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Disregard of the Corporate Entity

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NOTES

DISREGARD OF THE CORPORATE ENTITY

The characteristic of corporations which gives shareholders limited liability has profoundly affected American economic growth. Unfortunately, economic growth has not been the sole result of limited liability, for the corporate device can be used to achieve unjust ends. Disregard of the corporate entity, which eliminates limited shareholder liability, is an equitable remedy invoked when the benefits of incorporation are outweighed by equities in favor of unpaid creditors of the corporation. Judicial evolvement of the corporate disregard doctrine, however, has been equivocal and confusing; few standards exist to guide understanding. This Note evaluates the doctrine as it has evolved in Minnesota and other jurisdictions. In addition, this Note offers a suggested approach which attempts to identify the relevant policies and facts that should be considered when a court disregards a corporate entity.

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I. INTRODUCTION

The benefits derived from combination of resources and talents for common enterprise are exemplified nowhere better than by the private business corporation. The advantages of incorporation are evidenced by the overwhelming acceptance of the corporate device in American business;[1] it has been a major factor contributing to this nation's phenomenal industrial growth.[2] Through the use of corporations, investors can combine capital and participate in the profits of large and small business enterprises with the advantages of perpetual existence, free transferability of interest, and centralized management.[3] For these reasons, the corporation is accorded a favored status in the law. The Minnesota Supreme Court has recognized this status, stating: "The corporation is of the utmost importance to the industrial and commercial world. It is essential to the welfare of our business interests."[4]

Legislatures have endowed corporations with certain characteristics. Although limited liability has not always been one of these characteristics,[5] it is clear now that the attribute of limited shareholder liability

1. *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 1 (2d ed. 1970); U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1977, at 258 (2,144,000 corporate tax returns filed in 1976).

2. *See, e.g.*, H. BALLENTINE, CORPORATIONS § 1 (rev. ed. 1946); Oleck, *Remedies for Abuses of Corporate Status*, 9 WAKE FOREST L. REV. 463, 466 (1973) (corporation invaluable in the economic development of the United States); *cf.* I. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 2-3 (1927) (corporation allows trade on a scale commensurate with modern needs).

3. *See, e.g.*, H. BALLANTINE, *supra* note 2, § 1; H. HENN, *supra* note 1, §§ 73-75.

4. Congdon v. Congdon, 160 Minn. 343, 373, 200 N.W. 76, 87 (1924); *accord*, Ballantine, *Stockholders' Liability in Minnesota*, 7 MINN. L. REV. 79, 79-80 (1923) (corporation greatest factor in modern business). The status also carries with it an unqualified responsibility to act compatibly with the public interest. *See* Viiliainen v. American Finnish Workers Soc'y, 236 Minn. 412, 416, 53 N.W.2d 112, 115 (1952); *In re* E.C. Warner Co., 232 Minn. 207, 212-13, 45 N.W.2d 388, 392 (1950).

5. The early legislatures were unwilling to grant limited liability to shareholders of industrial corporations. *See* Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351, 1352 (1948).

Minnesota was among those states reluctant to free stockholders from liability for the debt of the corporations in which they owned stock. The Minnesota Constitution as adopted in 1857 provided: "Each stockholder in any corporation shall be liable to the amount of stock held or owned by him." MINN. CONST. art. 10, § 3 (1857) (amended 1872, 1930, and 1954; repealed 1974). An 1872 amendment inserted an exception for corporations "organized for the purpose of carrying on any kind of manufacturing or mechanical business . . . ." *Id.* (1872). The most significant development occurred in 1930 when the section was rewritten to vest in the legislature the power to "limit or otherwise regulate the liability of stockholders or members of corporations . . . ." *Id.* (1930). Only one exception

has played a major role in increasing the popularity of incorporation.[6] Without limited liability the amount of capital needed for modern business probably could not have been assembled.[7] The courts recognize this advantage, holding that incorporation even for the sole purpose of achieving limited liability is legally permissible.[8] Yet the limited liability attribute is not absolute; the courts have retained the power to ignore the corporate entity and impose shareholder liability in appropriate cases. This judicial power, labelled the doctrine of "disregard of the corporate entity"[9] or "piercing the corporate veil,"[10] developed to correct the inevitable injustices that were not intended to be sanctioned by incorporation.

The doctrine of corporate disregard is an equitable remedy.[11] As with any equitable remedy, the doctrine involves the balancing of competing policies.[12] The policies favoring incorporation therefore must be bal-

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to the legislative power remained: shareholders of banking or trust corporations were still liable for the debts of the corporation "contracted prior to any transfer of such stock and such individual liability shall continue for one year after any transfer of such stock . . . ." Pursuant to the 1930 amendment, the legislature passed Act of Apr. 18, 1933, ch. 300, § 18, 1933 Minn. Laws 406 (current version at MINN. STAT. § 301.19 (1976)), which effectively limited the liability of shareholders for the debts of the corporation once the shareholder had complied with the contract for subscription. The 1954 amendment removed the banking exception. The current version of the Minnesota Constitution, following its restructuring in 1974, *see* Act of Apr. 10, 1974, ch. 409, § 1, 1974 Minn. Laws 787, eliminated this provision entirely.

6. *See* Johnson v. Kinchen, 160 So. 2d 296, 299 (La. Ct. App. 1964) (limited liability encourages and promotes business which provides employment, creates sales of goods, and adds to the nation's economic and financial stability and prosperity); I. WORMSER, LAW OF PRIVATE CORPORATIONS 2 (1914) (limited liability the "greatest contribution of our civilization"); Ballantine, *supra* note 4, at 79-80 (limited liability "the corporation's most precious characteristic"). Lay persons assume unquestionably that shareholders have limited liability. *See* Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D. L. REV. 363, 363 (1969). Limited liability, however, may assume decreasing importance because of the concentration of investment in comparatively few corporations. Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1376 (1938).

7. *See* H. BALLANTINE, *supra* note 2, § 1; *cf.* W. COOK, THE PRINCIPLES OF CORPORATION LAW 19 (1925) ("limited liability is the 'open sesame' to the accumulated wealth of the world"); Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643, 654 (1932) (in medieval Europe men would often decline to enter into business transactions unless they could limit their liability).

8. *See, e.g.*, Anderson v. Abbott, 321 U.S. 349, 361-62 (1944) (limited liability is the rule of corporations, not the exception); Gledhill v. Fisher & Co., 272 Mich. 353, 359, 262 N.W. 371, 373 (1935); 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.2 (rev. perm. ed. 1974).

9. *In re* Will of Clarke, 204 Minn. 574, 579, 284 N.W. 876, 879 (1939).

10. *Id.*

11. *See, e.g.*, Erickson-Hellekson-Vye Co. v. A. Wells Co., 217 Minn. 361, 381-82, 15 N.W.2d 162, 173 (1944); 1 W. FLETCHER, *supra* note 8, § 41.2.

12. *See* United Paperworkers Int'l Union v. Penntech Papers, Inc., 439 F. Supp. 610, 617 n.7 (N.D. Me. 1977). The disregard remedy must be evaluated in terms of the two strong competing policies involved in the cases: the necessity to foster the growth of the

anced against the public policies supporting performance of contracts, repayment of debt, and compensation for personal injury.[13] Normally this evaluation occurs in cases involving close, parent-subsidiary, or affiliated corporations because the doctrine is rarely invoked against large publicly held corporations having many shareholders.[14] The more liberal use of the corporate disregard remedy over the last half-century reflects the frequently superior equities of the wronged creditor *vis-à-vis* the somewhat more abstract benefits to the national economy flowing from corporateness.[15] This Note will examine the doctrine of corporate disregard as it has developed in Minnesota.[16] Moreover, alternative theories and a suggested approach will be set forth.[17] Finally, exceptional applications of the doctrine involving policies not normally relevant to most disregard actions will be evaluated.[18]

II. MINNESOTA LAW

A. *Traditional Concepts*

The Minnesota Supreme Court has a long history of struggling with the scope of the corporate disregard doctrine. As in most jurisdictions, however, the Minnesota court has yet to elucidate standards concerning the doctrine,[19] although the court in a recent decision has taken some

corporate style of doing business and the need to compensate or pay corporate creditors. *See* Dobbyn, *A Practical Approach to Consistency in Veil-Piercing Cases,* 19 U. KAN. L. REV. 185, 185 (1971). A triangle of interests is presented: a plaintiff seeking to enforce an obligation, a corporation being held directly liable to the plaintiff, and a shareholder on whom the plaintiff is seeking to shift the liability. *Id.*

13. *See generally* 1 W. FLETCHER, *supra* note 8, § 41.3 (contracts, debts); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 4 (4th ed. 1971) (personal injury).

14. *See* F. O'NEAL, CLOSE CORPORATION LAW AND PRACTICE § 1.09a (2d ed. 1971 & Supp. 1977); Gillespie, *supra* note 6, at 378.

15. *See* McCaskill Co. v. United States, 216 U.S. 504, 515 (1910) (growing tendency to pierce corporate veil); Metropolitan Holding Co. v. Snyder, 79 F.2d 263, 266 (8th Cir. 1935); Note, *The Bodies Behind the Veil,* 76 S. AFR. L.J. 89, 90 (1959) (judges in America are more willing to pierce the veil than judges in South Africa or Great Britain).

16. See notes 19-120 *infra* and accompanying text.

17. See notes 121-97 *infra* and accompanying text.

18. See notes 198-223 *infra* and accompanying text.

19. *See* Note, *Corporations—Disclosing the Actual Identity of Related Corporations for the Purpose of Ignoring the Corporate Fiction When One is Insolvent,* 4 MINN. L. REV. 219, 221 (1920) (no disregard rule has been established which might furnish accurate test of disregard). *See generally* Wang, *The Corporate Entity Concept (Or Fiction Theory) and the Modern Business Organization,* 28 MINN. L. REV. 341 (1944).

A federal court in 1905 formulated what has been described as a "landmark" disregard rule: "[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." United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (E.D. Wis. 1905). A leading commentator apparently embraced the formulation. *See* Wormser, *Piercing the Veil of Corporate Entity,* 12 COLUM. L. REV. 496, 517 (1912). The Minnesota Federal District Court apparently adopted the *Milwaukee* formulation in the decision of *In re* O'Brien, 40 F.2d 554, 555 (D. Minn. 1930). The rule's weakness is its inutility as an

steps in that direction.[20]

In the latter part of the last century and the early part of the present one the Minnesota Supreme Court was reluctant to apply the doctrine of corporate disregard.[21] The court's attitude was based primarily on its great respect for the independence of the corporate entity, perhaps as a consequence of the Industrial Revolution.[22] For example, in *Gallagher v. Germania Brewing Co.*,[23] decided in 1893, the court stated that "it has been found absolutely essential, for the administration of justice, to treat a corporation as a collective entity, without regard to its individual shareholders. In no other way can title to corporate property be kept free from complication and uncertainty."[24] Similarly, in *Moe v. Harris*,[25] the court denied corporate creditors a remedy against shareholders of a corporation that had subscribed no stock, kept no books, adopted no bylaws, held no meetings, and elected no officers. Thus the court established early a firm respect for the corporate entity.[26]

Despite the court's initial reluctance to invoke the corporate disregard remedy, the injustices that can result from improper use of the corporate form caused the court to change its position. The factors the court has considered when deciding whether to invoke the corporate disregard

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analytic tool or standard by which to measure conduct. *See* Dobbyn, *supra* note 12, at 185-86 (years of quoting the formula have added little to its usefulness).

20. *See* notes 62-65 *infra* and accompanying text.

21. Minnesota commentators perhaps contributed to that attitude, urging that the corporate entity only be pierced in cases of actual common law fraud. *See* Note, *Corporations—Disregarding the Concept of a Separate Corporate Entity—Especially in Cases Lacking Elements of Fraud*, 10 MINN. L. REV. 598, 599-600 (1926). For an early view advocating the abolition of the corporate disregard remedy on the rationale that the same result can almost always be reached through other legal principles, see 20 HARV. L. REV. 223, 224 (1906).

22. One authority states:

> [T]he steaming breath of the Industrial Revolution was hot on the backs of businessmen and lawyers. The barriers created by the South Sea Bubble Acts began to give way in England in the first ten years of the 19th century; and in the second and third decades here the old prejudices [against corporations] went by the board.
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> . . . .
>
> . . . The corporate clothing of the early 19th century did not fit the burgeoning industry of the second half; and the community, perhaps wisely, decided that it would rather have economic growth than social control.

Berle, *Historical Inheritance of American Corporations*, in N.Y.U. SCHOOL OF LAW, SOCIAL MEANING OF LEGAL CONCEPTS 189, 195, 199 (1950).

23. 53 Minn. 214, 54 N.W. 1115 (1893).

24. *Id.* at 219, 54 N.W. at 1116.

25. 142 Minn. 442, 172 N.W. 494 (1919).

26. The Minnesota court offered the following practical reasons for not piercing the corporate veil: (1) title to corporate property must be kept free from complication, (2) the transferable nature of stock supports keeping shareholders distinct from the corporate entity, and (3) the individual and corporate obligations of the shareholders should be kept separate. *See* Gallagher v. Germania Brewing Co., 53 Minn. 214, 219, 54 N.W. 1115, 1116 (1893).

remedy include fraud, failure to observe corporate formalities, inadequate capitalization, excessive control or dominance, and presence of subsidiary or affiliated corporations.[27] The court's treatment of each of these factors will be discussed below.

1. *Fraud*

The most important doctrinal shift in Minnesota corporate disregard law, presaged by earlier opinions,[28] occurred in *Matchan v. Phoenix Land Investment Co.*[29] In that case the shareholder utilized several corporations through which he passed property in an attempt to avoid his creditors. Characterizing the transactions as "grossly and intentionally fraudulent,"[30] the court held that the shareholder's fraud was attributable to the corporation. In a vivid example of the metaphoric language so familiar to this area of the law, the court stated the following rule:[31]

> Where a corporation has been organized and used as an instrument of fraud; where, as here, an individual has incorporated himself in order to hinder and, if possible, defraud creditors, courts will go as far as necessary in disregarding the corporation and its doing in order to accomplish justice. Such a corporation is a mere parasitic growth, a mass of fungus, which will be lopped off clean whenever necessary to sound results.

Thus, the court in *Matchan* established the basic rule that the corporate entity will be disregarded when used by its shareholders to perpetrate a fraud.[32]

The dominant theme in Minnesota corporate disregard law since *Matchan* has been the requirement of fraudulent shareholder conduct,[33] although a recent case, *Manufacturers Building, Inc. v. Heller,*[34] allowed disregard without a finding of fraud. In *Heller* the court disregarded a corporate entity to decide a dispute between its shareholders after the trial court found that fraud was not involved. This apparent contradic-

27. *See* Note, *supra* note 19.

28. *See* Erickson v. Revere Elevator Co., 110 Minn. 443, 444, 126 N.W. 130, 131 (1910); State v. Creamery Package Mfg. Co., 110 Minn. 415, 433, 126 N.W. 126, 129 (1910).

29. 159 Minn. 132, 198 N.W. 417 (1924).

30. *Id.* at 137, 198 N.W. at 419.

31. *Id.* at 138, 198 N.W. at 420.

32. It is well established that fraud is a leading factor in disregard law. *See* 1 W. FLETCHER, *supra* note 8, § 44; Note, *supra* note 21.

33. *See* Ahlm v. Rooney, 274 Minn. 259, 264, 143 N.W.2d 65, 69 (1966); Fewell v. Tappan, 223 Minn. 483, 495, 27 N.W.2d 648, 655 (1947); Whitney v. Leighton, 225 Minn. 1, 8, 30 N.W.2d 329, 333 (1947), *aff'd on rehearing,* 225 Minn. 12, 30 N.W.2d 335 (1948); Central Motors & Supply Co. v. Brown, 219 Minn. 467, 469, 18 N.W.2d 236, 237 (1945); Lake Park Dev. Co. v. Paul Steenberg Constr. Co., 201 Minn. 396, 402, 276 N.W. 651, 655 (1937); Prudential Ins. Co. of America v. A. Enkema Holding Co., 196 Minn. 154, 157-58, 264, N.W. 576, 577-78 (1936).

34. 306 Minn. 180, 235 N.W.2d 825 (1975), *noted in* 3 WM. MITCHELL L. REV. 293 (1977).

tion can be explained by the fact that *Heller* did not involve corporate creditors but rather concerned a dispute among shareholders of a close corporation. In such a case, disregard can be justified on the rationale that partnership law often establishes more appropriately the rights of close-corporation shareholders *inter se* when third-party creditors are not involved.[35] When third-party creditors are involved the fraud requirement is probably still applicable.

Cases following *Matchan* indicate that the fraud requirement does not contemplate strict common law fraud, but rather fraud in the more general sense of using the corporate entity in an unjust manner.[36] These cases suggest that other factors may be relevant to whether the corporate entity should be disregarded, such as failure to follow corporate formalities,[37] inadequate capitalization,[38] and shareholder dominance of the corporation,[39] but generally only if they are coupled with fraud or themselves result in fraud.[40] Although fraud has dominated Minnesota corporate disregard law, the court has given weight to these other factors and therefore they do merit discussion.

2. *Corporate Formalities*

Corporations are expected to follow certain formalities, such as adopting bylaws,[41] preparing minutes,[42] keeping corporate and shareholder assets separate,[43] and holding shareholders' and directors' meetings.[44] Failure to comply with these requirements, however, is not fatal under the statutes to the corporate existence of an otherwise de jure corporation.[45] Thus, in *Whitney v. Leighton,*[46] the court held that evidence of

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35. *See* 3 WM. MITCHELL L. REV. 293, 295 (1977).

36. *See* Erickson-Hellekson-Vye Co. v. A. Wells Co., 217 Minn. 361, 380-82, 15 N.W.2d 162, 172-73 (1944) (corporate entity will be disregarded to obviate inequitable results); Prudential Ins. Co. of America v. A. Ankema Holding Co., 196 Minn. 154, 158, 264 N.W. 576, 578 (1936) (corporate entity will be disregarded to achieve some strong equitable result). This definition of fraud in disregard law is followed by most authorities. *See, e.g.,* 1 W. FLETCHER, *supra* note 8, § 44 (actual or constructive fraud). Constructive or legal fraud has been defined to mean a breach of a legal or equitable duty that tends to deceive others or to injure public interests. Stern v. National City Co., 25 F. Supp. 948, 957 (D. Minn. 1938), *aff'd sub nom.* City Co. v. Stern, 110 F.2d 601 (8th Cir. 1940), *rev'd on other grounds per curiam,* 312 U.S 666 (1941).

37. See notes 41-51 *infra* and accompanying text.

38. See notes 52-58 *infra* and accompanying text.

39. See notes 59-65 *infra* and accompanying text.

40. *See* Note, *supra* note 19, at 222, 227 (failure to observe formalities and shareholder dominance are merely evidentiary facts which are not conclusive).

41. *See* MINN. STAT. § 301.24 (1976).

42. *See id.* § 301.34(2).

43. *See, e.g.,* Gallagher v. Germania Brewing Co., 53 Minn. 214, 219, 54 N.W. 1115, 1116 (1893).

44. *See* MINN. STAT. §§ 301.25, .28 subd. 4(3) (1976).

45. *See* Moe v. Harris, 142 Minn. 442, 172 N.W. 494 (1919).

46. 225 Minn. 1, 30 N.W.2d 329 (1947), *aff'd on rehearing,* 225 Minn. 12, 30 N.W.2d 335 (1948).

failure to follow corporate formalities alone was not sufficient to justify corporate disregard. In *Whitney*, the defendant shareholder intermingled corporate and personal funds and failed to keep separate corporate financial records, yet the court held that "[i]n the absence of fraud, the corporation must be treated as a legal entity separate and apart from its stockholders."[47] *Whitney* seems to have made it clear that lack of formalities, without a showing of fraud, is not sufficient to justify the piercing remedy.[48]

Nonetheless, failure to observe corporate formalities is a factor the court can and normally will consider. For example, in *General Underwriters, Inc. v. Kline*,[49] decided after *Whitney*, the court disregarded the corporate entity, emphasizing that the corporation kept no books of account, had no corporate minutes for the preceeding four years, could not locate its corporate records, and had no separate corporate offices. The *General Underwriters* court also found the defendant shareholder had used the corporation as an instrument to defraud creditors.

Evidence of failure to observe corporate formalities pervades corporate disregard law.[50] This emphasis suggests that the failure to observe corporate formalities is sufficient by itself to justify disregard of the corporate entity. Analysis of *Whitney* and *General Underwriters*, however, suggests that failure to observe formalities is relevant because it may show fraud or injustice. Thus, evidence of failure to observe corporate formalities is relevant in Minnesota corporate disregard law, but perhaps for reasons different than those in other jurisdictions. Moreover, failure to observe formalities may indicate the shareholder's view of the business organization, and the court legitimately may take this into consideration in deciding whether to disregard the corporate entity.[51]

3. *Inadequate Capitalization*

The Minnesota Supreme Court has not had the opportunity to delineate the role that inadequate capitalization of a corporation by its shareholders should play in relation to the corporate disregard remedy.[52] A

47. 225 Minn. at 8, 30 N.W.2d at 333.

48. *Accord*, Moe v. Harris, 142 Minn. 442, 172 N.W. 494 (1919) (court denied piercing remedy and suggested creditors might have a remedy against the shareholders on a common law fraud theory).

49. 233 Minn. 345, 46 N.W.2d 794 (1951).

50. *See generally* Annot., 46 A.L.R.3d 428 (1972).

51. *E.g.*, Edward Finch Co. v. Robie, 12 F.2d 360, 362 (8th Cir. 1926); United States v. Figur, 80 F. Supp. 140, 141-42 (D. Minn. 1948). Disregard based on failure to observe formalities and fraud has been labelled the "identity" rule of the doctrine. *E.g.*, Dobbyn, *supra* note 12, at 186-87. The metaphor "identity" suggests an impermissible failure to separate personal and corporate business and thus serves as a basis for disregard. *Id.*

52. Other courts have struggled with the role of inadequate capitalization. *Compare, e.g.*, Minton v. Cavaney, 56 Cal. 2d 576, 579-80, 364 P.2d 473, 475, 15 Cal. Rptr. 641, 643 (1961) (in bank) (shareholders are personally liable "when they provide inadequate capitalization and actively participate in the conduct of corporate affairs") *with, e.g.*, Harris

decision sometimes cited by other authorities[53] as a leading inadequate capitalization case is *Erickson v. Minnesota & Ontario Power Co.*[54] In *Erickson* a subsidiary corporation caused property damage to the individual plaintiff. The subsidiary was without funds to pay for the damage, apparently because the defendant parent corporation capitalized the subsidiary in a manner that left it without any revenue. The court held the parent corporation liable for the subsidiary's tort, presumably at least in part because the parent caused the subsidiary to be inadequately capitalized. *Erickson,* however, is not without ambiguity. The court purported to impose shareholder liability on agency principles rather than by disregarding the corporate entity of the subsidiary.[55] Moreover, the court did not state clearly the role inadequate capitalization played in its decision. Nonetheless, *Erickson* does provide support for the proposition that inadequate capitalization can be a reason for imposing shareholder liability.[56]

The *Erickson* decision could suggest that inadequate capitalization is sufficient, without a showing of fraud, to disregard a corporate entity.[57] The court has never decided this issue, but it has suggested that inadequate capitalization is relevant because it tends to prove that fraud occurred.[58] Although Minnesota law is by no means clear on this point, this suggests that inadequate capitalization probably is not sufficient to invoke the piercing remedy unless it amounts to a fraud upon the corporation's creditors.

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v. Curtis, 8 Cal. App. 3d 837, 841, 87 Cal. Rptr. 614, 617-18 (1970) ("Appellants would have us declare that, per se, inadequate capitalization renders the shareholders, officers and directors liable for the obligations of the corporation. They cite no case so holding, and we know of none.").

53. *See, e.g.*, Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations,* 39 YALE L.J. 193, 203 (1929); Note, *Inadequately Capitalized Subsidiaries,* 19 U. CHI. L. REV. 872, 872 n.3 (1952).

54. 134 Minn. 209, 158 N.W. 979 (1916).

55. *Id.* at 214, 158 N.W. at 981; *see* 77 U. PA. L. REV. 808, 809 (1929) (citing *Erickson* for proposition that agency law is superior to application of disregard doctrine). For a general discussion of the law of agency and shareholder liability, see notes 89-93 *infra* and accompanying text.

56. *Accord,* United States v. Reserve Mining Co., 380 F. Supp. 11, 28-29 (D. Minn.) (subsidiary operated merely to "break even" each year), *modified,* 490 F.2d 688 (8th Cir.), *motion for stay of injunction granted,* 498 F.2d 1073 (8th Cir.), *successive motions to vacate stay denied,* 418 U.S. 911, 419 U.S. 802, 420 U.S. 1000 (1974), *aff'd sub nom.* Reserve Mining Co. v. EPA, 514 F.2d 492 (8th Cir. 1975). For a general discussion of inadequate capitalization as a factor in disregard law, see Annot., 63 A.L.R.2d 1051 (1959).

57. In support of its decision to pierce, the court merely reviewed the capitalization facts and then held that the subsidiary was the "mere agency" of the defendant. *See* Erickson v. Minnesota & Ont. Power Co., 134 Minn. 209, 214, 158 N.W. 979, 981 (1916).

58. *See* Ahlm v. Rooney, 274 Minn. 259, 263-64, 143 N.W.2d 65, 68-69 (1966). *But see* Texas Indus., Inc. v. Dupuy & Dupuy Developers, Inc., 227 So. 2d 265, 269 (La. Ct. App. 1969) (inadequate capitalization alone not sufficient evidence of fraud).

4. *Shareholder Dominance*

Many early Minnesota corporate disregard cases emphasize the dominance exercised over the corporation by the defendant shareholder.[59] Some even suggest that dominance alone can be a basis for imposing personal liability upon shareholders,[60] although these cases normally involve fraud as well as shareholder dominance.[61] The shareholder dominance factor is an elusive one, especially in the close-corporation setting, for the close corporation invariably is dominated by its shareholders.[62] The Minnesota Supreme Court recognized this in a relatively recent decision, *Ahlm v. Rooney,*[63] where it held that shareholder dominance of a close corporation, without fraud, was not a sufficient basis for imposing shareholder liability. The court recognized that the corporation was completely dominated by the defendant shareholder, but stated this was a phenomenon inherent in closely held corporations.[64] In light of *Ahlm,* dominance rightfully should play a minimal role in most future Minnesota corporate disregard cases.[65]

5. *Parent-Subsidiary and Affiliated Corporations*

The limited liability principle is designed primarily to benefit individual shareholders, and therefore the policies favoring limited liability probably are not as strong in cases involving subsidiary or affiliated corporations.[66] For this reason, the courts often are more willing to pierce the corporate veil if the shareholder is a corporation.[67]

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59. *See, e.g.,* Central Motors & Supply Co. v. Brown, 219 Minn. 467, 469-70, 18 N.W.2d 236, 237 (1945); Lake Park Dev. Co. v. Paul Steenberg Constr. Co., 201 Minn. 396, 399-400, 276 N.W. 651, 653-54 (1937); Walsh v. Mankato Oil Co., 201 Minn. 58, 61-62, 275 N.W. 377, 379 (1937); Minneapolis Civic & Commerce Ass'n v. Chicago, M. & St. P. Ry., 134 Minn. 169, 176-77, 158 N.W. 817, 819-20 (1916), *aff'd,* 247 U.S. 490 (1918).

60. *See, e.g.,* Lake Park Dev. Co. v. Paul Steenberg Constr. Co., 201 Minn. 396, 398-400, 276 N.W. 651, 652-54 (1937); Walsh v. Mankato Oil Co., 201 Minn. 58, 62, 275 N.W. 377, 379 (1937). Disregard involving shareholder dominance of a corporation frequently is labelled the "instrumentality" rule. Dobbyn, *supra* note 12, at 186.

61. *See* cases cited in note 60 *supra.*

62. *See* Kramer, *Symposium—The Close Corporation—Foreword,* 18 L. & CONTEMP. PROB. 433, 433 (1953); *cf.* Note, *Judicial Supervision of the One Man Corporation,* 45 HARV. L. REV. 1084, 1086 (1932) (dominance standard means little in sole shareholder corporation context; courts will either pierce veil or respect it depending upon the result desired).

63. 274 Minn. 259, 143 N.W.2d 65 (1966).

64. *Id.* at 264, 143 N.W.2d at 69.

65. *See* notes 186-93 *infra* and accompanying text.

66. *See* E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 196 (1936); Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases,* 48 B.U. L. REV. 123, 136 (1968) (limited liability specifically designed to protect personal fortunes).

67. *See* H. HENN, *supra* note 1, §§ 147-148 (absent illegitimate purposes, individual shareholders must observe two requirements to retain recognition of corporateness; subsidiary or affiliated corporations must observe five); E. LATTY, *supra* note 66, at 194-95;

It is clear that a parent or control corporation's complete stock ownership in a subsidiary or affiliate is not sufficient alone to pierce the corporate veil.[68] Beyond this principle, the Minnesota court's treatment of parent-subsidiary or affiliated corporations in disregard cases has not been consistent. In *Erickson v. Minnesota & Ontario Power Co.,*[69] discussed earlier,[70] the court held the parent corporation liable for the tort of its inadequately capitalized subsidiary. Similarly, the court in *Specht v. Missouri Pacific Railroad*[71] held the parent liable for the subsidiary's tort because both corporations were part of the same business enterprise. In neither *Erickson* nor *Specht* did the court indicate fraud was a prerequisite to the imposition of shareholder liability upon the parent corporations. In the more recent case of *Di Re v. Central Livestock Order Buying Co.,*[72] however, the court stated emphatically that "[i]n the absence of a claim and showing of fraud or other wrongful purposes, the subsidiary must be treated as a legal entity separate and apart from the parent."[73] Thus, *Di Re* could be viewed as altering any implications from the previous *Erickson* and *Specht* decisions, especially because the court's language in *Di Re* is much more specific than in *Erickson* or *Specht.* Yet the cases might be distinguished on the basis that *Di Re* was not a tort-creditor case while *Erickson* and *Specht* did involve tort

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Hamilton, *The Corporate Entity,* 49 TEX. L. REV. 979, 992 (1971); Note, *supra* note 53, at 872 n.1 (liability more limited when shareholder is not a corporation). *But see* Horowitz, *Disregarding the Entity of Private Corporations,* 14 WASH. L. REV. 285, 293 (1939) (corporate entity more frequently disregarded when shareholder is individual rather than corporation). Some commentators reject the view that parent and control corporations should be treated differently, apparently on the rationale that the individual shareholders of the parent or control corporation suffer economic loss by the parent or control corporation's payment. *See, e.g.,* 11 ARK. L. REV. 450 (1957); 56 MICH. L. REV. 299, 300 n.5 (1957). For a general discussion of parent-subsidiary disregard in cases involving contracts and torts, see Annot., 38 A.L.R.3d 1102 (1971) (liability of corporation for contracts of subsidiary); Annot., 7 A.L.R.3d 1343 (1966) (liability of corporation for torts of subsidiary).

68. *See, e.g.,* State v. Chicago & Nw. Ry., 133 Minn. 413, 415-16, 158 N.W. 627, 628 (1916).

69. 134 Minn. 209, 158 N.W. 979 (1916).

70. See notes 54-57 *supra* and accompanying text.

71. 154 Minn. 314, 191 N.W. 905 (1923). In *Specht,* a subsidiary was formed to avoid a large filing fee demanded by the state of Nebraska in which the railroad system was operating. An employee of the subsidiary was injured in Nebraska by a defective railroad car owned by the parent corporation. However, an agreement between the parent and its subsidiary provided that possession of all equipment entering Nebraska would pass to the subsidiary at the state line. The court held that the subsidiary was a mere agent of the parent. *Id.* at 320-21, 191 N.W. at 907-08.

72. 246 Minn. 279, 74 N.W.2d 518 (1956). In *Di Re,* the plaintiff was laid off by a subsidiary but was told that there was a position open for him with the parent corporation. Plaintiff refused the offer largely because the position was not consistent with his past training and skills. When plaintiff sought unemployment compensation, the subsidiary refused the claim, contending that the two corporations should be deemed to be a single employer and therefore the new position was merely a transfer. The court rejected the subsidiary's argument.

73. *Id.* at 284, 74 N.W.2d at 523.

creditors. This distinction can be justified on the rationale, discussed in greater detail elsewhere in this Note,[74] that tort creditors normally do not have the opportunity to investigate the financial stability of the subsidiary. On the other hand, the *Di Re* court may have been reacting narrowly to the shareholders' attempt in that case to pierce because corporate entities rarely are disregarded for the benefit of shareholders.[75] Thus, Minnesota disregard law in the area of multiple corporations must be considered unsettled.

B. In re Will of Clarke—*A Conceptual Modification*

The previous discussion sets forth the traditional approach taken by the Minnesota Supreme Court in corporate disregard cases. In a small number of cases, however, the court has deviated from the traditional approach and has applied a conceptually different approach. The leading case applying this different approach is *In re Will of Clarke*,[76] decided in 1939. *Clarke* involved questionable dividend payments made by a corporation, the stock of which constituted the corpus of a trust. The trustee also was the life beneficiary of the trust, and as trustee she caused the corporation to make large dividend payments to herself as life beneficiary of the trust. Remainder beneficiaries objected to the trustee's questionable activities and sought to have her adjudged personally liable. The trustee denied liability, contending that the corporate entity was responsible for the excessive dividend policy. The *Clarke* court used this opportunity to embark on a basically philosophical discussion of the corporate disregard doctrine. The court emphasized that a corporation is not a legal fiction but rather is a real legal person and as such can never be disregarded.[77] Although holding the trustee person-

74. See notes 151-93 *infra* and accompanying text.

75. *See, e.g., In re* Penn. Cent. Sec. Litigation, 355 F. Supp. 1026, 1035 (E.D. Pa. 1971); Shipp v. Bell & Ross Enterprises, Inc., 256 Ark. 89, 97-98, 505 S.W.2d 509, 515 (1974); Jonas v. State, 19 Wis. 2d 638, 644, 121 N.W.2d 235, 238-39 (1963).

76. 204 Minn. 574, 284 N.W. 876 (1939).

77. This distinction has long been debated in Minnesota law. Although the corporation is considered an entity separate and distinct from its shareholders, *see, e.g.*, Corcoran v. P.G. Corcoran Co., 245 Minn. 258, 269, 71 N.W.2d 787, 795 (1955), its conceptual nature has been subject to dispute. The Minnesota court sometimes has viewed the corporation as a fiction having no existence independent of statute. *See, e.g.*, Gallagher v. Germania Brewing Co., 53 Minn. 214, 218, 54 N.W. 1115, 1116 (1893). At other times the Minnesota court has viewed it as an entity having existence independent of statute. *See, e.g.*, Matthews v. Minnesota Tribune Co., 215 Minn. 369, 373, 10 N.W.2d 230, 232 (1943). The *Clarke* court adopted the latter theory which apparently was central to the rationale that liability should be placed directly on the wrongdoer involved. The court's analysis probably would not have suffered, however, had the court viewed the entity as a fiction instead of an independent entity. *See* I. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 43 (1927) (nature of corporate entity is a tempting but profitless discussion, more metaphysical than legal).

ally liable, the court offered the following rationale as a substitute for traditional disregard analysis:[78]

> Many cases present avowed disregard of corporate entity. . . . But they all come to just this—courts simply will not let interposition of corporate entity or action prevent a judgment otherwise required. Corporate presence and action no more than those of an individual will bar a remedy demanded by law in application to facts. . . . The method neither pierces any veil nor goes beyond any obstruction, save for its refusal to let one fact bar the judgment which the whole sum of facts requires.
>
> For such reasons, we feel that the method of decision known as "piercing the corporate veil" or "disregarding the corporate entity" unnecessarily complicates decision. It is dialectically ornate and correctly guides understanding, but over a circuitous and unrealistic trail. The objective is more easily attainable over the direct and unencumbered route followed herein.

The *Clarke* reasoning provides a viable alternative to traditional disregard analysis. The court's point was a simple one: if an individual's fraudulent or inequitable activities, even if done on behalf of a corporation, indicate the individual should assume personal liability for his activities, then the individual should be held liable personally regardless of the existence of the corporate entity.[79]

To a large extent, the distinction between *Clarke* and the more traditional approach is semantical, but *Clarke* also represents a shift in emphasis. Under *Clarke*, the activities of the individual defendant are scrutinized rather than those of the corporation. This shift in emphasis also could cause a shift in result. The result under traditional disregard analysis normally is to treat the corporation as a partnership and hold all shareholders liable as partners, even if some shareholders were not parties to the fraud or injustice.[80] The *Clarke* approach, however, would result in liability only to those persons who were parties to the fraud or injustice, a result arguably more defensible than that of the traditional corporate disregard approach.[81] Because the Minnesota court has followed both approaches in its allocation of liability,[82] it is unclear in Minnesota who should be held liable upon disregard.

78. 204 Minn. at 578-79, 284 N.W. at 878-79.

79. For a similar view, see Canfield, *The Scope and Limits of the Corporate Entity Theory*, 17 COLUM. L. REV. 128 (1917).

80. *See, e.g.*, Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 235 N.W.2d 825 (1975), *noted in* 3 WM. MITCHELL L. REV. 293 (1977); 1 W. FLETCHER, *supra* note 8, § 41.3.

81. *See* Panther Pumps & Equip. Co. v. Hydrocraft, Inc., 424 F. Supp. 815, 821-22 (N.D. Ill. 1976); 12 U. MIAMI L. REV. 122 (1957) (criticizing decision holding shareholder liable who was not a director of the corporation and who had not participated in any fraud).

82. *Compare In re* Will of Clarke, 204 Minn. 574, 577-79, 284 N.W. 876, 878-79 (1939) *with* Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 183, 235 N.W.2d 825, 827 (1975).

If the *Clarke* rationale has any shortcoming it is that sufficient deference may not be given to the principle of limited shareholder liability. The standards promulgated in *Clarke* are vague and, if followed, possibly could result in shareholder liability to an extent that might undermine the utility of incorporation, especially for small businesses.[83] This shortcoming could be avoided if fraud or injustice on the part of the shareholder was still required as a prerequisite to liability.[84]

The present status of the *Clarke* approach is uncertain. At infrequent intervals the court will cite *Clarke* and apply its reasoning instead of following more traditional Minnesota corporate disregard concepts.[85] In other cases, the court ignores the *Clarke* rationale and speaks in terms of disregarding the corporate entity or piercing the corporate veil.[86] The Minnesota court's failure to identify which of these conceptually different approaches (with potentially different results) should control represents one of the major uncertainties in Minnesota corporate disregard law.[87]

C. *Related Theories*

The Minnesota Supreme Court and most other courts have developed several theories of law that either supplement or in appropriate cases supplant the corporate disregard theory.[88] The primary related theories are agency, estoppel, and fraudulent conveyances law.

83. *See* Horowitz, *supra* note 67, at 288 n.18 (in *Clarke* the court rejected the disregard doctrine but substituted an equally unsatisfactory standard because of its vagueness).

84. *Clarke's* foundation, of course, was a form of fraud; the trustee wrongfully appropriated trust funds to her own use and to the detriment of remainder beneficiaries. The court since *Clarke* has suggested that fraud is a requirement under the *Clarke* rationale. *See* General Underwriters, Inc. v. Kline, 233 Minn. 345, 349-50, 46 N.W.2d 794, 797 (1951).

85. *See* Milwaukee Motor Transp. Co. v. Commissioner of Taxation, 292 Minn. 66, 71-73, 193 N.W.2d 605, 608-09 (1971); Corcoran v. P.G. Corcoran Co., 245 Minn. 258, 269, 71 N.W.2d 787, 795 (1955); Lenhart v. Lenhart Wagon Co., 210 Minn. 164, 169-70, 298 N.W. 37, 40 (1941).

86. *See* Ahlm v. Rooney, 274 Minn. 259, 263-64, 143 N.W.2d 65, 68-69 (1966); Di Re v. Central Livestock Order Buying Co., 246 Minn. 279, 284, 74 N.W.2d 518, 523 (1956); Central Motors & Supply Co. v. Brown, 219 Minn. 467, 469-70, 18 N.W.2d 236, 237 (1945); Erickson-Hellekson-Vye Co. v. A. Wells Co., 217 Minn. 361, 381-82, 15 N.W.2d 162, 173 (1944). *But see* General Underwriters, Inc. v. Kline, 233 Minn. 345, 349-50, 46 N.W.2d 794, 797 (1951) (traditional disregard analysis; *Clarke* cited); Country Club Dist. Serv. Co. v. Village of Edina, 214 Minn. 26, 35, 8 N.W.2d 321, 326 (1943) (same).

87. In 24 MINN. L. REV. 107, 109 (1939) the writer suggested that the Minnesota Supreme Court in *Clarke* apparently "paved the way for a clearer understanding" of the relationship between corporations and their shareholders. Because the Minnesota court has cited both the *Clarke* theory and traditional disregard theory in support of its shareholder liability decisions, this appeal apparently has not been heeded.

88. *See generally* Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate,* 71 HARV. L. REV. 1122, 1123-25 (1958) (noncorporate bases of shareholder liability).

1. *Agency*

Courts are fond of stating that a corporate entity can be disregarded because it was acting as an agent for its shareholders.[89] Often when the courts refer to a corporation as a "mere agent" for its shareholders the agency language is used as a metaphor like "alter ego" or "instrumentality" and is not intended to represent a strict application of agency principles.[90] It is wrong to refer to the application of agency principles as a method of disregarding a corporate entity; rather, agency law and corporate disregard law should be considered as distinct legal theories available for imposing shareholder liability.[91]

Occasionally, however, a corporation does act as an agent for its shareholders. When this ground for imposing shareholder liability is available, it probably is a sound and preferable basis for imposing liability because agency law has relatively clear and well-developed standards.[92] A finding of agency obviates the need to consider the applicability of the corporate disregard theory, and reference to agency as a basis for disregarding a corporate entity merely confuses the analysis.[93] Thus,

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89. *See, e.g.*, Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 235 N.W.2d 825 (1975); Prudential Ins. Co. of America v. A. Enkema Holding Co., 196 Minn. 154, 157-58, 264 N.W. 576, 578 (1936); *cf.* Erickson v. Minnesota & Ont. Power Co., 134 Minn. 209, 214, 158 N.W. 979, 981 (1916) (corporation may be agent of control corporation).

90. For example, a federal court stated in New York Trust Co. v. Carpenter, 250 F. 668, 673 (6th Cir. 1918), *aff'd on second appeal sub nom.* Wheeling & L.E.R.R. v. Carpenter, 264 F. 772 (6th Cir. 1920):

> The District Court used the word "agency" as a synonym of "adjunct," whatever that may mean, and as descriptive of a relation variously defined in the cases as "adjunct," "branch," "instrumentality," "dummy," "buffer," and "tool," but all in the sense of "means" through which a corporation's own business is actively prosecuted; or of the relation created when two corporations are in substance identical though operating under different names.

91. *See* Northern Nat. Gas Co. v. Superior Ct., 64 Cal. App. 3d 992, 994, 134 Cal. Rptr. 850, 857 (1976) (liability under agency principles predicated on scope of agent's authority; agent's existence never disregarded as in application of piercing principles); Lowendahl v. Baltimore & O.R.R., 247 App. Div. 144, 156, 287 N.Y.S. 62, 74-75, *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936); Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597, 611 (1936) ("it is hardly worthwhile torturing 'agency' to save 'entity' "); Wang, *supra* note 19, at 349 (if corporation is separate from shareholders, it cannot become an agent except through express or implied contract). *But see* Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CALIF. L. REV. 12, 21 (1925) (sole shareholder liability for acts of corporation better explained by agency than disregard principles).

92. *See* New York Trust Co. v. Carpenter, 250 F. 668, 673 (6th Cir. 1918) ("if a corporation is the agent of another . . . through which the other, as principal, . . . carries on business, the liability of the principal will be ascertained through principles of law well-known and long-established"), *aff'd second appeal sub nom.* Wheeling & L.E.R.R. v. Carpenter, 264 F. 772 (6th Cir. 1920); Elvalsons v. Industrial Covers, Inc., 269 Or. 441, 452, 525 P.2d 105, 111 (1974); Annot., 38 A.L.R.3d 1102, 1116-19 (1971). *See generally* RESTATEMENT (SECOND) OF AGENCY (1958).

93. *See, e.g.*, Note, *Piercing the Corporate Veil in Louisiana*, 22 LOY. L. REV. 993, 1000 (1976).

the courts should guard against using agency law as a guise for imposing shareholder liability in cases where the facts indicate the corporation was not acting as an agent for its shareholders.

2. *Estoppel*

An additional concept that may be relevant to the shareholder liability question is that of equitable estoppel. An estoppel arises when a person's conduct precludes him from asserting a right which he might otherwise have asserted because another person in good faith has relied detrimentally upon such conduct.[94] The doctrine of estoppel has broad application in the shareholder liability area and can be used both by and against the person attempting to pierce the corporate veil.[95]

Estoppel can be utilized on behalf of the plaintiff in cases where he did not know he was dealing with a corporation but instead believed he was contracting with the shareholder directly.[96] For example, the Minnesota court has found individual liability in cases where individuals incorporated during a course of dealing with the plaintiff creditor.[97] If the creditor was unaware of the incorporation and thought he was still dealing with individuals, and those individuals did not inform him otherwise, they will be individually liable to the creditor.[98] A variation of this principle is found in *Roberts v. Americana Nursing Homes, Inc.*,[99] where plaintiff creditor obtained a judgment against defendant corporation and commenced garnishment proceedings. An affiliated corporation of the defendant intervened to assert that the funds sought by the plaintiff belonged to it, notwithstanding that the defendant possessed the funds. The court held the intervenor was estopped from asserting the separateness of the corporations because it had led the plaintiff to believe that the defendant owned the funds. When the intervenor argued that the court should not disregard the corporate entities involved, the court corrrectly noted that the doctrine of disregard was not applicable because the case was being decided on estoppel grounds.[100]

The estoppel doctrine also can be utilized against the plaintiff credi-

94. *See* Del Hayes & Sons v. Mitchell, 304 Minn. 275, 281-86, 230 N.W.2d 588, 592-95 (1975) (distinguishing promissory estoppel from equitable estoppel), *noted in* 3 WM. MITCHELL L. REV. 276 (1977); Lundberg v. Northwestern Nat'l Bank, 299 Minn. 46, 50-51, 216 N.W.2d 121, 124 (1974).

95. *See generally* 1 W. FLETCHER, *supra* note 8, § 47.

96. *See id.* The same estoppel applies where creditors are misled as to which corporate debtor of a multiple-corporation enterprise they are dealing with. *See, e.g.*, June v. Vibra Screw Feeders, Inc., 6 Mich. App. 484, 489, 149 N.W.2d 480, 482 (1967); Roberts v. Americana Nursing Homes, Inc., 293 Minn. 388, 196 N.W.2d 296 (1972) (per curiam); Stauffer v. Isaly Dairy Co., 4 Ohio App. 2d 15, 27-28, 211 N.E.2d 72, 80 (1965).

97. *See* Johnson Bros. Oil Co. v. Chies, 293 Minn. 363, 199 N.W.2d 441 (1972).

98. *Id.; accord, e.g.*, S. Davis, Inc. v. McGuckin, 51 Misc. 2d 1071, 274 N.Y.S.2d 1007 (City Ct. 1966).

99. 293 Minn. 388, 196 N.W.2d 296 (1972) (per curiam).

100. *Id.* at 390, 196 N.W.2d at 297-98.

tor. The most prevalent situation is when the creditor is aware that he is dealing with a corporation and the shareholders have not misrepresented the financial condition of the corporation.[101] In this situation, especially if the shareholders had refused to or were not requested to guaranty the debt individually, the court is likely to find that the creditor is estopped from asserting the shareholders are individually liable for the debt.[102] Thus, estoppel principles can be of value to defendant shareholders as well as plaintiff creditors.

3. *Fraudulent Conveyances*

A final area related to shareholder liability is fraudulent conveyances law. Under the Uniform Fraudulent Conveyances Act, a creditor of the transferor can have a conveyance set aside in three basic situations: first, where the transfer was made with actual intent to hinder, delay, or defraud the creditors of the transferor;[103] second, where the transferor was insolvent at the time of the conveyance or was rendered insolvent by the conveyance and the transfer was made for less than fair consideration;[104] and third, where the transfer was made for less than fair consideration by a business left with an unreasonably small amount of assets.[105] Consequently, for example, if an insolvent corporation transfers assets to its shareholders for less than market value, corporate creditors can have that transfer voided.[106] Conversely, if an insolvent shareholder transfers assets to his corporation for less than market value, creditors of the shareholder can have the transfer set aside.[107] Fraudulent conveyances law, of course, is distinct from corporate disregard law. The Minnesota court in the past, however, occasionally has intermingled the two theories.[108] This intermingling is unfortunate because fraudulent conveyances law is a specific statutory form of relief with definite standards and requirements, and it does not necessarily involve the disregard of any corporate entity. Therefore, the failure to distinguish the two theories only serves to render both more confusing.[109]

101. *See generally* Comment, *Estoppel to Deny Corporate Existence,* 31 TENN. L. REV. 336 (1964).

102. *See* Wm. Mueller & Sons v. Chanhassen Redi Mix, 273 Minn. 214, 220, 140 N.W.2d 326, 330 (1966); State v. Rivers, 206 Minn. 85, 95, 287 N.W. 790, 794-95 (1939); Northern Bldg. & Loan Ass'n v. Witherow, 205 Minn. 413, 415-16, 286 N.W. 397, 398 (1939); Kingsley v. English, 202 Minn. 258, 261, 278 N.W. 154, 156 (1938); Richards v. Minnesota Sav. Bank, 75 Minn. 196, 206, 77 N.W. 822, 824 (1899).

103. MINN. STAT. § 513.26 (1976).

104. *Id.* § 513.23 ("balance sheet" insolvency); *id.* § 513.25 (equity insolvency).

105. *Id.* § 513.24.

106. *See, e.g.,* Advance Dry Wall Co. v. Wolfe-Gilchrist, Inc., 53 Mich. App. 215, 218 N.W.2d 866 (1974); 3 WM. MITCHELL L. REV. 287 (1977).

107. *See, e.g.,* Rose v. Rose, 241 App. Div. 3, 4-5, 271 N.Y.S. 5, 7-8 (1934).

108. *See, e.g.,* General Underwriters, Inc. v. Kline, 233 Minn. 345, 46 N.W.2d 794 (1951); Matchan v. Phoenix Land Inv. Co., 159 Minn. 132, 198 N.W. 417 (1924).

109. It is important to distinguish the fraudulent conveyances and corporate disregard

D. *Shortcomings of Minnesota Corporate Disregard Law*

The present shortcomings of Minnesota corporate disregard law cannot fairly be said to be severe or the fault of the Minnesota Supreme Court. The court's strong and relatively consistent emphasis on fraud indicates that it has maintained a healthy and necessary respect for the separateness of corporate entities, permitting disregard of corporate entities only when necessary to avoid fraud or injustice.[110] Moreover, the court's decision refusing to pierce in the close-corporation setting merely because of dominance by the shareholders indicates the court is sensitive to the reality that valid small corporations inevitably are dominated by their shareholders.[111] The shortcomings that do exist can be attributed primarily to the fact that the court has not had the opportunity in recent years to draw distinctions that probably should be drawn in this area. For example, it probably is sound to distinguish between tort and contract creditors, for the former normally have no opportunity to investigate the solvency of the debtor corporation while the latter, contract creditors, generally can investigate before contracting.[112] Similarly, inadequate capitalization quite arguably should be a major factor in deciding whether to disregard a corporate entity, for as a matter of public policy, shareholders should be required to give the corporation sufficient capital to pay reasonably foreseeable debts, at least with regard to potential tort liabilities.[113] Finally, it might be proper to distinguish parent-subsidiary and affiliated corporation cases from noncorporate shareholder cases on the rationale that corporate shareholders deserve less protection through limited liability than do individual shareholders.[114] The Minnesota Supreme Court has made none of these distinctions, primarily because it has not been presented with cases in which these distinctions should have been made.

Some of the present shortcomings of Minnesota corporate disregard law, however, are attributable directly to Minnesota Supreme Court decisions. The uncertain status of *In re Will of Clarke*,[115] which purported to eliminate the disregard theory in Minnesota,[116] is a major

theories because of the differences in result that apply. When a fraudulent conveyance is set aside, the creditor's remedy is only against the asset transferred. When the corporate entity is disregarded, the creditor's remedy is against all of the shareholder's nonexempt assets. *See* Comment, *Theory of the Corporate Entity and the One-Man Corporation in Louisiana*, 38 TULANE L. REV. 738, 743 (1964).

110. *See* note 33 *supra* and accompanying text.

111. *See* Ahlm v. Rooney, 274 Minn. 259, 264, 143 N.W.2d 65, 69 (1966).

112. For a discussion of this distinction, see notes 151-93 *infra* and accompanying text.

113. For a discussion of the appropriate role of inadequate capitalization in disregard law, see notes 153-54, 164-85 *infra* and accompanying text.

114. For a discussion of the special role of multiple-corporation structures in disregard law, see notes 189-93 *infra* and accompanying text.

115. 204 Minn. 574, 284 N.W. 876 (1939).

116. *See* notes 76-87 *supra* and accompanying text.

example. The court also has failed to explain justifiable deviations it has made from the traditional fraud approach. For example, in the 1976 case of *Manufacturers Building, Inc. v. Heller,*[117] a corporate veil was pierced without a finding of fraud.[118] The court failed to distinguish the facts of *Heller,* which involved a dispute among the shareholders, from cases involving third-party creditors. *Heller,* therefore, raises the issue of whether a corporate entity can be disregarded without a showing of fraud in cases involving corporate creditors.[119] Similarly, the court's occasional failure to distinguish agency and fraudulent conveyances principles from the disregard doctrine has created confusion.[120] Consequently, although the Minnesota Supreme Court's emphasis on fraud is generally sound, Minnesota corporate disregard law is in need of clarification and, in some instances, change.

III. Alternative Theories

Most courts have done little toward developing a coherent set of principles to govern the disregard of corporate entities.[121] However, some courts and commentators have suggested alternatives to the vague standards presently applied by most courts. This section will discuss some of the noteworthy examples of those alternatives.

A. *The Metaphor Approach*

Corporate disregard law is laden with judicial pronouncements of metaphors that, in many cases, seem to serve as the basis for shareholder liability. "Alter ego,"[122] "instrumentality,"[123] or any of the other piercing metaphors[124] accomplish this result. The purpose of the meta-

117. 306 Minn. 180, 235 N.W.2d 825 (1975), *noted in* 3 Wm. Mitchell L. Rev. 293 (1977).

118. In *Heller,* the court found no evidence of fraud or unfair dealing. *See* 306 Minn. at 183, 235 N.W.2d at 827.

119. *See* 3 Wm. Mitchell L. Rev. 293, 294-95 (1977).

120. *See* notes 89-93, 103-09 *supra* and accompanying text.

121. *See, e.g.,* Swanson v. Levy, 509 F.2d 859, 861-62 (9th Cir. 1975) (test of piercing the corporate veil has rarely been articulated with any clarity); Hanson Sw. Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 717 (Tex. Ct. App. 1977) (much confusion exists over the criteria necessary for disregarding the corporate entity). *See generally* Wang, *supra* note 19.

122. *E.g.,* General Underwriters, Inc. v. Kline, 233 Minn. 345, 346, 46 N.W.2d 794, 796 (1951).

123. *E.g.,* State v. McBride, 215 Minn. 123, 130, 9 N.W.2d 416, 420 (1943).

124. *See* United States v. Reserve Mining Co., 380 F. Supp. 11, 16 (D. Minn.) ("mere instrumentality or agent"), *modified,* 490 F.2d 688 (8th Cir.), *motion for stay of injunction granted,* 498 F.2d 1073 (8th Cir.), *successive motions to vacate stay denied,* 418 U.S. 911, 419 U.S. 802, 420 U.S. 1000 (1974), *aff'd sub nom.* Reserve Mining Co. v. EPA, 514 F.2d 492 (8th Cir. 1975); Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 181, 235 N.W.2d 825, 826 (1975) ("agent or conduit"); Whitney v. Leighton, 225 Minn. 1, 7, 30 N.W.2d 329, 332-33 (1947) ("tool"), *aff'd on rehearing,* 225 Minn. 12, 30 N.W.2d 335 (1948); Country Club Dist. Serv. Co. v. Village of Edina, 214 Minn. 26, 35, 8 N.W.2d 321, 326 (1943)

phor policy ostensibly is to point to some improper relation between the shareholders and the corporation that serves as the basis for disregard.[125] What is important to the piercing decision, however, is not the selection of a guideless metaphor but rather is the shareholder conduct and nature of the claim involved in the case.[126] Metaphors add nothing but confusion to the analysis and therefore should be avoided.[127]

B. *The California Approach*

The California courts,[128] and courts in other jurisdictions following the California lead,[129] have created a fixed standard by which to evaluate corporate disregard cases. Sometimes labelled the "alter ego" rule,[130] these courts will pierce a corporate veil where two facts have been established: (1) such a unity of interest and ownership between the corporation and its shareholders that the individuality of the corporation has ceased, and (2) the observance of the entity would sanction a fraud or

("hollow legal shell"); State v. Creamery Package Mfg. Co., 110 Minn. 415, 433, 126 N.W. 126, 129 (1910) (mere "cloak"). Professor Henn found 37 metaphors in common use. *See* H. HENN, *supra* note 1, at 250 n.2.

125. *See* Dobbyn, *supra* note 12, at 187 (common denominator of metaphor approach is concern for the relationship between shareholder and corporation).

126. In Berkey v. Third Ave. Ry., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926), Judge Cardozo recognized the evil of the metaphor approach in the parent-subsidiary corporations context: "The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."

127. The court in Hanson Sw. Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 717 (Tex. Ct. App. 1977) stated:

> Much confusion exists in determining the criteria for disregarding the corporate entity. This confusion exists partially because of the words used to describe the condition. Courts have used such terms as "dummy," "sham," "instrumentality," "agency," "adjunct," "tool," "device," and "business conduit," to name a few. What these words mean relative to the fact situation of the case is elusive.

Accord, Ballantine, *supra* note 91, at 18 (metaphors are too uncertain to be adopted as a test or rule of law); Fuller, *supra* note 6, at 1378-79 (metaphors often obscure the real issues involved). *But see* Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939) (metaphors do not comprise a rule but rather merely designate the broader equitable principle that corporate entity will be disregarded when used to accomplish fraud or injustice).

128. *See, e.g.*, Minton v. Cavaney, 56 Cal. 2d 576, 579, 364 P.2d 473, 475, 15 Cal. Rptr. 641, 643 (1961) (in bank); Riddle v. Leuschner, 51 Cal. 2d 574, 580, 335 P.2d 107, 110-11 (1959); Minifie v. Rowley, 187 Cal. 481, 487, 202 P. 673, 676 (1921).

129. *See* Dietel v. Day, 16 Ariz. App. 206, 208, 492 P.2d 455, 457 (1972); Farmers Warehouse, Inc. v. Collins, 220 Ga. 141, 150, 137 S.E.2d 619, 625 (1964); Surety Life Ins. Co. v. Rose Chapel Mortuary, Inc., 95 Idaho 599, 601, 514 P.2d 594, 596 (1973); Ampex Corp. v. Office Elec., Inc., 24 Ill. App. 3d 21, 24, 320 N.E.2d 486, 488 (1974); Kilpatrick Bros. v. Poynter, 205 Kan. 787, 796-97, 473 P.2d 33, 42 (1970); Plotkin v. National Lead Co., 87 Nev. 51, 52, 482 P.2d 323, 324 (1971).

130. *See* Schifferman, *The Alter Ego*, 32 J. ST. B. CALIF. 143 (1947).

promote injustice.[131] To satisfy the first requirement, the plaintiff creditor ordinarily must prove the shareholder dominated the corporation and failed to observe corporate formalities, thus indicating the shareholders did not treat the corporation as a separate entity.[132] The rationale of the two-tiered California approach appears to be that when the shareholders have not treated the corporation as a separate entity and, moreover, have used the entity as an instrument to perpetrate fraud or injustice, then the policies favoring incorporation are outweighed by those favoring compensation for creditors.[133]

The California approach bears strong resemblance to present Minnesota law, especially with regard to the fraud or injustice requirement.[134] The two-tier test might indicate that the second requirement, fraud, is insufficient by itself to pierce in California; thus, the creditor's burden would be greater there than in Minnesota. However, the facts in most Minnesota cases permitting corporate disregard indicate that the first requirement, unity of interest and ownership, also has been present.[135] The creditor's burden in California, therefore, probably is not any greater than in Minnesota. In fact, the courts following the California rule have shown a marked willingness to employ the remedy.[136]

The advantage of the California approach is that it provides some certainty to the application of the disregard doctrine and articulates the relevant conduct and policies involved rather than relying on vague metaphors.[137] Its disadvantage is that it fails to distinguish among various fact situations, such as tort and contract cases[138] and cases involving parent-subsidiary and affiliated corporations,[139] that arguably should be

131. For an extensive review of facts relevant to satisfy the California approach, *see* Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 838-40, 26 Cal. Rptr. 806, 813-15 (1962).

132. *See, e.g.,* Riddle v. Leuschner, 51 Cal. 2d 574, 580, 335 P.2d 107, 111 (1959); Claremont Press Pub. Co. v. Barksdale, 187 Cal. App. 2d 813, 816, 10 Cal. Rptr. 214, 216 (1960).

133. *See* Arnold v. Browne, 27 Cal. App. 3d 386, 397, 103 Cal. Rptr. 775, 783 (1972) (purpose of disregard doctrine not to protect every unsatisfied creditor; only where shareholders' bad faith conduct prevents payment will entity be disregarded).

134. In California, nonpayment of creditors through financial inability is not, without more, an inequitable result justifying disregard of the corporate entity. 30 S. CAL. L. REV. 538, 539 (1957). This approach is consistent with present Minnesota law. *See* Whitney v. Leighton, 225 Minn. 1, 8, 30 N.W.2d 329, 333 (1947) (must prove fraud), *aff'd on rehearing,* 225 Minn. 12, 30 N.W.2d 335 (1948).

135. *See* cases cited in note 33 *supra.*

136. *See* 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 751, at 138 n.18 (Supp. 1968); 30 S. CAL. L. REV. 538, 538 (1957) (many cases in which veil has been pierced under the broad California rule). The California courts are considered to be on the "forefront" of disregard cases involving inadequate capitalization. *See* Comment, *supra* note 66, at 136.

137. *See* Platt v. Billingsley, 234 Cal. App. 2d 577, 582, 44 Cal. Rptr. 476, 480 (1965) (long line of cases has established two criteria for piercing the corporate veil in California).

138. For a discussion of this distinction, see notes 151-93 *infra* and accompanying text.

139. For a discussion of this distinction, see notes 189-93 *infra* and accompanying text.

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treated differently. The California approach, however, would improve present Minnesota law to the extent that it sets specific standards to be applied in most corporate disregard cases without radically changing the substance or flexibility of existing Minnesota law.

C. *The Enterprise Entity Theory*

Proposed by Adolph Berle in 1947,[140] the enterprise entity theory of shareholder liability departs drastically from traditional disregard concepts. The theory applies to cases involving parent-subsidiary or affiliated corporation cases where business enterprises often are fragmented. Conceptually, the theory is quite simple. If one underlying business enterprise is composed of more than one corporate entity, then the entire enterprise should be held responsible for the liabilities of each component corporation.[141] The classic New York taxi cases provide a vivid example for the application of Berle's theory.[142] To minimize loss from foreseeable liabilities, individual taxis were separately incorporated as affiliates of a control corporation. Thus, if a taxi was involved in a serious accident, any payment for resulting liabilities was limited to the assets of the particular affiliate, typically a minimal amount, and the assets of the entire enterprise thereby were protected. Berle would ignore the separate components and hold the entire enterprise liable.[143]

The enterprise entity theory is antithetical to traditional disregard theory[144] and other corporate law principles which normally allow the

140. *See* Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

141. *Id.* at 354.

142. *See, e.g.*, Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962), *aff'd sub nom.* Mull v. Ford Motor Co., 368 F.2d 713 (2d Cir. 1966); Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966); Mangan v. Terminal Transp. Sys., Inc., 247 App. Div. 853, 286 N.Y.S. 666 (1936). *See generally* Note, *Piercing the Taxi Medallion*, 19 N.Y.U. INTRA. L. REV. 1 (1964).

143. *See* Berle, *supra* note 140, at 354. In Specht v. Missouri P. R.R., 154 Minn. 314, 191 N.W. 905 (1923) the Minnesota Supreme Court seemed to apply a rationale similar to the enterprise entity theory. To avoid a large state filing fee, a railroad incorporated a subsidiary corporation to do business in that state. The subsidiary apparently was adequately capitalized, formalities were observed, and each corporation had virtually independent management. When an employee of the subsidiary was injured, he sued the parent and recovered. The court said: "Plainly, this whole railroad is one entity. The [subsidiary] corporation is a mere subsidiary agency of the defendant for carrying on the Nebraska section of this composite whole." *Id.* at 320, 191 N.W. at 907.

144. *See* Ballantine, *supra* note 91, at 17 ("Even when two or more corporations are associated together under common control as several branches or departments of a single common enterprise, they are still normally to be regarded as separate and independent legal entities."). The enterprise entity theory essentially collapses multiple-corporate structures into a single enterprise for liability purposes and thereby implicitly disregards the separate identities of all the corporations involved. This approach to corporate disregard conflicts with the general rules that multiple corporations are considered separate and distinct entities, *see, e.g.*, Di Re v. Central Livestock Order Buying Co., 246 Minn. 279, 283, 74 N.W.2d 518, 523 (1956), and that sole stock ownership of one corporation by another does not destroy the former's legal entity, *see, e.g.*, Belle City Malleable Iron Co.

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use of complex corporate organizations.[145] As a result, the theory has not been widely adopted.[146] However, Berle's analysis does point to a potentially serious problem: the use of subsidiary and affiliated corporations can be abusive, especially where they obviously are undercapitalized in view of their foreseeable liabilities.[147] Thus while most courts have been reluctant to adopt the enterprise entity theory, many of them, invoking traditional disregard principles, have exhibited a greater tendency to disregard a subsidiary's or affiliate's corporate status than that of a corporation owned by individual shareholders.[148] This tendency would seem to be sound, for it is more onerous to impose liability on individuals than on a parent corporation whose own shareholders still retain limited liability (although they admittedly will suffer some financial loss if the parent is made to pay for the subsidiary's liabilities).[149]

IV. SUGGESTED APPROACH

The California and enterprise entity approaches offer valuable contributions to corporate disregard law, but neither is sufficiently comprehensive. The shortcomings of present Minnesota law call for a reevaluation of corporate disregard that draws from the best aspects of these approaches, present Minnesota law, and suggestions by other commentators. Set forth below is a suggested approach to corporate disregard. The basic premise of this suggested approach is that the courts should consider the nature of the claim involved before applying the corporate disregard remedy. There are essentially two types of creditor's claims: contract or consensual claims, and tort or nonconsensual claims.[150] Each

v. Clark, 172 Minn. 508, 510, 215 N.W. 855, 856 (1927). *See* Comment, *Disregarding the Corporate Entity: Contract Claims,* 28 OHIO ST. L.J. 441, 464 (1967).

145. *See* Milwaukee Motor Transp. Co. v. Commissioner of Taxation, 292 Minn. 66, 72-73, 193 N.W.2d 605, 609 (1971) ("There is nothing wrong with the organization of a subsidiary corporation to carry on a phase of the parent company's operations, and, in contemplation of law, the liabilities and obligations arising from such transactions between them may be the same as those existing between corporations having no common relationship.").

146. Hamilton, *supra* note 67, at 985. *But see* NLRB v. Deena Artware, Inc., 361 U.S. 398, 403-04 (1960); Hartford Steam Serv. Co. v. Sullivan, 26 Conn. Sup. 277, 281, 220 A.2d 772, 774 (1966); Block v. Ford Motor Co., 286 A.2d 228, 232-33 n.12 (D.C. Ct. App. 1972) (court did not use Berle theory but indicated that on proper facts it might).

147. *See* Hanson v. Bradley, 298 Mass. 371, 380, 10 N.E.2d 259, 264 (1937) (not unusual for creators of subsidiary corporations to capitalize them inadequately and thereby impede creditors' ability to collect).

148. *See* E. LATTY, *supra* note 66, at 193-201; Corrigan & Schirott, *Piercing the Corporate Veil: Dispelling the Mists of Metaphor,* 17 TR. LAW. GUIDE 121, 133 (1973); Hamilton, *supra* note 67, at 992.

149. *See* E. LATTY, *supra* note 66, at 193-201; Fuller, *supra* note 6, at 1377 n.13, 1382 (initial insulation against liability involved in individual shareholder case; double insulation involved in parent-subsidiary case).

150. Contract creditors may be considered consensual creditors because they consented to do business with the corporation. *See* Cataldo, *Limited Liability with One-Man Com-*

type will be considered separately, followed by a discussion of the allocation of liability among shareholders or others responsible for the loss.

A. *Contract or Consensual Creditors*

The consensual creditor normally intends to bargain with the corporation. In the usual case, the freedoms of contract are available during negotiations, including the opportunity to investigate the financial stability of the corporation and the ability to negotiate for shareholder guaranty of the obligation.[151] If the creditor fails to take advantage of these opportunities, he should be deemed to have done so at his own risk, especially in view of the widespread understanding of the limited liability principle.[152] Consequently, evidence of shareholder dominance, inadequate capitalization, or failure to observe corporate formalities

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panies and Subsidiary Corporations, 18 L. & CONTEMP. PROB. 473, 476 (1953). Tort creditors, however, may be considered nonconsensual creditors because they presumably did not consent to be injured and any resulting judgment obtained would be based on the unwilling nature of the debt. *See* Note, *Disregarding the Corporate Fiction in Florida: The Need for Specifics*, 27 U. FLA. L. REV. 175, 177-78 nn.14-15 (1974). The terms "consensual" and "nonconsensual" make clear the rationale of the suggested approach proposed by this Note and thus are referred to their analogues, "contract" and "tort."

151. *See* Zaist v. Olson, 154 Conn. 563, 581-82, 227 A.2d 552, 561 (1967) (dissenting opinion); Obre v. Alban Tractor Co., 228 Md. 291, 296-97, 179 A.2d 861, 863 (1962); Hanson Sw. Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 718 (Tex. Ct. App. 1977); Comment, *supra* note 144, at 442 (consensual creditor normally expected to investigate). Indeed, a refusal by a creditor to guaranty personally the obligation presents the strongest case against employment of the corporate disregard remedy. *See* Hamilton, *supra* note 67, at 986.

152. *See* John S. Westervelt's Sons v. Regency, Inc., 1 N.J. Super. 466, 470, 63 A.2d 818, 820 (Ch. Div. 1948) (if plaintiff wanted to charge defendant shareholders personally, it should have had them join in the contract), *aff'd*, 3 N.J. Super. 173, 65 A.2d 776 (App. Div. 1949), *aff'd*, 3 N.J. 472, 70 A.2d 767 (1950); Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525, 554 (creditors are risk takers just as shareholders are); Note, *One Man Corporations—Scope and Limitations*, 100 U. PA. L. REV. 853, 862 (1952). This result is justifiable on several legal principles. *See* Hamilton, *supra* note 67, at 984 (risk assumption); Comment, *supra* note 144, at 446 (waiver and estoppel).

The writer in Note, *Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation*, 45 S. CAL. L. REV. 823, 837-40 (1972) [hereinafter cited as *Inadequate Capitalization: The California Approach*] would argue that unless the creditor knew the corporation was in poor financial condition, the consensual creditor's ability to investigate should not serve to deny a remedy against shareholders of an inadequately capitalized corporation in the event of nonpayment because the limited liability principle was not meant to sanction inadequately capitalized corporations and creditors should be able to rely on the expectation that their debtor is adequately capitalized. Shareholders, it is said, are supposed to bear the risk of corporate failure, not creditors. This see-no-evil approach unfairly benefits the consensual creditor. *See* Note, *supra* note 88, at 1128 (insolvency of a corporation is a risk creditors are normally required to bear). The reliance of the approach on a presumption of initial adequate capitalization finds no support in the corporation statutes and probably does not comport with close-corporation reality. *See* Tennery, *The Potential of the Close Corporation: A Question of Economic Validity*, 14 How. L.J. 241, 256 (1968).

should have little relevance in most consensual creditor disregard cases,[153] unless they otherwise indicate a fraud on creditors.[154] In these cases, the policies supporting limited liability should prevail over those favoring compensation of creditors because the equities of an unpaid creditor who was free to evaluate the corporate debtor and failed to obtain security are not compelling.[155]

The policies favoring limited liability in consensual creditor cases, however, are significantly lessened when the transaction is tainted with fraud, deception, or misrepresentation.[156] When the corporation's financial adequacy is misrepresented or the fact of incorporation is suppressed, the consensual nature of the transaction is vitiated and the corporate veil should be pierced.[157] Moreover, if the corporation, by fraudulent or unjust means, takes actions after the contract is consummated that render it difficult or impossible for the creditor to collect his debt from the corporation, the disregard remedy should be available.[158] Application of the disregard remedy in these cases is analogous to ac-

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153. *See, e.g.*, DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686 n.13 (4th Cir. 1976) (inadequate capitalization); Moe v. Harris, 142 Minn. 442, 444-45, 172 N.W. 494, 495 (1919).

154. *See* Ahlm v. Rooney, 274 Minn. 259, 263-64, 143 N.W.2d 65, 68-69 (1968); Comment, *supra* note 144, at 465 (a showing of control by shareholder over corporation may give rise to inference of fraud).

155. *See, e.g.*, Kopper Glo Fuel, Inc. v. Island Lake Coal Co., 436 F. Supp. 91, 99 (E.D. Tenn. 1977); Quickick, Inc. v. Quickick Int'l, 304 So. 2d 402, 408-10 (La. Ct. App.) (where consensual creditor not deceived as to debtor's financial status, corporate veil will not be pierced), *cert. denied*, 305 So. 2d 123 (La. 1974); Hanson v. Bradley, 298 Mass. 371, 381, 10 N.E.2d 259, 264 (1937); Bartle v. Home Owners Coop., Inc., 309 N.Y. 103, 106, 127 N.E.2d 832, 833 (1955).

156. *See, e.g.*, United Paperworkers Int'l Union v. Penntech Papers, Inc., 439 F. Supp. 610, 617-18 (N.D. Me. 1977) (fraud or misrepresentation required in the contract cases because parties are free to weigh the potential benefits and risks of the agreement); Gillespie, *supra* note 6, at 390-91; Comment, *supra* note 66, at 135.

157. *See, e.g.*, Ahlm v. Rooney, 274 Minn. 259, 264, 143 N.W.2d 65, 69 (1966); Whitney v. Leighton, 225 Minn. 1, 8-9, 30 N.W.2d 329, 333 (1947), *aff'd on rehearing*, 225 Minn. 12, 30 N.W.2d 335 (1948); Note, *supra* note 88, at 1129 (failure to investigate should not bar recovery in cases of fraud or misrepresentation).

158. Comment, *supra* note 144, at 470 (this type of conduct indicates the transaction or its repercussions were not consensual in nature). Professor Bradley has proposed the following statute to govern disregard actions involving consensual creditors:

> The existence of the corporation as a legal entity distinct from its shareholders and the shareholders' privilege of limited liability shall not be affected by the fact that the affairs of the corporation are directly managed by the shareholders; nor by the fact that the board of directors of the corporation are parties to agreements respecting the exercise of their powers; nor by the fact that lawful restrictions are imposed upon the transfer of the stock of the corporation. In the absence of actual fraud, persons who voluntarily engage in any kind of dealings or transactions with a corporation, on a corporate basis, may look only to the assets of the corporation for the satisfaction of claims arising out of those dealings or transactions.

Bradley, *supra* note 152, at 554.

tions for damages arising from contracts induced by false representation.[159]

B. Tort or Nonconsensual Creditors

The standards to be applied by the courts in cases involving tort or nonconsensual creditors should be significantly different from those applied in consensual creditor cases.[160] The tort creditor normally does not intend to bargain with the corporation; unlike the consensual creditor, the nonconsensual creditor generally has no opportunity to investigate the financial adequacy of the corporation or to obtain shareholder guaranty of the liability.[161] Consequently, the equities favoring compensation for nonconsensual creditors, especially where personal injury is involved, are much stronger than in consensual creditor cases.[162] For this reason, factors such as inadequate capitalization, disregard of corporate formalities, and shareholder dominance should play a more important role in nonconsensual disregard cases than in consensual creditor cases.[163]

Inadequate capitalization in corporate disregard law is an elusive concept. In Minnesota, any corporation can commence business with a capitalization of $1,000[164] and there is no requirement that public liabil-

159. *See, e.g.*, I.L. Corse & Co. v. Minnesota Grain Co., 94 Minn. 331, 335, 102 N.W. 728, 729 (1905).

160. *E.g.*, Zubik v. Zubik, 384 F.2d 267, 273 (3d Cir. 1967) (the distinguishing factor is creditor reliance in a consensual transaction), *cert. denied*, 390 U.S. 988 (1968).

161. *E.g.*, Hanson Sw. Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 717 (Tex. Ct. App. 1977) (courts are less reluctant to pierce in tort cases than in contract cases because the creditor in contract cases had the opportunity to select his debtor; in a tort case, no such selection is made); Comment, *supra* note 144, at 443-44.

162. *E.g.*, Gillespie, *supra* note 6, at 392 (depending upon one's value system, it is arguable that the nonconsensual creditor should receive more sympathetic treatment than the consensual creditor); Note, *supra* note 88, at 1130 (involuntary creditor has greater equity); 10 Sw. L.J. 77, 79 (1956) (courts are more willing to pierce in tort cases).

163. *See* Gillespie, *supra* note 6, at 392 (shareholder dominance and failure to follow formalities are relevant because they suggest a measure of responsibility for corporation's actions). *But see* Comment, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190, 1193 (1967) (liability based on lack of formalities makes compensation depend upon purely fortuitous circumstances); 1975 WASH. U.L.Q. 201 (1975) (corporate activities unrelated to plaintiff's suit should be irrelevant). In the classic work, Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929), the authors proposed the following standards which parent corporations should follow to avoid liability to subsidiary tort creditors: (1) a separate and sufficient financial unit should be set up and maintained, (2) the day-to-day business of the two units should be kept separate, (3) the formal barriers between the two management structures should be maintained, and (4) the two units should not be represented as being one unit. *Id.* at 196-97. The authors suggest these considerations are less relevant in contract cases where fraud or an inequitable result apparently is required. *See id.* at 217-18.

164. *See* MINN. STAT. § 301.04(6) (1976). Obviously, minimum statutory capitalization does not offer much protection for corporate creditors. *See* Note, *Statutory Minimum*

ity insurance be maintained.[165] Consequently, it probably is improper to impose shareholder liability simply because the corporation does not have sufficient assets to cover all tort liabilities; a more restrictive standard is necessary.[166] A standard that has received judicial acceptance is that capitalization is inadequate when grossly disproportionate to the nature of the business and the risks reasonably foreseeable to the operation of the business.[167] This standard is sound because it recognizes that limited liability is an important and justifiable reason for incorporation, yet it also recognizes that shareholders should have some duty to have funds or insurance available to compensate persons injured by the corporation's foreseeable torts.[168]

In nonconsensual creditor cases, inadequate capitalization should be a critical factor,[169] but it is unclear whether inadequate capitalization alone should justify imposition of shareholder liability.[170] One can argue

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Capitalization Requirements, 5 WILLAMETTE L.J. 331, 339 (1969); Comment, *supra* note 163, at 1190-91 (inadequately capitalized corporations are inevitable product of incorporation; modern statutes invite financial irresponsibility). It has been suggested that to protect creditors, existing stated capital requirements be abandoned in favor of higher capital requirements that cannot be reduced. *See* Note, *The Inadequacy of Stated Capital Requirements,* 40 U. CIN. L. REV. 823, 841 (1971).

165. For most businesses, liability insurance is essential and the cost is not prohibitive. *See* Gillespie, *supra* note 6, at 402.

166. *See* Fisser v. International Bank, 282 F.2d 231, 240 (2d Cir. 1960) (legislatures sanction minimum capitalization); Gillespie, *supra* note 6, at 386; 30 S. CAL. L. REV. 538, 539 (1957) (mere failure of payment not sufficient basis for piercing). *See generally* Annot., 63 A.L.R.2d 1051 (1959). Compliance with minimum statutory capitalization does not create a presumption of adequate capitalization. *See* Note, *Statutory Minimum Capitalization Requirements,* 5 WILLAMETTE L.J. 331, 340-41 (1969).

167. *See* Anderson v. Abbott, 321 U.S. 349, 362 (1944); Arnold v. Phillips, 117 F.2d 497, 502 (5th Cir.), *cert. denied,* 313 U.S. 583 (1941). State and federal statutes offer an alternative definition of inadequate capitalization that may be relevant to the capitalization definition in disregard law. Section five of the Uniform Fraudulent Conveyances Act and section 67(d)(2) of the Bankruptcy Act deem fraudulent any transaction that leaves the debtor with an unreasonably small capital from which to satisfy claims. *See* Sheahin, *Complaint Alleging Inadequate Capitalization,* 55 ILL. B.J. 881, 884 (1967).

168. *Cf.* Viiliainen v. American Finnish Workers Soc'y, 236 Minn. 412, 416, 53 N.W.2d 112, 115 (1952) (corporations under unqualified responsibility to act compatibly with public interest); *In re* E.C. Warner Co., 232 Minn. 207, 212-13, 45 N.W.2d 388, 392 (1950) (same).

169. *See* Gillespie, *supra* note 6, at 392; Hamilton, *supra* note 67, at 988 (inadequate capitalization should be important factor in determining whether shareholders will be held liable for corporate torts); Note, *supra* note 93, at 1013 (in cases of corporate negligence, inadequate capital should be a primary factor); *cf.* Schoenberg v. Benner, 251 Cal. App. 2d 154, 165, 59 Cal. Rptr. 359, 367 (1967) (contract case).

170. *See, e.g.,* United Paperworkers Int'l Union v. Penntech Papers, Inc., 439 F. Supp. 610, 617 n.7 (N.D. Me. 1977); Harris v. Curtis, 8 Cal. App. 3d 837, 841-42, 87 Cal. Rptr. 614, 618-19 (1970); North Arlington Medical Bldg., Inc. v. Sanchez Constr. Co., 86 Nev. 515, 522, 471 P.2d 240, 244 (1970).

Several reasons support the view against basing disregard on inadequate capitalization only: (1) concern that hindsight would play too dominant a role in the evaluation, (2) difficulties apparent in formulating a workable measure, and (3) low statutory capitalization requirements are conclusive of the issue. 56 MICH. L. REV. 299, 300 (1957).

that at least in cases involving grossly undercapitalized corporations with significant and readily foreseeable tort liabilities, such as blasting companies, inadequate capitalization alone should justify disregarding the corporate entity.[171] It would be unconscionable to allow dangerous enterprises to do business without liability insurance and with only the statutory minimum of capitalization, thus shifting all risks of the business upon a public not having the means to obtain prior guaranty of compensation for resulting injuries.[172] Thus, for firms that have significant tort liability exposure, shareholder liability to nonconsensual creditors should follow on the basis of inadequate capitalization alone.[173] This standard is vague, but the courts should be capable of determining which corporations pose a serious risk to public safety and the reasonable amount of capital needed to compensate persons injured by corporate torts in view of that risk.[174]

On the other hand, where a corporation does not have significant exposure to tort liability, inadequate capitalization alone may not justify shareholder liability.[175] The lack of a legislative requirement of liability insurance and the minimal statutory capitalization requirement indicate a legislative intent favoring the limited liability principle even in tort cases. In these situations, an additional requirement that the shareholders must have disregarded corporate formalities by, for example, commingling corporate and shareholder funds or not keeping adequate corporate records might be reasonable.[176] The rationale for this

171. *See* Mull v. Colt Co., 31 F.R.D. 154, 163 (S.D.N.Y. 1962) (taxis), *aff'd sub nom.* Mull v. Ford Motor Co., 368 F.2d 713 (2d Cir. 1966); Dixie Coal Mining & Mfg. Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930) (compensation action for miner's death); Corrigan & Schirott, *supra* note 148, at 129 (corporation engaged in dangerous activities may be undercapitalized regardless of amount); Note, *supra* note 93, at 1013 (if the business is risky, a greater amount of protection for creditors should be required).

172. *See* Walkovszky v. Carlton, 18 N.Y.2d 414, 426, 223 N.E.2d 6, 13, 276 N.Y.S.2d 585, 595-96 (1966) (dissenting opinion); Hamilton, *supra* note 67, at 988 (corporate disregard on the basis of inadequate capitalization prevents a risky business from transferring its risk of loss to innocent members of the general public).

173. *See* Minton v. Cavaney, 56 Cal. 2d 576, 579-80, 364 P.2d 473, 475-76, 15 Cal. Rptr. 641, 643-44 (1961) (in bank) (shareholder held liable for death of plaintiff's daughter in corporation's swimming pool; corporation had no assets); Comment, *supra* note 66, at 136 (inadequate capitalization is particularly relevant where corporation in contact with significant segment of public).

174. Expert testimony by accountants and financial analysts will aid in this process. *Cf.* Costello v. Fazio, 256 F.2d 903, 909 (9th Cir. 1958) (expert opinion of inadequate capitalization in bankruptcy). The courts are required to make similar determinations in analogous areas of the law, such as with the abnormally dangerous activities theory of strict liability in tort law. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS §§ 519-524 (1977); 3 WM. MITCHELL L. REV. 310 (1977).

175. *See* N. LATTIN, THE LAW OF CORPORATIONS 76-77 (2d ed. 1971) (popcorn man on street corner would be adequately capitalized at the $1,000 statutory minimum because little danger of large tort liability).

176. *See* Zubik v. Zubik, 384 F.2d 267, 273-74 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968); Dillman v. Nobles, 351 So. 2d 210, 213 (La. Ct. App. 1977); *Inadequate Capitaliza-*

additional requirement involves what might be termed a "quid pro quo"[177] theory: where the shareholders have not respected the existence of the corporate entity, the courts similarly should be less reluctant to recognize the corporate existence and limited liability. Legislatures and courts expect that shareholders will observe corporate formalities. Although disregard of formalities is not fatal to corporate existence,[178] it is not unreasonable to withhold the limited liability characteristic of corporateness when the shareholders do not respect the corporation. In nonconsensual creditor cases involving inadequately capitalized corporations, the equities in favor of compensating victims of corporate torts are strong. When the shareholders of such corporations have disregarded corporate formalities, the balance should be tipped in favor of compensating victims of their torts by imposing shareholder liability.[179] Thus, where a corporation not having significant tort liability exposure is inadequately capitalized and the shareholders fail to observe corporate formalities, the piercing remedy should be applied.[180]

Evidence of failure to observe formalities typically will not have any causal relation to the nonconsensual creditor's injury. This standard, therefore, may be criticized for injecting irrelevant, purely fortuitous evaluations into the disregard analysis. Admittedly, this suggestion involves a value judgment. Failure to observe formalities suggests that the shareholders do not view their business organization as a corporation.[181] The courts should view the organization similarly if the corporation is inadequately capitalized and is not exposed to significant tort liability.

A final and difficult question concerning inadequate capitalization must be addressed: should the inadequacy of capitalization be determined as of the commencement of business as a corporation or as of the commission of the tort?[182] Because adequacy of capitalization in tort-

tion: The California Approach, *supra* note 152, at 859 (when disregard of formalities is combined with financial management that leads to bankruptcy, personal liability may result). Where corporate formalities are observed, however, the corporate entity should not be so readily disregarded. *See* Cornwell v. Williams Bros. Lumber Co., 139 Ga. App. 773, 229 S.E.2d 551 (1976) (disregard not granted in tort action against parent corporation where corporations located on different floors of building, assets not commingled, bank accounts separate, equipment separate, tax returns separate, minute books separate, bylaws separate, corporate records separate, liability insurance policies separate, employees and payrolls separate).

177. "Quid pro quo" means "something for something." BLACK'S LAW DICTIONARY 1415 (4th ed. 1968).

178. *See* note 45 *supra* and accompanying text.

179. *See* Note, *supra* note 88, at 1130-31.

180. Failure to observe corporate formalities without a showing of inadequate capitalization, however, should not justify shareholder liability in view of the strong policies supporting the corporate device. Note, *supra* note 150, at 186-87.

181. Gillespie, *supra* note 6, at 392 (shareholder failure to observe corporate formalities is relevant because it suggests a measure of responsibility for corporation's actions).

182. In *Inadequate Capitalization: The California Approach*, *supra* note 152, at 823, the writer suggests that adequacy of capitalization should be measured at the time of incorpo-

creditor cases will often involve a determination of whether liability insurance has been purchased,[183] the most reasonable rule probably would be to recognize a continuing obligation that the corporation be adequately capitalized.[184] If a corporation is grossly undercapitalized in view of foreseeable tort liabilities, it should maintain an adequate liability insurance policy; if that corporation cannot afford such a policy, or neglects to obtain one, it should continue business at the shareholders' risk, not at the risk of the public.[185] Consequently, corporations should be required to maintain adequate capitalization throughout corporate existence to assure compensation for claims of nonconsensual creditors. The requirement that shareholders maintain adequate capitalization probably should not, however, be applied in cases involving consensual creditors as distinguished from nonconsensual creditors. Because consensual creditors may investigate capitalization and obtain security, the risk of inadequate capitalization should be placed upon the creditor as a risk of business.

A final factor that may be relevant in nonconsensual creditor cases is shareholder dominance of the corporation. Shareholder dominance is a pervasive concept in corporate disregard law.[186] The difficulty with using this factor is that no definition of dominance or control can be fashioned that distinguishes impermissible dominance from the dominance that typifies most corporations, especially close corporations.[187] Thus, dominance or control probably is not a satisfactory factor to be considered in most cases.[188]

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ration, otherwise no corporation would ever be afforded limited liability at the time of financial difficulty. This suggestion equates inadequate capitalization for disregard purposes with mere insolvency. Inadequate capitalization in disregard law refers to capitalization grossly disproportionate to foreseeable liability in the business. *See* notes 167-68 *supra* and accompanying text. Thus at the time of business failure, liability would attach under the inadequate capitalization standard only if the amount involved was grossly disproportionate to the corporation's foreseeable liability, not if the corporation was merely insolvent. This Note proposes that adequate capitalization be an ongoing requirement. *See* text accompanying note 184 *infra*. If shareholders of financially threatened corporations fail to maintain adequate capitalization, they should accept the risk or cease doing business altogether. Dix, *Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation*, 53 Nw. U.L. Rev. 478, 494 (1958).

183. *See Inadequate Capitalization: The California Approach*, *supra* note 152, at 841 n.74.

184. *See* DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686 (4th Cir. 1976); Dix, *supra* note 182, at 491; Comment, *supra* note 66, at 139.

185. *See* Comment, *supra* note 163, at 1201-04 (suggesting requirement of compulsory insurance for small corporations).

186. *See, e.g.*, Maryland v. General Stevedoring Co., 213 F. 51, 77-78 (D. Md.), *aff'd sub nom.* Joseph R. Foard Co. v. Maryland, 219 F. 827 (4th Cir. 1914).

187. *See, e.g.*, Ahlm v. Rooney, 274 Minn. 259, 264, 143 N.W.2d 65, 69 (1966).

188. *See* Note, *supra* note 62, at 1086 (all one-shareholder corporations of necessity are dominated by their shareholders; therefore, any close corporation could be pierced if piercing were allowed on the basis of shareholder dominance alone). Professor Dobbyn, on the other hand, views the control element as crucial to the disregard analysis. He

et al.: Disregard of the Corporate Entity

The dominance or control factor should have some significance, however, in cases involving inadequately capitalized subsidiary or affiliated corporations without significant tort liability exposure, where the policies favoring limited liability are not as strong.[189] In these cases, it is possible to formulate an acceptable standard of impermissible dominance or control.[190] If a subsidiary or affiliated corporation has independent management that determines the capitalization of the corporation, then dominance or control is not present.[191] If, however, the parent and subsidiary or control and affiliated corporations have virtually identical directors and officers, dominance and control probably are present.[192] Dominance or control should then be considered as a factor, when combined with inadequate capitalization, to justify piercing in the multiple-corporation setting.[193]

proposes a test of disregard for both consensual and nonconsensual claims upon a showing of shareholder control of a corporation and use of that control to hinder unjustly a creditor's ability to collect. Dobbyn, *supra* note 12, at 190. Dobbyn's reliance on the control factor in the close-corporation context seems to ignore the reality of control and dominance that typifies close corporations. *See* note 62 *supra* and accompanying text.

189. *See* note 66 *supra* and accompanying text.

190. In 1931 Professor Powell proposed the following three-part test of disregard in cases involving parent and subsidiary or affiliated corporation cases: (1) defendant's control, (2) defendant's fraud or wrong, and (3) unjust loss or injury to the creditor. F. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 103-05 (1931). This test, incorporating the control and fraud rule that should govern multiple-corporation disregard cases, is still valid. Powell found several indicia of sufficient parent control:

(1) parent owns all of the subsidiary's stock;
(2) common directors or officers of corporations;
(3) parent finances the subsidiary;
(4) parent subscribes to all the stock of the subsidiary or otherwise causes its incorporation;
(5) subsidiary has grossly inadequate capital;
(6) parent pays salaries and other expenses or losses of the subsidiary;
(7) subsidiary has substantially no business except with the parent or has no assets except those conveyed to it by the parent;
(8) parent describes subsidiary as a department or division;
(9) parent uses subsidiary's assets as its own;
(10) directors and officers of subsidiary do not act independently but rather take orders from the parent;
(11) formal legal requirements of subsidiary are not observed.

Id.

191. *See* Cornwell v. Williams Bros. Lumber Co., 139 Ga. App. 773, 229 S.E.2d 551 (1976) (tort action against parent corporation; of eight directors only two were common to both and only three of eight shareholders were common; disregard not granted); Note, *supra* note 19, at 222 (affiliated corporations with identical shareholders may be operating in entirely different fields and have no business dealings in common).

192. *See, e.g.*, Allegheny Airlines, Inc. v. United States, 504 F.2d 104, 112-13 (7th Cir. 1974), *cert. denied*, 421 U.S. 978 (1975); Pennsylvania R.R. v. Anoka Nat'l Bank, 108 F. 482, 486 (8th Cir. 1901) (disregard granted where defendant dominated and controlled subsidiary; officers were identical); American Trading & Prod. Corp. v. Fischbach & Moore, Inc., 311 F. Supp. 412, 414-15 (N.D. Ill. 1970).

193. *See, e.g.*, Allegheny Airlines, Inc. v. United States, 504 F.2d 104, 113 (7th Cir.

C. *Allocation of Liability*

When the corporate disregard remedy is appropriate, the further issue arises concerning who should be held personally liable. Under traditional application of the remedy, which has been followed in Minnesota,[194] the corporation is treated as a partnership and all shareholders are held liable as partners.[195] This mechanical approach can unjustly punish innocent shareholders who may be only passive investors.

The Minnesota court in the case of *In re Will of Clarke*[196] presented an alternative approach to the allocation of shareholder liability. Under *Clarke* only the individual responsible for the fraud or injustice will be held liable, thus avoiding the injustice of holding shareholders liable who are not responsible for the fraudulent or inequitable conduct of the corporation.[197] The *Clarke* rule appears to be the better approach. Thus, each case should be analyzed separately to determine which shareholders perpetrated the fraud or reasonably could have stopped the fraud from occurring, rather than automatically holding all shareholders personally liable.

D. *Summary*

In summary, this Note advocates the use of varying standards in corporate disregard cases, depending upon the nature of the claim and the type of shareholder involved. In consensual or contract creditor cases, limited liability should be preserved unless: (1) the shareholders misrepresent the financial stability of the corporation or the fact of incorporation, or (2) the shareholders, after contracting, render it difficult or impossible for the creditor to receive payment for the debt because of fraud or other injustice. In nonconsensual or tort creditor cases, the standards should vary. If the corporation is engaged in a business involving significant foreseeable tort liability, inadequate capitalization alone should justify piercing the corporate veil. If the corporation is not engaged in a business involving significant foreseeable tort liability, both inadequate capitalization and disregard of corporate formalities by shareholders should be required. Finally, if the case involves parent and subsidiary or affiliated corporations not engaged in a business involving significant foreseeable tort liability, inadequate capitalization plus dominance should be sufficient to invoke the corporate disregard remedy.

1974), *cert. denied,* 421 U.S. 978 (1975); Gentry v. Credit Plan Corp., 528 S.W.2d 571, 573-74 (Tex. 1975).

194. *See* Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 183, 235 N.W.2d 825, 827 (1975), *noted in* 3 WM. MITCHELL L. REV. 293 (1977).

195. *See* note 80 *supra* and accompanying text.

196. 204 Minn. 574, 284 N.W. 876 (1939).

197. *Accord, Inadequate Capitalization: The California Approach, supra* note 152, at 835 n.57 (not all shareholders should be held personally liable; only those in a position to affect capital structure should be held liable).

V. EXCEPTIONAL APPLICATIONS OF THE CORPORATE DISREGARD THEORY

The corporate disregard doctrine described above is designed to apply in the typical case involving tort and contract creditors seeking to hold corporate shareholders personally liable for corporate debts. Corporate disregard also has application in cases not involving tort or contract creditors that require a special policy evaluation normally foreign to the typical case. Three types of these cases deserve special mention: cases involving probate administration, cases involving attempted evasion of statutes, and cases involving disputes among shareholders. It is important to recognize that the relative ease with which the courts sometimes disregard corporate entities in these cases is attributable primarily to peculiar policies not present in normal creditor disregard cases; therefore the language and standards contained in these special cases should not be relied upon in other corporate disregard cases.

A. *Probate Administration*

The doctrine of corporate disregard sometimes plays a role in the administration of estates, where the testator owned all the stock of a small corporation.[198] The problem generally arises because the testator devises corporate property directly to his devisees, rather than devising the shares of the corporation.[199] In these cases, the courts often are liberal in applying the corporate disregard remedy to uphold the devise, which would otherwise fail because the testator shareholder technically cannot transfer corporate property but rather can transfer only his shares in the corporation.[200] The decision whether to pierce in these cases and treat the corporate property as that of the testator depends primarily upon whether corporate creditors would be disadvantaged. If corporate creditors would not be disadvantaged by disregarding the corporate entity, then there can be little objection to upholding the devise and thereby fulfilling the testator's intent.[201]

198. *See generally* Younger, *Death and the Close Corporation,* 34 BROOKLYN L. REV. 1 (1967); Comment, *Corporations: Disregard of the Corporate Entity for the Benefit of Shareholders,* 1963 DUKE L.J. 722, 731-32.

199. *See* H. BALLANTINE, *supra* note 2, § 125; Fuller, *supra* note 6, at 1397-401.

200. *See, e.g., In re* Bauer's Will, 289 N.Y. 326, 332-33, 45 N.E.2d 897, 899 (1942) (one-shareholder corporation disregarded and corporate money used to pay gifts in shareholder-testator's will); *In re* Stukalo's Will, 7 Misc. 2d 1042, 166 N.Y.S.2d 478 (Sur. Ct. 1957) (testator owned 99 of 100 shares); *In re* Dunigan's Will, 177 Misc. 212, 215-16, 30 N.Y.S.2d 38, 42 (Sur. Ct. 1941); Fidelity Trust Co. v. Service Laundry Co., 160 Tenn. 57, 61-63, 22 S.W.2d 6, 8 (1929). *But see* Crane v. Horton, 287 Mass. 160, 163-64, 191 N.E. 391, 392 (1934). *See also In re* Trust Created by Warner, 263 Minn. 449, 458, 117 N.W.2d 224, 230 (1962) (where corporation is used only as convenient mode for administering trust property, it will be disregarded in accounting dispute).

201. *See In re* Turley's Estate, 160 Misc. 190, 192-93, 289 N.Y.S. 704, 706-07 (Sur. Ct. 1936) (where there are no intervening interests, corporate entity may be disregarded to effectuate decedent's intent); *In re* Winburn's Will, 136 Misc. 19, 22, 240 N.Y.S. 208, 210-

B. *Avoidance of Statutory Obligations*

Corporations sometimes are formed in an attempt by the shareholders to avoid the effect of obligations imposed by statutes. Not all such attempts necessarily are evil; they frequently are upheld as legitimate uses of the corporate entity.[202]

Shareholders cannot invoke the corporate entity as a defense to criminal prosecutions in cases where they are personally guilty of criminal conduct. For example, in *State v. McBride*[203] defendant was charged with selling intoxicating liquor without a license. The sale was made by an employee of a corporation owned and managed by defendant. The corporation was a closed one and was dominated by defendant, who knew liquor was on the premises for purposes of sale. Defendant claimed he could not be held criminally liable for the criminal acts of the corporation's employee. The Minnesota Supreme Court disagreed, holding that the existence of a corporation was irrelevant and that defendant was guilty as an accessory because he hired and supervised the employee and attempted to use the corporation merely as a shield to protect himself from criminal liability. The court noted that corporate officers normally are not criminally liable for the acts of other agents of the corporation, but can be criminally liable as aiders, abettors, or accessories, despite the fact that a corporate entity is involved.[204] The principles espoused in *McBride* are sound; the corporate entity cannot be the basis for negating criminal liability where the individual is personally responsible for the crime either directly or as an accessory.[205] And although the *McBride* court spoke in terms of corporate disregard, that doctrine actually need not be invoked in these cases. Rather, the individual merely is being held personally responsible for his own criminal conduct.[206]

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11 (Sur. Ct. 1930) (devise upheld; corporation had sufficient assets to satisfy corporate creditors).

202. For example, it is normally legitimate to form a corporation to avoid personal liability for future obligations. Canfield, *supra* note 79, at 141.

203. 152 Minn. 123, 9 N.W.2d 416 (1943).

204. *Id.* at 130, 9 N.W.2d at 420.

205. *See* Sell v. United States, 336 F.2d 467, 472 (10th Cir. 1964); State v. Creamery Package Mfg. Co., 110 Minn. 415, 433, 126 N.W. 126, 129 (1910) (illegal monopoly); Commonwealth v. Bonetti, 211 Pa. Super. 161, 165, 235 A.2d 447, 449 (1967) (worthless check); State v. Milbrath, 138 Wis. 354, 361, 120 N.W.2d 252, 254-55 (1909) (embezzlement); Berle, *supra* note 140, at 353 (same result even if articles of incorporation state crime to be corporation's business purpose).

206. Direct criminal liability of shareholders is illustrated in the recent case of State v. Strimling, No. 47542 (Minn. Mar. 10, 1978). Defendant shareholders were prosecuted for submitting to the state fraudulent nursing home cost reports to obtain reimbursement from welfare funds for services rendered to low-income patients. Defendants' practice of diverting corporate assets to their own use resulted in the appearance of artificially high operating costs. The cost reports were prepared by an officer of the corporation. Defendants contended that they did not authorize or approve the practice and thus should be absolved from liability. The court held the respondeat superior argument irrelevant because the defendants were charged as aiders and abettors of the criminal acts. In response

Where the statute attempted to be avoided is noncriminal, the courts tend to take a different view than in criminal cases by attempting to distinguish between bona fide avoidance and impermissible evasion of statutory restrictions.[207] Bona fide avoidance usually involves avoidance of a statute designed for the benefit of the individual who incorporates, as opposed to avoidance of statutes designed to protect third parties.[208] For example, usury statutes are intended to shield individuals from overreaching by unscrupulous lenders, and they usually except corporate borrowers from their scope.[209] The courts normally will permit individuals to incorporate for the purpose of avoiding usury statutes.[210] The rationale for this result appears to be twofold: the interests of third-party creditors are not involved, and the individual who made the decision to incorporate should not thereafter be allowed to have the corporate entity disregarded for his own benefit.[211]

Impermissible evasion, on the other hand, occurs where the corporate entity is used to evade a noncriminal statute that was enacted to protect the government or third parties. In this instance the courts have been more willing to apply the corporate disregard remedy.[212] If the statute or regulation in question would be subverted by incorporation and the legitimate interests of the state or a third party would be adversely affected, the fact of incorporation will be ignored by the courts.[213] Taxa-

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to defendants' alternative argument that the corporation ratified their actions, the court declared emphatically that the corporate entity cannot immunize shareholder criminal liability by ratification.

207. *See* Metropolitan Holding Co. v. Snyder, 79 F.2d 263, 266-67 (8th Cir. 1935); H. BALLANTINE, *supra* note 2, § 132.

208. *See, e.g.,* Schenley Distillers Corp. v. United States, 326 U.S. 432, 437 (1946) (corporate entities will be disregarded when used to avoid a clear legislative purpose; they will not be disregarded when chosen to secure advantages and no violence to legislative purpose results if not disregarded).

209. *See* Charmoll Fashions, Inc. v. Otto, ___ Minn. ___, ___, 248 N.W.2d 717, 719 (1976), *noted in* 4 WM. MITCHELL L. REV. 227 (1978); Dahmes v. Industrial Credit Co., 261 Minn. 26, 31, 110 N.W.2d 484, 487 (1961); MINN. STAT. § 334.021 (1976).

210. *See, e.g.,* Gangadean v. Flori Inv. Co., 106 Ariz. 245, 247, 474 P.2d 1006, 1008 (1970); Rabinowich v. Eliasberg, 159 Md. 655, 663, 152 A. 437, 440 (1930); Jenkins v. Moyse, 254 N.Y. 319, 324, 172 N.E. 521, 522 (1930). *See generally* Note, *Incorporation to Avoid Usury Laws,* 68 COLUM. L. REV. 1390 (1968); Note, *Efficacy of the Corporate Entity in Evasion of Statutes,* 26 IOWA L. REV. 350, 357-58 (1941) [hereinafter cited as *Evasion of Statutes*]; 15 MINN. L. REV. 112, 113 (1930) (parties may shape their transactions "with the usury laws before their eyes"). The result may be otherwise, however, where the lender deceptively induces the debtor to incorporate to circumvent the usury law. *See, e.g.,* Gelber v. Kugel's Tavern, Inc., 10 N.J. 191, 196-97, 89 A.2d 654, 657 (1952). *See generally* Comment, *supra* note 198, at 724-26.

211. *See, e.g.,* Toffolon v. Town of Avon, ___ Conn. ___, ___, 378 A.2d 580, 587 (1977); Sams v. Redevelopment Auth., 431 Pa. 240, 244-45, 244 A.2d 779, 781 (1968); *Evasion of Statutes, supra* note 210, at 357-58; note 75 *supra* and accompanying text.

212. The rationale for this result apparently is that there can be no immunity granted to a corporation which will permit it to evade the policies established by the legislature. *Evasion of Statutes, supra* note 210, at 351.

213. *See* Canfield, *supra* note 79, at 135 (where statute is designed to prevent a "serious

tion cases provide a good example of this distinction. As a general rule the corporate entity is a separate entity for taxation purposes.[214] Preferential tax treatment is a justifiable reason for incorporating in most cases.[215] However, the rule is well established that when incorporation is for the sole purpose of tax evasion the corporate entity will be disregarded for tax purposes.[216] This rule is commonly justified under the business purpose doctrine; if a corporation is formed for no business purpose except the evasion of taxation it may be disregarded.[217] Thus, proof of shareholder dominance, failure to observe corporate formalities, and inadequate capitalization normally should not be relevant if the corporation carried on a business activity and was more than merely a tax avoidance device.[218]

C. *The Internal-Dealings Rule*

The internal-dealings rule of corporate disregard law is a little-used rule that can be applied to settle conflicts among shareholders of a close corporation where the rights of third parties and creditors are not involved.[219] The apparent rationale of the rule is that when a close corpora-

public evil" courts will disregard corporate entities); *Evasion of Statutes, supra* note 210, at 358 (where statute is of "extreme social importance" courts will disregard corporate entities).

214. *E.g.*, Webber v. Knox, 97 F.2d 921, 923 (8th Cir. 1938) (corporation and sole shareholder not identical for purposes of computing capital gains holding period); George A. Hormel & Co. v. United States, 10 F. Supp. 623, 626 (D. Minn.) (a corporation and its shareholders generally are separate and distinct in tax matters), *appeal dismissed*, 82 F.2d 1011 (8th Cir. 1935); Milwaukee Motor Transp. Co. v. Commissioner of Taxation, 292 Minn. 66, 73, 193 N.W.2d 605, 609 (1971) (courts are reluctant to disregard separate legal entities merely to grant shareholders tax relief); Cargill, Inc. v. Spaeth, 215 Minn. 540, 547, 10 N.W.2d 728, 732 (1943) (corporation and shareholder will be treated separately for income tax purposes except where corporation is used merely for tax avoidance purposes).

215. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.02 (3d ed. 1971) (disparity between relatively flat corporate rates and graduated individual rates is constant inducement to investment in corporations).

216. *See, e.g.*, E. Albrecht & Son v. Landy, 114 F.2d 202, 204 (8th Cir. 1940); James Realty Co. v. United States, 176 F. Supp. 306, 311 (D. Minn. 1959), *aff'd*, 280 F.2d 394 (8th Cir. 1960). *See generally* 7 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 38.07-.15 (1976); Cleary, *The Corporate Entity in Tax Cases*, 1 TAX L. REV. 3 (1945).

217. *See* Minnesota Farm Bureau Sec. Inc. v. United States, 63-1 U.S.T.C. (CCH) ¶ 9138 (D. Minn. 1963); James Realty Co. v. United States, 176 F. Supp. 306, 311 (D. Minn. 1959), *aff'd*, 280 F.2d 394 (8th Cir. 1960); Community Hosp. Linen Serv., Inc. v. Commissioner of Taxation, ___ Minn. ___, ___, 245 N.W.2d 190, 195 (1976); Note, *Disregard of the Corporate Entity in Tax Cases*, 80 U. PA. L. REV. 892, 895 (1932) (suggesting that the disregard doctrine in tax law is normally premised on fraud).

218. *See, e.g.*, Taylor v. Commissioner, 445 F.2d 455, 457 (1st Cir. 1971); Skarda v. Commissioner, 250 F.2d 429, 433-35 (10th Cir. 1957).

219. *See* Sale v. Ambler, 335 Pa. 165, 171, 6 A.2d 519, 521-22 (1939); Harrison v. Puga, 4 Wash. App. 52, 63, 480 P.2d 247, 254-55 (1971); 1 W. FLETCHER, *supra* note 8, § 46; 68 HARV. L. REV. 541, 542 (1952) (internal-dealings theory should not apply where third parties are involved).

tion is operated basically as a partnership, then partnership law is the most appropriate source to determine the rights of shareholders *inter se*.[220] This rule can be valuable in determining these shareholder rights where corporate law does not satisfactorily do so.[221] However, the rule should not be invoked where legislatively or judicially created principles of corporate law adequately resolve the dispute or are designed to resolve the dispute.[222] Thus, the rule should be viewed as supplementing corporate law principles rather than displacing them.[223]

VI. CONCLUSION

The corporate device helped bring this nation's economy from its agrarian origins to the modern industrial model that it is today. Limited liability of shareholders played a prominent role in that development, but the evils that can result from its employment for improper purposes cannot be ignored. The doctrine of corporate disregard recognizes the equities in favor of the unpaid creditor as well as the policies favoring corporateness.

Development of the corporate disregard doctrine by the courts often has been equivocal and deficient in analysis of the important policies involved; metaphors predominate, remedies are confused, and standards are absent. Although the Minnesota corporate disregard law is no more refined than most other jurisdictions, it is unique, for it offers two approaches to corporate disregard. One is the traditional approach, with its emphasis on fraud, and the second is the *Clarke* approach, which simply places liability on the wrongdoer involved without pretending to pierce any corporate veil. Moreover, in *Ahlm v. Rooney*[224] the court recognized the fallacy of the pervasive dominance factor in disregard law. The Minnesota court has established a good foundation for disregard analysis. Yet, its overall approach still cannot be considered sufficiently comprehensive.

This Note has advocated the use of varying standards for the courts to observe in disregard actions. Application of the doctrine should depend upon the nature of the claim and type of shareholder involved. The nature of the claim is important because different types of claims in-

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220. *See* 3 WM. MITCHELL L. REV. 293, 295 (1977).

221. *See* Urnest v. Forged Tooth Gear Co., 102 Ill. App. 2d 178, 186, 243 N.E.2d 596, 601 (1968); Siegel v. Ribak, 43 Misc. 2d 7, 13, 249 N.Y.S.2d 903, 908-09 (Sup. Ct. 1964).

222. In Manufacturers Bldg., Inc. v. Heller, 306 Minn. 180, 183, 235 N.W.2d 825, 827 (1975) the court applied the piercing doctrine in a dispute between shareholders. Although the court did not explain the grounds for piercing, the case can be rationalized by reference to the internal-dealings rule. *See* 3 WM. MITCHELL L. REV. 293, 295 (1977).

223. *See* I. WORMSER, THE DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 48 (1927) (the entity theory often must be ignored in determining the rights of stockholders *inter se*; in these cases, disregard of the concept of corporate entity is incidental rather than fundamental).

224. 274 Minn. 259, 143 N.W.2d 65 (1966).

volve different policies affecting limited liability. The disregard remedy should be available to consensual creditors only upon a showing of some fraud or misrepresentation. Nonconsensual creditors, on the other hand, should face a less restrictive burden; because they are unable to choose their debtor, their ability to be compensated should rest upon different considerations. Thus, inadequate capitalization, failure to observe corporate formalities, and dominance should have some relevance. Finally, only those persons who cause the fraudulent or unjust result should be held liable when the corporate disregard remedy is invoked.