Volume 86 | Issue 1 Article 10

September 1983

Confronting Close Corporate Status in West Virginia: Alternative Theories to Prevent Abuse to the Detriment of Creditors

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STUDENT MATERIAL

Student Notes

CONFRONTING CLOSE CORPORATE STATUS IN WEST VIRGINIA: ALTERNATIVE THEORIES TO PREVENT ABUSE TO THE DETRIMENT OF CREDITORS.

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I. INTRODUCTION

The close corporation is a widely used and accepted form of business organization.[1] Many business proprietors and partners have chosen the close corporation as a vehicle for exercising maximum entrepreneurial freedom and, at the same time, enjoying minimum liability exposure. Indeed, the proliferation of small, closely-held corporations has likely been further encouraged by other advantages in the modern business climate, such as favorable tax treatment, investment facilitation, and even some popular perception that incorporation is synonymous with business success. All these potential advantages, however, tend to create a false sense of unlimited freedom among close corporation principals.

While larger, public corporations may be subject to popular criticism of their lack of "corporate social responsibility" and a popular disdain for corporate "bigness,"[2] close corporations present another different type of social responsibility concern. The misconceived notion that corporate status means no personal liability, together with the functional and practical resemblance of close corporations and partnerships or proprietorships,[3] creates an enormous potential for using corporate status to frustrate the legitimate claims of creditors.

In some cases, the problem is resolved at the outset, either by safeguards used by the person dealing with the close corporation,[4] or by statutory pro-

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[1] 1 O'NEAL, CLOSE CORPORATIONS (Callaghan) § 1.02 (1971 Cum. Supp. 1982). Of course, this assumes a broad definition of a "close corporation" as one in which there are relatively few shareholders. Some legal scholars would prefer the term be used more narrowly to designate only those incorporated enterprises "in which the participants consider themselves partners, inter sese . . . ." *Id.* For the purpose of this Note, the term will be used in the narrower sense, referring only to those corporations which are functionally closely related to a partnership.

[2] Oleck, *Remedies for Abuses of Corporate Status*, 9 WAKE FOREST. L. REV. 463 (1973).

[3] Masinter v. Webco Co., 262 S.E.2d 433 (W. Va. 1980).

[4] Such safeguards might include, inter alia:

a) contracting for additional personal liability of the sole or principal shareholders,

tection for certain creditors.[5] We are concerned here, however, with those cases in which a creditor or claimant has had either no opportunity or no economic reason to use costly safeguards and is afforded no specific statutory protection. Only after the creditor's claim or ability to collect is prejudiced in some way does he realize that close corporate status is being used against him.

Generally, the sole or principal shareholders of a close corporation have relied on the traditional notions of corporate separateness and limited liability[6] to impair the ability of creditors to satisfy their claims. A simple hypothetical helps illustrate the typical situation.

A is the principal shareholder of Fuel Brokers, Inc., a family-owned business which deals in the procurement of long-term contracts for the purchase and sale of coal. With or without direct fault on A's part, Fuel Brokers, Inc. becomes severely burdened by its own obligations. These obligations may be contracted-for debts, civil judgments, or even burdensome contract duties, to name only a few. In any event, A realizes that everything Fuel Brokers, Inc. has, as well as everything it may have in the foreseeable future, is subject to these claims.

To negate this burden, A takes what he may believe are perfectly legitimate steps to preserve his business, but which, nevertheless, prejudice the rights of creditors. The methods fall into three basic categories:

1) In planning ahead, A initially organizes his business so that the corporation potentially liable for claims will have little or no assets with which to satisfy them.

2) In response to or in contemplation of a claim against the corporation, A effects a transfer of important assets to himself, a third person, or another corporation.

3) To insulate future operations, A creates a "new" close corporation, carrying on the profit-making activities of its predecessor but free of its obligations.

This Note will focus on the situation where A takes one or all of these steps and will discuss alternative theories with which to challenge them. These theories, all based on well-recognized exceptions to traditional notions of entrepreneurial freedom, are 1) the doctrine of "piercing the corporate

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b) contracting for a security interest in collateral property of the corporation,

c) examining of corporate financial statements, records, and accounts, and

d) requiring performance or surety bonding.

[5] *See, e.g.*, W. VA. CODE §§ 46-6-101 to 111 (1966) (Creditor listing and notice requirements of "bulk transfer" article of U.C.C.).

[6] *See infra* text accompanying notes 10-13.

veil,"[7] 2) the law of "fraudulent conveyances"[8] and 3) the doctrine of "corporate opportunity."[9]

Each theory is addressed individually because each was developed to address a particular abuse. Nevertheless, courts have not always applied any of them narrowly and substantial "overlap" has resulted. As will be seen, this characteristic will enable a creditor using all of the arguments in the alternative to not only challenge almost any nature or type of activity to his detriment, but also to reinforce the persuasiveness of his challenge with alternative applicable grounds for relief.

II. THE DOCTRINE OF PIERCING THE CORPORATE VEIL

A. *Background and Explanation of the Doctrine*

Corporation law has long been preoccupied with the idea of "limited liability" for shareholders.[10] This idea is premised on the "separateness" of the corporate entity, which makes it

> a legal personality capable of making and executing contracts, possessing and owning real and personal property in its own name, suing and being sued as a person distinct from its owners, the shareholders, and carrying on business in much the same manner as a natural person acting through agents of its own selection.[11]

This general rule has been broadly applied by the courts, even where all the stock in a corporation is owned by one person[12] and where the corporate structure is admittedly adopted for the sole purpose of avoiding personal liability.[13] Naturally, such broad protection has led to cases in which courts could not ignore the use of the corporate entity to defeat the very public policy which had fostered its use.

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[7] *See infra* text accompanying notes 10-81.

[8] *See infra* text accompanying notes 82-118.

[9] *See infra* text accompanying notes 119-38.

[10] 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATION § 25 (rev. perm. ed. 1974) [hereinafter cited as Fletcher].

[11] *Id.* at § 25. *See also* Sanders v. Roselawn Memorial Gardens, Inc., 152 W. Va. 91, 159 S.E.2d 784 (1968); Lowther v. Bridgeman, 57 W. Va. 306, 50 S.E. 410 (1905); Floyd v. National Loan & Inv. Co., 49 W. Va. 327, 38 S.E. 653 (1901); Pyles v. Riverside Furniture Co., 30 W. Va. 123, 2 S.E. 909 (1887); Blue Jacket Consol-Copper Co. v. Scherr, 50 W. Va. 533, 40 S.E. 514 (1901).

[12] Southern States Coop., Inc. v. Dailey, 280 S.E.2d 821 (W. Va. 1981); De Stubner v. United Carbon Co., 126 W. Va. 363, 28 S.E.2d 593 (1943); De Stubner v. Microid Process, Inc., 124 W. Va. 591, 21 S.E.2d 154 (1942); William C. Atwater & Co. v. Fall River Pocahontas Collieries Co., 119 W. Va. 549, 195 S.E. 99 (1937); Fleming v. J. G. McCrory Co., 114 W. Va. 439, 174 S.E. 325 (1933). *See also* Fletcher, *supra* note 10, at § 25.1; DeWitt Truck Brokers, Inc., v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976).

[13] 1 W. FLETCHER, *supra* note 10, at § 41.2; Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L. REV. 371, 373 (1981).

Eventually, practically all authorities came to agree that under some circumstances in a particular case, the corporation may be disregarded as an entity standing between its owners and their adverse parties.[14] The exception is used to withhold the usually privileged attributes of limited liability and legal personality where they would "produce unjust or undesirable consequences inconsistent with the purpose of the concept."[15]

The basic rationale, for application of what came to be known as the doctrine of "piercing the corporate veil," is found in the oft-cited case of *United States v. Milwaukee Refrigerator Transit Co.*[16] Therein, the court found disregard of the corporate entity appropriate "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime,"[17] and the law will regard the organization as an "association of persons" rather than a corporation.[18] In West Virginia, this rationale has been echoed as recently as 1980 in *Jules, Inc. v. Boggs*.[19]

B. *Application of the Doctrine Generally*

The most striking characteristic of cases addressing the piercing question is their lack of guidance. In applying the doctrine, courts have tended to merely point an accusing finger at the corporation and its owners and use some appropriate metaphor to describe the arrangement and justify disregard of the corporate entity.[20] The noted authority, Professor Hamilton, has described this technique as

> inherently unsatisfactory since it merely states the conclusion and gives no guide to the considerations that led a court to decide that a particular case should be considered an exception to the general principle of non-liability. A systematic analysis, moreover, is not readily discernible in the cases, and many courts continue to rely on metaphors to explain their results.[21]

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[14] 1 W. FLETCHER, *supra* note 10, at §§ 41-47. *See also* H. BALLENTINE, BALLENTINE ON CORPORATIONS §§ 122-41 (rev. ed. 1946); H. HENN, LAW OF CORPORATIONS §§ 146-53 (2d ed. 1970); N. LATTIN, THE LAW OF CORPORATIONS § 14 (2d ed. 1971); 1 H. OLECK, MODERN CORPORATION LAW §§ 10-12 (1958 & Cum. Supp. 1978).

[15] HENN, *supra* note 14, at § 146.

[16] 142 F. 247 (E. D. Wis. 1905).

[17] *Id.* at 255.

[18] *Id. See also* Note, *Corporations—Disregard of the Corporate Entity*, 43 W. VA. L.Q. 141 (1936-37).

[19] 270 S.E.2d 679, 683 (W. Va. 1980) (quoting United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (E. D. Wis. 1905)). *Jules* presents an unusual application of the doctrine justifying administrative denial of an application for a liquor license. *See also infra* note 65.

[20] Some typical examples of the metaphors used: mere adjunct, alias, alter ego, alter idem, arm, blind, branch, buffer, cloak, coat, corporate double, instrumentality, mouthpiece, name, nominal identity, phrase, puppet, screen, sham, simulacrum, snare, stooge, subterfuge, tool. *See* Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979 (1971).

[21] *Id.* at 979.

What, then, should be the focus of an inquiry into the propriety of applying the general rule of the doctrine of piercing? The authorities take differing approaches. Professor Hamilton, for example, suggests that analysis should be directed not to the nature of corporateness but to the substantive policies underlying the issues. In support of this position, he notes four general principles that tend to appear whenever a corporate recognition problem is addressed. They are:

1) notions of simple justice and fairness,

2) a desire to retain reasonable procedures and avoid substantive tangles,

3) a desire to protect potential creditors and minority shareholders, and

4) a predilection to hold a shareholder to his election of corporateness.[22]

Another authority has suggested that the test being applied is, in reality, that familiar animal "totality of circumstances."[23] By definition, it permits a court to deal with each case on its own distinctive facts without providing guidance for future application.[24] This suggests that the courts are attempt-

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[22] *Id.* at 1008-09.

[23] Barber, *supra* note 13, at 374.

[24] *Id.* In support of this conclusion, the Professor lists the following factors, one or more of which has been present in each case where a court pierced the veil:

1) commingling of funds and other assets of the corporation with those of the shareholders,
2) diversion of corporate funds or assets to noncorporate uses,
3) failure to maintain corporate formalities necessary for the issuance of stock,
4) individual shareholder's representations to a third party of personal liability for a corporate obligation,
5) failure to maintain minutes or other corporate records,
6) identical equitable ownership of two entities,
7) identity of directors and officers responsible for supervision and management of two entities,
8) failure to adequately capitalize for reasonable risks of the undertaking,
9) absence of separately held corporate assets,
10) use of the corporation as a shell or conduit for some particular aspect of the business of an individual or another corporation,
11) sole ownership of all stock by one individual or family,
12) use of same office or business location by the corporation and shareholders as individuals,
13) employment of same attorney or other important employees by the corporation and shareholders as individuals,
14) concealment or misrepresentation of identity of interests in the corporation and personal business activities of the shareholders as individuals,
15) disregard of legal formalities and failure to maintain an arm's length relationship among related entities,
16) use of corporation to procure benefits for another person or entity,
17) diverson of corporate assets to the detriment of creditors, or manipulation to concentrate assets in one entity and liabilities in another,

ing to balance the competing interests. On the one hand are the policies behind insulating shareholders from personal liability and, on the other, the policies justifying piercing.[25]

All this policy discussion, unfortunately, puts the analysis right back where it started—the piercing doctrine is invoked whenever a court finds it appropriate. However, at least four general theories may be discerned under which most, if not all, of the decisions can be grouped. They are:

1) the failure of formalities theory,

2) the failure of fairness theory,[26]

3) the agency theory,[27] and

4) the enterprise entity theory.[28]

Of these, only the first three are popularly applied. The enterprise entity theory is not frequently used (even where it might be) because it appears to be appropriate in only a small number of situations.[29] Its particular importance however, in the circumstances contemplated by this Note, will be discussed below,[30] along with the other more popular theories.

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18) contracting by the corporation with intent to avoid risk of nonperformance, and

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

Id. (citing Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962)).

[25] Barber, *supra* note 13, at 375-76.

[26] *Id.* at 376. This particular commentator lumps the first two theories together into a "two-prong test" which was applied in Automotriz del Golfo de Cal. v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957). For analytical purposes, their distinction is important because some courts might find either sufficient, standing alone.

[27] Barber, *supra* note 13, at 400. Agency might be an alternative category for those cases which fall under the "alter ego" (or other synonymous metaphor) umbrella. This particular authority would, however, group those cases under the "formalities" theory and group only those cases relying on strict agency principles under the agency heading.

Professor Barber also provides an invaluable "laundry list" of guidelines and safeguards, designed to help shareholders avoid the spectre of personal liability, under the categories of:

1) the "formalities" element,

2) the "fairness" prong and

3) the agency theory.

Id. at 402-03. Obviously, if a corporation's shareholders have heeded the warning contained therein, the task of a potential creditor's counsel is made significantly more difficult.

[28] Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

[29] The "enterprise entity" theory is derived from the decision in Taylor v. Standard Gas & Elec. Corp. 306 U.S. 307 (1939) (known as the *Deep Rock* case). Simply stated, it applies where the corporate entity does not correspond to the actual enterprise, but only to a fragment of it. In such a case, the court may combine two or more corporations into an aggregate enterprise entity which more accurately represents the business arrangements of the persons involved. Berle, *supra* note 28, at 348.

[30] *See infra* text accompanying notes 67-76.

C. *Problems in Application of the Doctrine*

1. Failure of the courts to recognize the distinction between tort and contract claims

In light of the varying consideration given to innumerable factors by the courts, it is surprising to find an almost total disregard for whether the creditor's claim sounds in tort or contract, before courts consider which factors weigh most heavily against, or in favor of, piercing. Some commentators urge, and this writer agrees, that there is an obvious and important distinction between the two types of cases.[31]

For example, consider the effect of factors under the "formalities" theory, such as maintenance of corporate meeting minutes, issuance of stock and use of the same business location by the corporation and its shareholders. The defenders of the corporate entity can persuasively argue that a creditor with a claim arising out of a contract normally has a prior opportunity to determine the validity of the corporate status. Therefore, the argument continues, the creditor should be estopped from denying either the existence or the separateness of the corporation.[32]

With tort claims, the persuasiveness of the distinction goes the other way, benefitting the creditor. There, a prior opportunity to determine corporate status rarely exists, so it would be illogical to require the tort creditor to show a failure of formalities to justify piercing.[33]

Nevertheless, courts have failed to use this important distinction to give practical meaning to their analytical approach. Properly, the distinction should be used to focus the court's attention on factors which really make a difference in the relationship between the parties, even before those factors are considered.

2. Disproprotionate weight given to individual factors in the piercing analysis

One difficulty in using the "totality of circumstances" test described above,[34] or any other analysis to predict the disposition of a potential piercing

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[31] Barber, *supra* note 13, at 380-86. *See also* Comment, *Alternate Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 B.U.L. REV. 123 (1968); Hamilton, *supra* note 19, at 984.

[32] "[W]here a party knows of the relationship between a corporation and its stockholder and chooses freely and voluntarily to deal or contract with them in their respective capacities, he is estopped to claim that the individual stockholder is the alter ego of the corporation or vice versa." 1 W. FLETCHER, *supra* note 10, at § 47 (citing Slover v. Winston, 155 Va. 971, 157 S.E. 150 (1931)).

[33] Barber, *supra* note 13, at 381. Conversely, if the creditor asserts failed formalities as justification for piercing, the defendant can use the creditor's inability to investigate in advance and absence of reliance to rebut.

[34] *See supra* text accompanying notes 23-25.

situation, is that courts give varying weight to factors considered in making their decisions. Although a reasoned synthesis of these cases is impossible, one can readily perceive a tendency by the courts to focus on certain factors as being more persuasive than others. Hopefully, by recognizing the disproportionate individual influence of some of these factors, an attorney may more easily and accurately make his evaluation of the strengths and weaknesses of his client's case.

a. *Inadequate Capitalization.* In any case involving the issue of piercing, capitalization of the corporation is an important factor. The essence of any request for piercing is that a judgment against the corporation would be uncollectable, which implies insufficient capital.

In considering adequacy of capitalization, we begin with the general rule that capital must be sufficient to cover the reasonably foreseeable risks of the business.[35] The two most popular approaches used in this analysis are: 1) the financial analysis approach—comparing capitalization of companies in the same industry;[36] and 2) the insurance approach—requiring policy limits to cover actuarially projected, reasonably anticipated losses.[37]

Whichever test is used, many courts have failed to establish in their analysis exactly when capitalization will be considered. In fact, most have merely assumed, without considering, that capitalization is to be considered at the time of corporate formation.[38] The Fourth Circuit Court of Appeals, however, has applied a much more practical analysis. In *DeWitt Truck Brokers Inc. v. W. Ray Flemming Fruit Co.*,[39] that court reasoned that the "obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter—during the corporation's operations."[40]

This ongoing consideration of the level of capitalization makes inherent good sense when one considers the interests at stake. A potential creditor is not concerned with the *incorporators'* efforts to adequately capitalize. Indeed, capitalization at incorporation may be totally irrelevant to the issue of the corporation's ability to meet its obligations when they arise.

Whether emphasized or not, capitalization should be only one factor in

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[35] 1 W. FLETCHER, *supra* note 10, at § 44.1.

[36] Barber, *supra* note 13, at 392. This information is normally available in such publications as *Moody's Manual of Investments, Standard & Poor's Corporation Records,* and *Dunn & Bradstreet, Inc. Reports* for nearly all industries.

[37] Barber, *supra* note 13, at 394. The insurance industry has compiled data on what "reasonably anticipated losses" might be for many major industries. Compliance with these projections would be evidence of adequate capitalization.

[38] Hamilton, *supra* note 20, at 986; 1 W. FLETCHER, *supra* note 10, at § 44.1.

[39] 540 F.2d 681 (4th Cir. 1976) (South Carolina case).

[40] *Id.* at 686. *See also* Dix, *Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation*, 53 NW. U.L. REV. 478, 494 (1958).

any consideration of a piercing question. The same Fourth Circuit Court of Appeals, which liberally and practically applied its analysis on the capitalization issue, has also explicitly held that it is only one factor and "[t]he conclusion to disregard the corporate entity may not . . . rest on a single factor . . . ."[41] Nevertheless, inadequate capitalization remains one of the most emphasized points and one which merits special attention when addressing the piercing question.[42]

b. *Failure to follow corporate formalities.* This important factor normally lurks in the background when courts are describing corporations metaphorically as the "alter ego" or "instrumentality" of a person.[43] Its basic premise is, simply stated—if an organization is going to be a corporation, it ought to act like one.[44]

While many courts treat formalities as just one consideration in the piercing analysis, it is often made up of several individual factors, all tending toward the conclusion that the shareholders themselves have disregarded the corporate entity.[45]

For the creditor or other proponent of piercing, an examination of a close corporation's operations with formalities in mind may be a revelation. Almost any corporation is, at one time or another, in non-compliance with some technical requirements and the likelihood of non-compliance tends to increase as the size of the corporation decreases. Thus, for uninitiated shareholders, corporate formalities may create a trap.[46] This trap, however, cannot be boldly relied upon by the would-be piercer. Courts will likely be willing to listen to

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[41] 540 F.2d at 687. Since the undercapitalization in some degree is almost always present in piercing cases (or the creditor would not be trying to pierce), courts should avoid overemphasizing it as a factor.

[42] *See* Anderson v. Abbott, 321 U.S. 349 (1944); Iron City Sand & Gravel Div. of McDonough Corp. v. West Fork Towing Corp., 298 F. Supp. 1091 (N.D. W. Va. 1969), *rev'd on other grounds*, 440 F.2d 958 (4th Cir. 1971).

[43] *See supra* note 20, for a list of other metaphors sometimes used when following the same line of analysis.

[44] This theory has become so well recognized as to be referred to by some writers as "the doctrine of alter ego." 1 W. FLETCHER, *supra* note 10, at § 41.1. *See also* Tynes v. Shore, 117 W. Va. 355, 185 S.E. 845 (1936).

[45] A helpful list of the factors which create a substantial risk that the court will also ignore the corporate entity has been compiled. Some of these are:

1) incorporating without issuance of shares of stock,
2) shareholders; or director's meetings infrequently or never held,
3) decisions made by shareholders as if partners,
4) shareholders or officers do not sharply distinguish personal and corporate property,
5) corporate funds used to pay personal expenses and vice versa, without proper accounting, and
6) complete corporate and financial records are not maintained.

See Hamilton, *supra* note 20, at 990.

[46] *Id.* at 991.

explanations for failure to comply with *technical* rules and, in the case of close corporations, there is a good explanation. Shareholders of a close corporation "often find managing the business a full-time occupation; formal corporate affairs [tend to be] put off or ignored because there is full agreement in fact by all interested parties . . . ."[47] In any event, when the final tally is made under a "totality of circumstances"[48] analysis, these factors tend to pile up quickly on the side favoring piercing.

A notable feature of the "alter ego" or "instrumentality" theory is that it is theoretically applicable whether the "person" behind the corporate veil is an individual or another corporation.[49] The theoretical qualification is required because *courts* tend to view situations involving parent-subsidiary, brother-sister, or other conglomerate arrangements with much less sympathetic restraint than they have for one-man corporations, even if the doctrine itself does not.[50] Courts are probably more willing to pierce the corporate veil when the principal is a corporation rather than an individual, simply on consequences alone, because another corporation will be held liable for the pierced corporation's obligations. Where the principal is an individual, however, piercing imposes personal liability on non-business assets.[51] Therefore, counsel on either side of the piercing issue may want to consciously consider and explain to the court the consequences, adverse of favorable, of piercing. Like the distinction between tort and contract cases,[52] it may help focus the court's attention on which factors to look for as the circumstances unfold.

c. *Presence of fraud.* Because prevention of fraud is one of the generally accepted justifications for piercing,[53] circumstances which indicate its presence weigh heavily in any analysis. The type of fraud contemplated in piercing, however, is obviously something less than *actual* fraud, in the legal sense.[54] Instead, the term has been used whenever there is any evidence of intent to defraud, bad faith or a mere showing that injustice may result.[55] As Professor Barber suggests, "fraud" in piercing cases would be more appropri-

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[47] *Id.*

[48] *See supra* text accompanying notes 23-25.

[49] Hamilton, *supra* note 20, at 991.

[50] *See generally* Berle, *supra* note 28.

[51] Hamilton, *supra* note 20, at 983, 992. Many cases dealing with the "alter ego" theory phrase the test in terms of agency. Obviously, if a court finds that a corporation is, in fact, the "agent" of another, liability follows. To refer to application of "agency" law as "piercing" in these cases is "both unnecessary and confusing." *Id.* at 983.

[52] *See supra* text accompanying notes 31-32.

[53] *See supra* note 19.

[54] 1 W. FLETCHER, *supra* note 10, at § 44.

[55] Iron City Sand & Gravel Div. of McDonough Corp. v. West Fork, Towing Corp., 298 F. Supp. 1091 (N.D. W. Va. 1969) *rev'd on other grounds*, 440 F.2d 958 (4th Cir. 1971); Associated Vendors Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 838, 26 Cal Rptr. 806, 813 (1962).

ately called "unfairness."[56] Unfortunately, most case law has failed to recognize that a somewhat lower standard may be applied.[57]

Equally problematic is the tendency of courts to consider fraud in their analysis without considering the distinction between the piercing doctrine and the law of fraudulent conveyances. In those cases where a creditor's rights are prejudiced by some change in the ownership of the corporation's assets, the distinction gives the creditor an alternative theory of recovery which, depending upon the circumstances, may be more specifically applicable to the problem.[58]

D. *Particular Applicability of the Doctrine to Close Corporation Problems*

By nature, close corporations tend to resemble other business organizations with few members. Functionally, close corporations have characteristics which tend to foster recognition problems and recognition is the foundation of corporate separateness. Whenever "piercing" is employed, that recognition is judicially refused. It is not surprising, then, to find that decisional law treating the "piercing" question contains few, if any, cases in which the shareholders of a corporation with stock publicly-traded or widely-held were held personally liable on corporate obligations.[59]

Moreover, public policy and the objective underlying corporate existence also dictate against the use of "piercing" against a public corporation.[60] One commentator has suggested that piercing the corporate veil of a large corporation would amount to "burning down the house in order to roast the pig in it."[61] Thus, the doctrine is not only applicable to close corporations, it may be *exclusively* applicable.

Where an unsecured creditor faces efforts to use the corporate entity against him, piercing may be the sharpest and truest arrow in the quiver. Creditors are the very object of one of the doctrine's protective purposes and

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[56] Barber, *supra* note 13, at 377.

[57] *See, e.g.*, Kap-Tex, Inc. v. Romans, 136 W. Va. 489, 67 S.E.2d 847 (1951); DeStubner v. United Carbon Co., 126 W. Va. 363, 28 S.E.2d 593 (1943); William C. Atwater & Co. v. Fall River Pocahontas Callieries Co., 119 W. Va. 549, 195 S.E. 99 (1937); Southern Coop. Foundry Co. v. Warlick Furniture Co., 117 W. Va. 336, 185 S.E. 773 (1936). *See also* 1 W. FLETCHER, *supra* note 10, at § 44.

[58] *See infra* text accompanying notes 83-119.

[59] *See supra* text accompanying note 1.

[60] Barber, *supra* note 13, at 372. *But see* Berle, *supra* note 28, in which the "enterprise entity" theory is presented as applicable to "large businesses" as well.

[61] Oleck, *supra* note 2, at 484. The comment in text was made in the context of a discussion of possible sanctions for socially irresponsible corporate conduct. Of course, this is only true because public corporations sustain numerous diverse interests. Creditors may be advised to consider that the same analogy applies where close corporate piercing will defeat other valid public policy objectives.

its most frequent proponents. Any indication that recognition of the corporate entity will "delay, hinder, and defraud creditors,"[62] will be a factor in the court's analysis. The particular advantage of using "piercing," however, lies in two additional characteristics which are not immediately apparent.

1. Flexibility—The "Enterprise Entity" Theory

As previously mentioned, the piercing doctrine has been analyzed with so many factors considered that its application can be described as a "totality of circumstances" test.[63] Although this makes predictability difficult,[64] the other side of the coin is flexibility. The importance of flexibility becomes even more readily apparent when one considers the myriad forms which corporate recognition problems may take.

Obviously, every corporation is going to be different, just as its members' objectives, methods and even personalities are different from those in other corporations. It follows, then, that the particular conduct or structure of a corporation, which operates to invoke the doctrine, will be equally difficult to pinpoint. Nevertheless, the doctrine has been applied in cases involving totally unrelated problems, from corporate insolvency[65] to corporate reputation.[66] Taken literally, the broad statement of proper circumstances for application of the rule[67] leaves only the bounds of legal imagination as a constraint on its use.

One particular approach, which demonstrates how malleable the doctrine can be, is Professor Berle's "enterprise entity" theory.[68] Whereas the generally conceived situation giving rise to piercing involves just one corporation, the "enterprise entity" theory focuses on the overall business purpose of the "persons" controlling it. It is designed to permit a court to declare an overall business enterprise to be the real entity behind one or more corporations and make the entire operation responsible for the obligation of any of its compo-

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[62] Southern Coop. Foundry Co. v. Warlick Furniture Co., 117 W. Va. 336, 342, 185 S.E. 773, 776 (1936). *See also* 1 W. FLETCHER, *supra* note 10, at § 44.

[63] *See supra* text accompanying notes 20-30.

[64] *See supra* note 24 and accompanying text.

[65] *See, e.g.*, DeWitt Truck Brokers, Inc. v. W. Ray Fleming Fruit Co., 540 F.2d 681 (4th Cir. 1976).

[66] *See* Jules, Inc. v. Boggs, 270 S.E.2d 679 (W. Va. 1980) in which the West Virginia Supreme Court of Appeals used the doctrine to approve an inquiry into the reputation and character of corporate officers and stockholders by the State's Alcoholic Beverage Control Commissioner in his decision not to grant the corporation a private club liquor license.

[67] "[W]hen the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." *Id.* at 683 (quoting United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (E. D. Wis. 1905)).

[68] Berle, *supra* note 28.

nent members. This type of analysis allows a court to address those situations where one corporation may itself satisfy the requirements of recognition, but the interrelationship of two or more corporations is being used to subvert public policy.[69] While "piercing" obviously can apply whether the "person" behind the corporation is an individual or another corporation, the analysis has historically been under the "alter ego" or "instrumentality" theory.[70] That approach is inherently limited by a "two-entity" focus and a particular concern with how the dual relationship might have misled those who dealt with either.

The "enterprise entity" theory, on the other hand, is more broadly concerned with maintaining a perceived public policy in having corporate organization correspond with the entire business operation.[71] Thus, it can be applied to modern day commercial situations in which a single business is conducted by a "constellation of corporations."[72] The distinction, is that where "piercing" is normally urged to tear down the corporate entity, the "enterprise entity" theory can be used to actually *erect* a new entity (in a sense, a *de facto* corporation)[73] "with a body of assets to which liabilities are assigned more nearly in accord with the ascertainable fact of the enterprise and its relationship to outsiders."[74]

A creditor who finds that a corporation he has dealt with is part of such a fragmented enterprise is, of course, confronting a corporate structure which was probably in place at the time his claim arose. Therefore, he will be hard-pressed to argue that it is a "new" corporation, being used to keep assets beyond his reach. That, however, is the attractiveness of the "piercing" doctrine generally; it permits a creditor to argue for "piercing" without relying on activity after his claim arose. The premise of the argument allows the piercing proponent to direct a court's attention to corporate structure as well as corporate conduct,[75] which may be very persuasive in certain instances.

Consider, for example, the typical situation where an entrepreneur decides on a corporate structure which isolates high-risk activity in one corporation and valuable assets in another. Although this arrangement may seem particularly reprehensible to those with public policy and social responsibil-

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[69] *Id.* at 352-53.

[70] *See supra* text accompanying notes 49-52.

[71] *Berle, supra* note 28, at 345.

[72] *Id.* at 343.

[73] *Id.* at 345.

[74] *Id.* at 349.

[75] With application of any theory in a "piercing" case, arguments must be tailored to the facts. There will be few situations where the "enterprise entity" theory, or any other, is the only theory. Any attempt to categorize a case as particularly appropriate for the application of any one theory would, obviously, narrow the court's equitable perception and limit the persuasiveness of a "totality of the circumstances" argument.

ity perspectives,[76] common understanding of modern commercial dealings compels the conclusion that such arrangements do, in fact, exist.[77]

In this situation, the aggrieved party can use more conventional piercing arguments and the "enterprise entity" theory to fix liability on other corporations involved in the same overall business of the individual, as well as on the individual himself. The choice to use either or both would depend, of course, on where there were assets available to satisfy the claim.

As an important corollary, the individual contemplating such a corporate arrangement, before or after an obligation arises, finds himself under a much more onerous *personal* threat. If he decides to use multiple corporations at the outset, or a "new" corporation to continue his business after its predecessor has incurred some crippling obligation, he may find that not only those assets held by all the corporations involved but also his own personal assets are at stake. An individual behind two corporations is certainly no more secure than his less inventive colleagues who do business through only one.

2. Fiduciary Duty of Close Corporation Managers

A long-recognized principle, in any type of corporation, is that dominant or controlling shareholders, directors and officers owe a fiduciary duty to the corporation.[78] In close corporations, however, this fiduciary duty of the managers has been found to extend not only to the corporation and its shareholders, but also to creditors of the corporation.

In *Pepper v. Litton*,[79] the United States Supreme Court held that a dominant or controlling shareholder will be held to "the fiduciary standards of conduct which he owes the corporation, its stockholder, *and creditors*."[80] The Court went on to explain that "[h]e cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter

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[76] *See* Hamilton, *supra* note 20, at 1003. *See also* Automotriz del Golfo de Cal. v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Holland v. Joy Candy Mfg. Corp., 14 Ill. App. 2d 531, 145 N.E.2d 101 (1957).

[77] Members of close corporations naturally want to take as much advantage of the corporate structure as possible. When their members see their more sophisticated publicly-held corporate cousins taking advantage of diversification, subsidiary, and holding company arrangements (to name only a few), imitation in the close setting naturally follows. While some may not be ready to contend that such arrangements are acceptable even in a larger public corporation, *see* Oleck, *supra* note 2, they are particularly objectionable in smaller close corporations where there are simply fewer assets to go around.

[78] Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919) (dominant or controlling shareholders); Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875) (directors); Bayliss v. Rood, 424 F.2d 142 (4th Cir. 1970); Meadows v. Bradshaw-Diehl Co., 139 W. Va. 569, 81 S.E.2d 63 (1954); Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931); Hope v. Valley City Salt Co., 25 W. Va. 789 (1885).

[79] 308 U.S. 295 (1939).

[80] *Id.* at 311 (emphasis added).

how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements."[81]

To the aggrieved creditor, the existence of this duty and the implications that come with it are amazingly helpful. Not only are the problems of showing non-compliance with corporate formalities and other particular proof problems eliminated, but the burden of proof is entirely shifted to the defendant. More significantly, the standard is not merely proof that the transaction or circumstances were legitimate or reasonable. Instead, the fiduciary relationship means that the dominant shareholder's dealings with the corporation will be the subject of "rigorous scrutiny" and he must "not only prove the good faith of the transaction, but also . . . the inherent fairness from the viewpoint of the corporation and all those interested therein."[82]

By pointing out this important, heightened standard in close corporations, a creditor may be able to create a shift in a court's perception of the circumstances from the outset. Instead of waiting for the piercing proponent to pile up factors which support piercing, the court, in a challenge of *close* corporate status, should require the defendant to show why piercing is *not* justified. The advantage to the piercing proponent of such a shift is obvious. Establishing the existence of the situation giving rise to a fiduciary duty becomes the threshold of the piercing analysis and the inherent fairness of the situation, if established by the defendant, can be rebutted by factors normally used to justify piercing affirmatively. While this situation may not always be present, its potential should always be considered in the close corporation situation.

III. THE LAW OF FRAUDULENT CONVEYANCES

A. *Distinction from the "Piercing" Doctrine*

As discussed earlier, fraud occupies a special niche in the hearts of courts invoking the piercing doctrine.[83] Some courts have suggested that the corporate veil should be pierced only upon a showing of fraud, actual or constructive.[84] Others have invoked the piercing doctrine when the activity complained

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[81] *Id.* "[T]hat standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders." *Id.* at 307.

[82] *Id.* at 306. The court in *Pepper* carefully noted that it was dealing with a bankrupt corporation and a creditor's claim being asserted by the trustee. At least one lower court has viewed this as a limitation on the holding. *See In re* Fussell, 15 Bankr. Rep. 1016, 1020 (W. D. Va. 1981). This limitation, however appropriate in the bankruptcy context, should not be read to preclude a court's consideration of the duty, generally. Surely, any duty which creates an enforceable right in a bankruptcy trustee when breached by the dominant shareholder, must logically create some right or interest in the creditors to whom it was owed prior to bankruptcy.

[83] *See supra* text accompanying notes 52-57.

[84] Iron City Sand & Gravel Div. of McDonough Corp. v. West Fork Towing Corp., 298 F. Supp. 1091 (N.D. W. Va. 1969), *rev'd on other grounds*, 440 F.2d 958 (4th Cir. 1971). *See also*

of involved a transfer of assets, which the law of fraudulent conveyances quite adequately addresses.[85]

All this suggests that the courts or, more likely, counsel for the piercing proponents may have overlooked an important alternative ground upon which transfers to the hindrance of corporate creditors may be set aside. In those frequent instances where the factors gathered to support piercing include a transfer of assets, that particular transaction may be attacked without regard to the corporate entity's existence or recognition. Since the ultimate goal is satisfaction of obligations and not imposition of liability, the law of fraudulent conveyances may be the better tool with which to pursue that goal. Much like piercing, it can stand alone to achieve the desired result. In concert with piercing, it can be tailored to fit the particular facts of more varied situations which work to prejudice creditors' rights.

B. *Statutory Basis*

One important distinction between the piercing doctrine and the law of fraudulent conveyances is that the latter has a statutory basis.[86] While "piercing" is judge-made doctrine, fraudulent conveyances law in West Virginia is embodied in a statute with notable historical origins.[87] It is based on the common law which developed under an English statute[88] and, in its current form, provides:

> [e]very gift, conveyance, assignment or transfer of, or charge upon, any estate, real or personal, every suit commenced, or decree, judgment, or execution suffered or obtained, and every bond or other writing given, *with intent to delay, hinder, or defraud creditors, purchasers, or other persons*, of or from what they are or may be lawfully entitled to, shall as to such creditors, purchasers, or other persons, their representatives or assigns, be void.[89]

Although the principle has been given statutory authority the statute has long been recognized as merely declarative of the common law.[90] This link with judge-made authority is important in that the statute addresses only

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Rockford Equip. Co. v. J. R. Simplot Co., 92 Idaho 218, 440 P.2d 338 (1968); Herman v. Mobile Homes Corp., 317 Mich. 233, 23 N.W.2d 757 (1947); Donnally v. Hearndon, 41 W. Va. 519, 23 S.E. 646 (1896).

[85] *See, e.g.*, Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941); National Carloading Corp. v. Astro Van Lines, 593 F.2d 559 (4th Cir. 1979); Southern Coop. Foundry Co. v. Warlick Furniture Co., 117 W. Va. 336, 185 S.E. 773 (1936).

[86] *See* Note, *The Law of Fraudulent Conveyances in West Virginia*, 43 W. VA. L. Q. 266 (1937).

[87] W. VA. CODE §§ 40-1-1 to -16 (1982) are entitled "Acts Void As to Creditors and Purchasers."

[88] Stat. 13 Eliz., ch. 5 (1570) (emphasis added). *See generally* 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 58-62 (rev. ed. 1940).

[89] W. VA. CODE § 40-1-1 (1982) (emphasis added). This provision has existed in its present form in West Virginia since 1933.

[90] Hutchison v. Kelly, 40 Va. (1 Rob.) 123 (1842); Hunters v. Waite, 44 Va. (3 Gratt.) 26 (1846).

transfers made with "intent to delay, hinder or defraud."[91] Since proof of particular intent must be inferred from the circumstances surrounding the transfer,[92] courts began to develop a list of circumstances indicative of intent to defraud. From the first known attempt to list these circumstances[93] until modern times,[94] they have been referred to as "badges" or "indicia" of fraud.[95]

C. *Application of the Statute*

When all the indicia or badges of fraud are considered, the test traditionally applied by the courts is whether a reasonable man would conclude that the conveyance was made with an intent to hinder, delay or defraud.[96] Much like the "totality of circumstances" test applied when the doctrine of piercing the corporate veil is used,[97] the task of the creditor challenging a

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[91] W. VA. CODE § 40-1-1 (1982). *See also* 13 Eliz., ch. 5 (1570).

[92] Miller v. Gillespie, 54 W. Va. 450, 46 S.E. 451 (1903); Sturm v. Chalfant, 38 W. Va. 248, 18 S.E. 451 (1893); Hunter's Ex'rs v. Hunter, 10 W. Va. 321 (1877).

[93] Twyne's Case, 3 Coke 806, 76 Eng. Rep. 809 (1601). There the justices in Star Chamber noted the following *badges* of fraud:

1) the gift was "general,"
2) the donor continued in possession,
3) it was made in secret,
4) it was made "pending the writ,"
5) there was "a trust between the parties," and
6) the deed recited "that the gift was made honestly, truly and bona fide."

76 Eng. Rep. at 812-14.

[94] *See, e.g.*, Patterson v. Patterson, 277 S.E.2d 709 (W. Va. 1981), in which the West Virginia Supreme Court of Appeals found the following *indicia* of fraud:

1) gross inadequacy of consideration,
2) retention of possession or control by grantor,
3) pursuit of the grantor by his creditors by the time of the transaction, and
4) transfer of property to relatives pending litigation.

Id. at 718. *See also* Mullens v. Frazer, 134 W. Va. 409, 59 S.E.2d 694 (1950); Miller v. Correll, 97 W. Va. 215, 124 S.E. 683 (1924); Citizen's Bank v. Wilfong, 66 W. Va. 470, 66 S.E. 636 (1909); Wood v. Harmison, 41 W. Va. 376, 23 S.E. 560 (1895).

[95] For a thorough historical analysis of "badges of fraud," *see* Note, *supra* note 85.

[96] *Patterson*, 277 S.E.2d at 718; *see also* Miller v. Gillespie, 54 W. Va. 450, 46 S.E. 451 (1903); Sturm v. Chalfant, 38 W. Va. 248, 18 S.E. 451 (1893); Hunter's Ex'rs v. Hunter, 10 W. Va. 321 (1877).

Nearly every American jurisdiction has a fraudulent conveyance law. Most of these have a statute like West Virginia's, based on the common law and old English statutes. In twenty-three states, however, legislatures have adopted the Uniform Fraudulent Conveyance Act, drafted in 1919 by the National Conference of Commissioners on Uniform State Laws. The Uniform Act carries the ostensibly objective (reasonable man) test of the common law one step further. It rejects the possibility of intent as a matter of law, adopting purely objective standards instead. These include conveyances by an insolvent without fair consideration, UNIF. FRAUD. CONVEY. ACT § 4 (1919), and conveyances made with *actual* intent to hinder, delay or defraud. *Id.* at § 7 (emphasis added). A detailed analysis of the act is beyond the scope of this Note.

[97] *See supra* text accompanying notes 22-24. *See also* Temple v. Jones, Son & Co., 179 Va. 286, 19 S.E.2d 57 (1942).

fraudulent conveyance is essentially one of marshalling factors. Courts may differ on where the test is satisfied, but they seem to agree that the more indicia or badges of fraud the proponent can prove, the more likely relief will be provided.

D. *Designed to Protect Creditors*

A basic premise of fraudulent conveyance law is that a debtor is legally obligated to devote his property to satisfy his creditors' demands.[98] In West Virginia, any creditor who has been injured by a fraudulent deed may assert the statute[99] and have the transfer, whatever its nature, set aside.[100] By the language of the statute, the transfer of "any estate, real or personal"[101] is covered, making applicability a rare point of issue.

One unique additional feature of West Virginia's statute is its applicability to transfers or charges by insolvent debtors creating preferences.[102] The contrary majority rule, excepting preferences, is based on common law reasoning that a preference, as such, is not a fraudulent conveyance and that a debtor, though insolvent, could convey his property and prefer any one creditor over others,[103] so long as there was no fraudulent intent. As of 1895, West Virginia took its present statutory position that, where the debtor is insolvent, special rules should apply.[104] Interestingly, although the preference portion of the statute does not mention fraud or intent to defraud, cases have indicated that a creditor attacking a transfer as an unlawful preference must still prove fraud.[105]

Another variation of the statute which protects creditors is the invalidation of "voluntary conveyances."[106] This section, however, creates rights only in creditors whose claims existed at the time of the voluntary conveyance. Without regard to the debtor's intent, the "voluntary" portion of the statute

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[98] Clarke v. Friggins, 27 W. Va. 663 (1886).

[99] Charter v. Maxwell, 132 W. Va. 282, 52 S.E.2d 752 (1949); Carr v. Davis, 64 W. Va. 522, 63 S.E. 326 (1908).

[100] The particular form of the conveyance is immaterial since "the statute embraces *all* transfers of property where the intent is to harm creditors in enforcing their claims." Note, *supra* note 85, at 267. *See also* Humphrey v. Spencer, 36 W. Va. 11, 14 S.E. 410 (1892); Kanawha Valley Bank v. Wilson, 25 W. Va. 242 (1884).

[101] W. VA. CODE § 40-1-1 (1982).

[102] *Id.* at § 40-1-5.

[103] Wolf v. McGugin, 37 W. Va. 552, 16 S.E. 797 (1893); Jackson v. Kittle, 34 W. Va. 207, 12 S.E. 484 (1890). *See also* Smith v. Whitman, 39 N.J. 397, 189 A.2d 15 (1963).

[104] Note, *supra* note 85, at 287.

[105] Warren Ref. & Chem. Co. v. Dyer, 101 W. Va. 452, 132 S.E. 877 (1926); Bankers' Pocahontas Coal Co. v. Flanagan Coal Co., 100 W. Va. 707, 131 S.E. 545 (1926).

[106] W. VA. CODE § 40-1-3 (1982) ("every transfer or charge which is not upon consideration deemed valuable in law").

permits only *prior* creditors to attack the conveyance as void.[107] *Subsequent* creditors may only impeach a voluntary conveyance by proceeding under the primary theory of the statute[108] and showing fraudulent intent.[109]

Thus, the law of fraudulent conveyances gives creditors three alternatives, with certain conditions, with which to pursue a debtor; fraudulent transfers, preferences, and voluntary conveyances are all within its scope. There is, however, no distinction as to which type of debtor may be the subject of this pursuit, so the analysis can be separated from any attack on the corporate entity. This is particularly important with close corporations since assets are frequently transferred back and forth between them and their members.

Creditors aggrieved by a debtor's transfer will usually find some type of relief available under the broad scope of fraudulent conveyances, even if only an opportunity to show that some manifestations of "unfairness" exist.[110] In this way, an unsuccessful attempt to avoid the transfer under a fraudulent conveyance theory may, nevertheless, help the court conclude that the close corporation/grantor should not be recognized as a separate entity and that "piercing" is, therefore, an appropriate alternative remedy.

E. *Possibility of Tort Liability for Fraudulent Conveyances*

In addition to a statutory attack on a transfer designed to hinder creditors, there is some authority to support a common-law tort cause of action on similar facts. This additional theory would be important in any situation where the creditor could prove damages not redressed by setting aside the fraudulent transfer.[111]

A tort action based on fraud and deceit is analogous to a statutory fraudulent conveyance attack in that both are premised on an injury to the plaintiff's interest in property. An actual fraud upon creditors naturally occurs whenever there is an intention to prevent them from recovering just debts by an act which places the property of the debtor beyond their reach.[112] Moreover, fraud has been broadly defined to include "all acts, omissions, and

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[107] *Id. See also* Greer v. O'Brien, 36 W. Va. 277, 15 S.E. 74 (1892).

[108] W. VA. CODE § 40-1-1 (1982).

[109] F.S. Corson Co. v. Hartman, 144 W. Va. 790, 111 S.E.2d 346 (1959); Bankhead v. Baughman, 115 W. Va. 483, 176 S.E. 854 (1934); Lockhand v. Beckley, 10 W. Va. 87 (1877). For a discussion of the distinction between a prior and a subsequent creditor, see Peale v. Grossman, 70 W. Va. 1, 73 S.E. 46 (1911).

[110] *See supra* text accompanying notes 52-57.

[111] Generally, the remedy provided upon proof of a fraudulent conveyance is limited to setting it aside. *See* Patterson v. Patterson, 277 S.E.2d 709 (W. Va. 1981).

[112] Burt v. Timmons, 29 W. Va. 441, 2 S.E. 780 (1887). *See also* Hulings v. Hulings Lumber Co., 38 W. Va. 351, 185 S.E. 620 (1893).

concealments which involve a breach of legal duty, trust or confidence justly reposed, and which are injurious to another, or by which undue and unconscientious advantage is taken of another."[113] Constructive fraud is arguably broad enough to include a transfer to conceal assets because it constitutes "a breach of a legal or equitable duty, which, irrespective of moral guilt of the actor, the law declares fraudulent, because of its tendency to deceive others, to violate public or private confidence, or to injure public interests.[114]

The West Virginia Supreme Court of Appeals has recently demonstrated its willingness to make this type of analogy and inject fraud and deceit principles into cases traditionally based on the same underlying concerns.[115] Thus, in those situations where the statutory remedy provides inadequate relief to a creditor (for example where costs, expenses, and losses additional to the original obligation are incurred as a consequence of the fraudulent transfer), West Virginia courts should be receptive to this analogy on the basic idea that the plantiff is entitled to be compensated for actual losses.[116] Where circumstances support the argument, exemplary (punitive) damages might also be appropriate to punish the defendant and deter others from engaging in the same type of conduct against public policy.[117]

In the diverse factual situations contemplated by this Note, there may be more or less persuasive grounds for tort liability, depending upon how much interest the creditor has in the property actually transferred. Where, for example, the creditor has obtained a judgment against the debtor (which constitutes a lien against all the debtor's real property within the state[118]) the creditor has a recognized property interest in that real estate. A subsequent fraudulent transfer of real estate by the debtor may expose him and his conspirators to liability for improperly interfering with the execution of a judg-

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[113] Stanley v. Sewell Coal Co., 285 S.E.2d 679, 682 (W. Va. 1982). See also Dickel v. Smith, 38 W. Va. 635, 18 S.E. 721 (1893).

[114] *Stanley,* 285 S.E.2d at 683 (citing Miller v. Huntington & Ohio Bridge Co., 123 W. Va. 320, 15 S.E.2d 687 (1941)).

[115] *Stanley,* 285 S.E.2d at 683. The court found that an action for retaliatory discharge (a tort in West Virginia) was "sufficiently related to an action for fraud and deceit" that a statute providing for "survival" of a cause of action for fraud and deceit also applied to a retaliatory discharge action. *Id. See also* W. VA. CODE §§ 55-2-12, 55-7-8a (1981).

[116] *See* Yates v. Crozer Coal & Coke Co., 76 W. Va. 50, 84 S.E. 626 (1915); Talbott v. West Virginia C. & P. Ry., 42 W. Va. 560, 26 S.E. 311 (1896).

[117] Leach v. Biscayne Oil & Gas Co., 289 S.E.2d 197 (W. Va. 1982); Hensley v. Erie Ins. Co., 283 S.E.2d 227 (W. Va. 1981). This writer admits some reservation on the possibility that the courts would invoke public policy as justification for exemplary damages, especially where proof of malice or willful wanton misconduct would be difficult to prove and the injury complained of is hindrance of *creditor's* rights. This would certainly be an uncharacteristic situation for any court to find appropriate for additional sanctions against the defendant. *Cf.* Mandolidis v. Elkins Ind., 246 S.E.2d 907 (W. Va. 1978), which discusses appropriate circumstances for imposition of punitive damages.

[118] W. VA. CODE § 38-3-6 (1966).

ment.[119] Where that interference causes the creditor to incur costs and expenses of pursuing the property, loss of use or rents, or any damage to the property, it should be recoverable.

In arguing this tort theory, counsel must consider the particular circumstances and tailor alternative grounds. Any creditor can argue that he has a property interest in seeing any one piece of property remain in the hands of the debtor for ultimate satisfaction of the debt. The more certain and identifiable that interest, however, the more likely it will be protected.

IV. THE DOCTRINE OF CORPORATE OPPORTUNITY

A. *Explanation of the Doctrine*

In a narrow category of cases, directors, officers, or controlling shareholders of a close corporation have been held liable on the theory that certain business opportunities of the corporation may not be usurped to benefit individual personal interests. This theory is commonly known as the corporate opportunity doctrine.[120]

There are two particular situations where this doctrine may be utilized by creditors to protect their ability to have their claim against a close corporation satisfied. The first is where an individual or group of individuals was already doing business through more than one business organization when the creditor's claim arose.[121] Typically, the close corporation is only one of several or is related, usually by common ownership or control, to a partnership or proprietorship. In this situation, the controlling members routinely decide which business opportunities will be allocated to which entity in the overall business.[122]

Alternatively, the dominant or controlling members may have been using only one close corporation to pursue a particular business activity but, after the creditor's claim arises, that business begins to "expand" into other existing or newly-created business organizations. In either case, the creditor is faced with the possibility that the close corporation he had dealt with will have its revenue-generating capacity impaired by allocation of its business activities to other organizations.

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[119] *See, e.g.*, James v. Powell, 25 A.D.2d 1, 266 N.Y.S.2d 245 (1966), involving an attempt to execute judgment on the property of one Adam Clayton Powell who had conveyed away his property to frustrate that execution. *See also* Comment, *Creditor's Rights—Tort Liability for Fraudulent Conveyance*, 68 W. VA. L. REV. 416 (1966).

[120] 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 861.1 (rev. ed. 1975). *See also* Comment, *The Corporate Opportunity Doctrine*, 18 Sw. L.J. 96 (1964); Note, *Liability of Directors for Taking Corporate Opportunities, Using Corporate Facilities, or Engaging in a Competing Business*, 39 COLUM. L. REV. 219 (1939).

[121] *See* Berle, *supra*, note 28 for a discussion of the "enterprise entity" theory.

[122] This is the typical situation in which the doctrine is asserted. *See* Comment, *supra* note 120, at 96.

The leading case on the corporate opportunity doctrine is *Guth v. Loft*,[123] which stated the rule that:

> if there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or reasonable expectancy, and, by embracing the opportunity the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.[124]

In determining whether a particular business activity constitutes a corporate opportunity, at least three tests have developed, including:

1) the "expectancy test"—limiting "opportunities" to those situations in which the corporation has an existing interest or expectancy or where a corporation's purpose is frustrated by individual interference;

2) the "line of business test"—limiting the definition to situations where an insider engages in business closely associated with existing or prospective activities of the corporation, and

3) the "fairness test"—applying ethical standards of fairness to the facts.[125]

These tests have, most recently, been applied with a preference for the "fairness" approach or some variation on the same theme. This is appropriate because the very premise of the doctrine is the fiduciary relationship of directors and officers to the corporation, which calls into play notions of good faith, trust and fair dealing.[126]

B. *Remedy Provided by the Doctrine*

The general rule in applying the doctrine is that, if usurpation by the insider is proven, the opportunity and its proceeds will be held as a constructive trust for the benefit of the corporation.[127] This is exactly the relief an aggrieved creditor needs to protect his interest. The revenues or profits generated through the activity can be identified in the hands of the receiving entity and called upon to satisfy the creditor's claim. Where the business is service oriented and has few tangible assets, this remedy appears extremely attrac-

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[123] 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939).

[124] *Id.* at 272-73, 5 A.2d at 510-11.

[125] Miller v. Miller, 222 N.W.2d 71 (Minn. 1974); Comment, *supra* note 120, at 97-98.

[126] Pepper v. Litton, 308 U.S. 295 (1939); Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931); Sweeney v. Grape Sugar Ref. Co., 30 W. Va. 443, 4 S.E. 431 (1887). *See also* 3 W. FLETCHER, *supra* note 120 at § 863.

[127] Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939). Tierney v. United Pocahontas Coal Co., 85 W. Va. 545, 102 S.E. 249 (1920) ("such acquisition will be taken to be for the benefit of the corporation").

tive.[128] It addresses the situation where assets are insufficient or unavailable, making it a viable alternative to the law of fraudulent conveyances. By focusing on the fiduciary duties of officers, directors and controlling shareholders[129] to the corporation, it also reinforces and supplements an argument for "piercing the corporate veil."

C. *Problems in Assertion of the Doctrine by Creditors*

In the situations addressed by this Note, a substantial hurdle stands between a creditor and successful use of the doctrine. Traditionally, the cause of action under the doctrine has been narrowly granted under circumstances which may make its use by creditors difficult. The close corporation situation, however, lends itself to exceptions which help broaden the otherwise limited application.

1. Cause of action is the corporation's

From its inception, the doctrine has been asserted primarily by persons with identifiable interests in the corporation, such as stockholders (through a derivative action) or, occasionally, directors and officers.[130] The defendant in such a case might argue, quite persuasively, that a mere creditor of the corporation has only an inchoate interest, at best, in the corporation's on-going business activities. Such an interest would be insufficient to justify interference with otherwise valid business judgments, under normal circumstances.

This argument, however, pales considerably when the position of the creditor of a close corporation is being addressed. A creditor, while not as directly interested in the corporation as a shareholder, is, nevertheless, an object of the fiduciary duty imposed upon directors and officers.[131] In a close corporation, the controlling members have an even greater fiduciary obligation; they must prove the good faith and inherent fairness of any challenged transaction "from the viewpoint of the corporation and those interested therein."[132] As a practical matter, when a close corporation is being managed by its sole shareholder, there may be no one better situated to assert the corporation's rights than a creditor.

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[128] Where the business is labor or service intensive (e.g., the coal brokerage hypothetical), this theory would be much more useful than where the business is capital intensive (e.g., manufacturing).

[129] By virtue of his strategic corporate position, a controlling stockholder in a close corporation is in the same fiduciary relationship to the corporation and its creditors as directors and officers. Pepper v. Litton, 308 U.S. 295 (1939); *See* Comment, *supra* note 120, at 113.

[130] *See, e.g.*, Miller v. Miller, 222 N.W.2d 71 (Minn. 1974) (shareholder's derivative action); Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931) (minority stockholders); Tierney v. United Pocahontas Coal Co., 85 W. Va. 545, 102 S.E. 249 (1920) (minority stockholders).

[131] *In re* Parsons Lumber & Planing Mill Co., 218 F. 674, 677 (N.D. W. Va. 1914); Rathbone v. Parkersburg Gas Co., 31 W. Va. 798, 804, 8 S.E. 570, 573 (1888).

[132] Pepper v. Litton, 308 U.S. 295, 306 (1939) (emphasis added); *see also* Geddes v. Anaconda Copper Mine Co., 254 U.S. 590, 599 (1921).

Usurpation of a corporate opportunity can be compared to any other type of mismanagement, official misconduct or waste of assets because it works to the detriment of the corporation. When that detriment is a factor in the insolvency of a corporation, the creditor's interest becomes even more critical. Thus, in insolvency, the creditor's rights are asserted collectively by the receiver or trustee. These include any cause of action which the corporation itself may have against its managers for breach of their duties.[133]

This is especially true in West Virginia where a long line of cases stands for the proposition that managers of an insolvent corporation are bascially trustees, holding the corporation's property for the benefit of all the creditors.[134] These cases seem to indicate that a creditor's standing to challenge managerial decisions detrimental to the corporation improves as the corporation's financial position deteriorates until, finally, the creditor is given at least a qualified right to assert what would otherwise be the corporation's rights. Thus, it follows that the utility of the corporate opportunity doctrine may be at its highest when the financial position of the corporation is at its lowest. One other factor, however, prohibits this conclusion.

2. Financial inability of the corporation as a defense

A basic issue in any assertion of the corporate opportunity doctrine is the ability of the corporation to avail itself of the opportunity. A business opportunity cannot be a "corporate opportunity" when the corporation, because of insolvency, legal restrictions or any other factor, would not be able to act upon the opportunity.[135] Therefore, if a creditor waits too long to attempt to assert the rights of the corporation, he may find that the hurdle of a lack of standing to assert the doctrine is replaced by the defense of corporate inability. Since the date for consideration of the inability defense is the date on which the opportunity was appropriated, it appears that the later it occurs in the corporation's downhill financial slide, the more applicable the defense becomes.

There is authority, however, for the opposite view, that financial inability of the corporation is no defense to usurpation of a corporate opportunity.[136] That line of authority rests heavily on the fiduciary responsibility of the managers. The reasoning is that if such conduct were justified on the theory of financial inability of the corporation, there would be a temptation for the man-

[133] *See, e.g.*, Besselieu v. Brown, 177 N.C. 65, 97 S.E. 743 (1919).

[134] *E.g.*, Lilly v. Ernst, 113 F. Supp. 178 (S.D. W. Va. 1952); Ohio Fin. Co. v. Mannington Window Glass Co., 86 W. Va. 322, 103 S.E. 333 (1920); Ruffner v. Welton Coal & Salt Co., 36 W. Va. 244, 15 S.E. 48 (1892).

[135] Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931). *See also* 3 W. FLETCHER, *supra* note 120, at § 862.1.

[136] Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934), *cert. denied*, 294 U.S. 709, *reh'g denied*, 294 U.S. 733 (1935); W. H. Elliott & Sons Co. v. Gotthardt, 305 F.2d 544 (1st Cir. 1962).

agers to refrain from using their best efforts on behalf of the corporation, since its inability opens up an avenue of personal profit for them.[137] This authority also recognizes that financial inability and insolvency are not synonymous. Insolvency implies that the business's assets are insufficient to meet existing obligations and at least some of the manager's decision-making powers have been nullified. Financial inability, on the other hand, might be nothing more than inadequate resources, or lack of access to the resources that would be required, to pursue a new business venture. Where insolvency connotes actual inability, financial inability may be merely a matter of business judgment.

The corporate opportunity doctrine is an uncharacteristic theory for attacking a scheme to defeat the interests of creditors. In applying it to the facts of any one situation, special consideration must be given to creditor standing and financial inability hurdles. Where it does apply, however, it is entirely consistent with, and complements, an argument for "piercing the corporate veil," because it is determined on the objective facts and circumstances at the time the opportunity arose.[138] Likewise, in situations where the potential injury to a creditor is diminished corporate revenues as well as a transfer of assets, the doctrine nicely supplements the law of fraudulent conveyances. One court has specifically held that where the officers and directors of a corporation form a new corporation whose purpose and line of business is close to that of the former corporation, equity, *under the proper circumstances* will impose a constructive trust for the benefit of the former, on the theory of misappropriation of corporate opportunity.[139]

V. CONCLUSION

For an unsecured creditor, the task of pursuing satisfaction of its claim through a maze of corporate structures or transactions can be formidable. Likewise, the wide diversity of methods in which corporate status may be manipulated to the detriment of creditors makes it nearly impossible to formulate a "canned" challenge. Nevertheless, since the foregoing theories have developed in light of these differing circumstances, each can be tailored to take advantage of factors weighing in the creditor's favor. Used together, they can be more persuasive than any one alone. Yet, each has its own special situations for application and effectiveness.

The doctrine of piercing the corporate veil is an appropriate consideration anytime the validity of corporate separateness is unclear. In close corporations, the inherent similarities with unincorporated business organizations,

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[137] *Irving Trust*, 73 F.2d at 124.

[138] Borden v. Sinskey, 530 F.2d 478 (3d Cir. 1976); Morad v. Coupounas, 361 So. 2d 6 (Ala. 1978); Schreiber v. Bryan, 396 A.2d 512 (Del. Ch. 1978).

[139] Morad v. Coupounas, 361 So. 2d 6 (Ala. 1978) (emphasis added).

and the inevitable tendency to function as such, make it even more applicable. Especially in a jurisdiction which recognizes the fiduciary duties in the close corporate setting, the doctrine can be effectively used to fix liability on either individuals or related corporations hiding behind the corporate veil.

The law of fraudulent conveyances, as compared to the doctrine of piercing the corporate veil, can be utilized anytime a transfer of assets is involved without regard to the identity of transferor and transferee. In those situations where piercing applies, it effectively reinforces the challenge as a back-up argument. Even if the piercing attack fails, the conveyance of valuable assets can be unwound, providing the same favorable result.

As an added benefit, the piercing doctrine and fraudulent conveyance law are linked by fiduciary relationships and are sensitive to any evidence of fraud. Therefore, they complement each other by strengthening the other's persuasive appeal. Although distinctively different, they are premised on the same underlying concern with fairness to creditors.

The doctrine of corporate opportunity, while much less frequently asserted, fits nicely into the reliance on fiduciary relationships and closes an important gap. Where business opportunities have been diverted away from the close corporation, a creditor may find it much more productive than other theories. Despite its limited availability for use by creditors against corporations generally, the special situation of close corporations appears to be particularly appropriate for its use. Again, the exaggerated fiduciary element in close corporations and the underlying concern with fairness to creditors buttress its applicability.

All three theories are particularly dependent on the "totality of the circumstances." While each is designed to address a certain abuse, any factual situation may be appropriate for the assertion of any combination of them. Thus, they should be pleaded alternatively and concurrently, with careful concern for distinction and reinforcement rather than confusion of each with the others.

Although all the factors to be considered are discussed in the case law, this precedent discloses certain "more persuasive" factors, such as breach of fiduciary duty or fraud, in any review of the totality of the circumstances. By focusing on those factors which weigh heavily in favor of all three alternative challenges, the implementation of any of them is made more palatable to the courts.

By casting the challenges against the background of fairness and public policy on which corporate existence is based, the propriety and likelihood of creditor relief is enhanced. Whether one of the theories discussed in this Note or some other is utilized, fairness and equity will always weigh heavily in favor of creditor relief whenever a close corporation's actions or structure offend the very public policy which justifies its existence.