not lay stress upon any feeling of solicitude for the accused or try to strike a balance between the equities of the government and those of the accused. Rather, it seems to stem from a realization by the courts that the law is mechanistic in that it does not consider the ability of the offender to resist temptation. As Professor Sayre declared: "Historically, our substantive criminal law is based upon a theory of punishing the vicious will. It postulates a free agent confronted with a choice between

<sup>1</sup> Bernstein, *In Re Eve*. 65 N. J. L. J. 273 (1942).

<sup>2</sup> Genesis 3:13.

<sup>3</sup> 4 N. C. 31 (1817).

<sup>4</sup> 4 N. C. 44 (1817).

<sup>5</sup> 287 U. S. 435 (1932).

<sup>6</sup> *Id.* at 440.

<sup>7</sup> Anderson, *Some Aspects of Entrapment*, 13 BROOKLYN L. REV. 187, 188 (1942); Note, 2 SO. CALIF. L. REV. 283 (1929).