Florida Law Review

Volume 27 | Issue 1 Article 9

September 1974

Disregarding the Corporate Fiction in Florida: The Need for Specifics

J. Penn Carolan

inevitable that courts in many jurisdictions will consider cases involving not only the physician's liability in unsuccessful surgical sexual sterilizations, but also the liability of pharmacists for negligently filling oral contraceptive prescriptions[174] and the liability of manufacturers for the negligent design or fabrication of birth control devices.[175] It is crucial that the courts not be led by the apparent equities of the situation to decide these cases of first impression in such a way as to foreclose future recoveries as a matter of law.[176]

The liberal offset rule applied in *Troppi* and followed in *Coleman v. Garrison*[177] permits the finders of fact in each case to balance the wide range of benefits and detriments that may arise in connection with the birth of an unplanned child. Allowing a case-by-case determination of the recovery in this manner better comports with established theories of American jurisprudence than does excluding further consideration of claimed injuries because of a judicially perceived public accord.

MICHAEL LANNING FOX

DISREGARDING THE CORPORATE FICTION IN FLORIDA: THE NEED FOR SPECIFICS

Disregard of the corporate fiction is the exception rather than the rule.[1] It is a judicial remedy designed to prevent abusive utilization of the corporate form.[2] Florida courts have delineated various tests to be used in identifying those situations in which the corporate fiction will be disregarded. The circumstances requiring application of this doctrine of disregard are described by such verbal characterizations[3] as alter ego, instrumentality, identity, and

174. *See* Troppi v. Scarf, 31 Mich. App. 240, 187 N.W.2d 511 (1971).

175. Courts have recently held that in most instances there is no warranty of the effectiveness of birth control pills. Jorgensen v. Meade Johnson Laboratories, Inc., 336 F. Supp. 961 (W.D. Okla. 1972); Whittington v. Eli Lilley & Co., 333 F. Supp. 98 (S.D.W. Va. 1971).

176. *Compare* Hays v. Hall, 477 S.W.2d 402 (Tex. App.), *rev'd*, 488 S.W.2d 412 (Tex. 1972), *with* Terrell v. Garcia, 496 S.W.2d 124 (Tex. App. 1973).

177. 281 A.2d 616 (Del. Super. Ct. 1971).

1. *E.g.*, Robert's Fish Farm v. Spencer, 153 So. 2d 718, 721 (Fla. 1963); Advertects, Inc. v. Sawyer Indus., 84 So. 2d 21 (Fla. 1955).

2. The concept of the corporation as a separate legal entity is employed in a manner violative of its intended purposes and hence will be disregarded when used to defeat public convenience, justify wrong, protect fraud, or defend crime. *See, e.g.*, United States v. Milwaukee Refrigeration Transit Co., 142 F. 247, 266 (C.C.E.D. Wis. 1905); State *ex rel.* Continental Distilling Sales Co. v. Vocelle, 158 Fla. 100, 27 So. 2d 728 (1946).

3. Justice Cardozo, referring to use of the instrumentality rule in cases involving parent-subsidiary relationships, stated: "The whole problem . . . 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." Berkey v. Third Ave. Ry., 244 N.Y. 84, 94-95, 155 N.E. 58, 61 (1926).

subterfuge.[4] Because the situations in which the corporate fiction will be disregarded are described in such broad generalities,[5] the labels are of limited value to the attorney trying to ascertain whether the fiction will be disregarded in a specific fact situation. Nevertheless, it is this very generalization that gives the remedy its strength and vitality, for such generalization permits flexible employment of the remedy as a panacea for a wide variety of wrongs.

Although the doctrine of disregard is an equitable remedy, it is not limited to equity jurisdiction,[6] nor is it barred by the existence of alternative legal remedies.[7] In fact, the frauds and wrongs for which the doctrine may supply relief are often independently actionable under other theories of liability. For example, an action in deceit will normally lie in a situation where the corporate fiction is disregarded and unlimited liability is imposed on a shareholder or affiliate corporation.[8] Thus, the doctrine has important utility as an independent remedy.

This note explains the policies behind the doctrine of disregard and analyzes the situations suitable for employment of the doctrine in an effort to identify the specific requirements that must exist before a court will pierce a corporate veil. Because most Florida cases dealing with the doctrine of disregard concern credit transactions and because credit transactions involve the conflict between the policies behind limited liability and those calling for disregard of the corporate form, such transactions are emphasized.[9]

---

4. Professor Henn lists thirty-eight such epithets. H. HENN, LAW OF CORPORATIONS 250 n.2 (2d ed. 1970).

5. For examples of various descriptions that defy precise analysis, see House of Koscot Dev. Corp. v. American Line Cosmetics, Inc., 468 F.2d 64 (5th Cir. 1972) (applying Florida law); Advertects, Inc. v. Saywer Indus., 84 So. 2d 21 (Fla. 1955); Sirmons v. Arnold Lumber Co., 167 So. 2d 588 (2d D.C.A. Fla. 1964).

6. *See, e.g.*, Barnes v. Liebig, 146 Fla. 219, 1 So. 2d 247 (1941); Bellaire Sec. Corp. v. Brown, 124 Fla. 47, 84, 168 So. 625, 633 (1936).

7. *See* House of Koscot Dev. Corp. v. American Line Cosmetics, Inc., 468 F.2d 64 (5th Cir. 1972) (applying Florida law). In *Koscot* two alternative theories were submitted to the jury, the first based on the alter ego theory, the second on the theory that a defendant had tortiously interfered with plaintiff's contract. Many courts require fraud to be present before the doctrine will be applied in consensual credit transactions. *See, e.g.*, Codomo v. Emanuel, 91 So. 2d 653 (Fla. 1956); Advertects v. Sawyer Indus., 84 So. 2d 21 (Fla. 1955). *See generally* Note, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441, 443-46 (1967).

8. The doctrine may be more advantageous than a deceit action in this situation because of the possible existence of differing statutes of limitations or difficulties in proving material misrepresentation, detrimental reliance, or intent. Similarly, in an action for breach of contract or warranty, proof of a contract or promise with the defendant when the actual agreement is between the plaintiff and the corporation might be hindered by the statute of frauds.

9. Although the doctrine of disregard is applicable to all corporations, it is most frequently applied to close corporations and corporations occupying a parent-subsidiary relationship. A subsidiary corporation is similar to a close corporation in that generally both have a small number of shareholders. In fact, the parent corporation often is the sole shareholder of the subsidiary, creating a situation similar to that encountered in a one-man corporation. The major distinction between these types of corporations is that

POLICIES INVOLVED IN DISREGARDING THE CORPORATE FICTION

Although limited liability has not always been available, it is presently the major motive for incorporation.[10] Limited liability was granted to encourage investment of risk capital in needed enterprises.[11] The legal invention of the corporation with attendant limited liability for shareholders has been cited as the major factor contributing to our present high standard of living, and consequently it is accorded a favored position in the law.[12]

Because limited liability is the basic characteristic that distinguishes a controlling shareholder from a principal, the policy behind limited liability must be considered whenever a corporate obligation resulting from a credit transaction is sought to be imposed on a shareholder.[13] There are two types of credit transactions: consensual (contract) and nonconsensual (tort). Consensual credit cases generally involve principles of assumption of the risk, estoppel, and limited liability, which favor adherence to the corporate fiction.[14] Abuse of the corporate privilege may, however, militate in favor of dis-

---

the subsidiary corporation, unlike the close corporation, is usually commercially dependent on its stockholder. Because of the similarity in economic structures, standards applicable to one are usually applicable to the other. *See generally* H. HENN, *supra* note 4, §§147-48.

The frequency of application of the doctrine to these corporations is attributable to economic realities, as the shareholders in both types are more likely to be able to exercise the control or create the misleading situations that trigger application of the doctrine. These economic realities have always existed, but until recently corporate statutes have failed to distinguish the close corporation and the parent-subsidiary corporation from the larger publicly held corporation. Thus, close corporations have been subjected to the same standards as publicly held corporations. See text accompanying notes 160-178 *infra*. Because Florida has enacted separate standards for close corporations and because of the economic realities that make the doctrine particularly applicable to them, this note will emphasize close corporations.

10. English common law provided for the granting of charters of incorporation, but denied shareholders limited liability. 8 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW 203 (1926). Special legislative acts and royal charters were the source of the first grants of limited liability in England, but the privilege was allowed only to corporations of "semi-public nature such as a canal or railroad." Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts,* 61 HARV. L. REV. 1351 (1948). In the United States after the Colonial Revolution, however, even semi-public enterprises were unable to obtain limited liability. *Id.* at 1352. Florida first granted the privilege to most corporations in 1868, FLA. STAT. ANN. §608.44 (1970), *History and Source of Law,* while California refused to grant limited liability to corporations until 1930. CAL. CONST. art. XII, §3 (1879) provided for unlimited personal liability for shareholders, and it was not repealed until Nov. 4, 1930.

11. *See* Cataldo, *Limited Liability with One-man Companies and Subsidiary Corporations,* 18 LAW & CONTEMP. PROB. 473 (1953); Rankin, *The Endless Problem of Corporate Personality,* 32 COLUM. L. REV. 643, 654 (1932); Note, *Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation,* 45 S. CAL. L. REV. 823, 834 (1972).

12. I. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 2 (1924).

13. *See generally* Note, *supra* note 7.

14. Contract cases are considered to be consensual credit transactions because the contracting party has consented to do business with the corporation. The doctrine of assumption of the risk exists because the contracting party has voluntarily consented to contract with the corporation, realizing that the corporation alone will be responsible for any

regarding the corporate fiction and consequent limitations on shareholder liability. In nonconsensual credit cases, only the strong policy of limited liability supports a separate corporate entity concept while public protection arguments[15] are advanced to justify application of the doctrine of disregard.[16]

Many cases involving application of the doctrine of disregard do not involve conflicts with the limited liability policy. Taxation questions, for example, involve constitutional issues and fiscal policies relating to the amount of tax due rather than liability for taxes owed.[17] Jurisdictional problems concerning service of process involve questions of due process and minimal contacts.[18] Also, cases in which corporations attempt to evade technical wording of statutes raise questions of legislative intent, just as the issue of enforceability of an injunction against an affiliate corporation or shareholder in-

---

breaches of contract that may occur. Similarly, because of the contracting party's assumed ability to protect himself by diligent investigation and because the limited liability aspects of the corporation are considered to be within the contemplation of the parties, the doctrine of estoppel may apply as well.

15. Tort cases are considered noncensensual credit transactions because the tort victim obviously has not consented to be injured. A tort victim who has obtained a judgment against his tortfeasor has thus become an unwilling creditor. For a discussion of various aspects of nonconsensual credit transactions, see Note, *supra* note 11, at 840-44; Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190 (1967).

16. Policy conflicts involving credit transactions will be analyzed further in the discussion of inadequate capitalization. See text accompanying notes 128-34 *infra*.

17. Application of the doctrine of disregard of the corporate fiction in taxation cases has special importance in Florida because of the extensive utilization of limited partnership in land transactions. The general partner in these limited partnerships is often a corporation formed by the limited partners. The Internal Revenue Service has begun to apply the doctrine to this type of situation. Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

18. Jurisdiction emphasizes the corporate relationships considered under the instrumentality and alter ego theories. See note 26 *infra*. In a manner similar to the corporate fiction, jurisdiction involves legal fictions and thus to some extent must emphasize form over substance. Instances in which such emphasis is evident arise most often in cases involving parent-subsidiary relationships. *See, e.g.*, Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925); Berkman v. Ann Lewis Shops, 246 F.2d 44 (2d Cir. 1957) (applying Florida law). The mere existence of a parent-subsidiary relationship does not validate service upon the subsidiary in order to reach the parent, nor does the fact that the parent owns all the stock of the subsidiary establish that the parent is doing business within the meaning of the Florida jurisdictional statute. FLA. STAT. §48.081 (1973). *See, e.g.*, Turner v. Jack Tar Grand Bahamas, Ltd., 353 F.2d 954 (5th Cir. 1965); Hermetic Seal Corp. v. Savoy Electronics, Inc., 290 F. Supp. 240 (S.D. Fla. 1967) (applying Florida law). Even additional factors such as the identity of officers and directors of the parent and subsidiary corporations or the residence of the officers and directors of both the parent and subsidiary do not supply the necessary minimum contact. *See* Hermetic Seal Corp. v. Savoy Electronics, Inc., 290 F. Supp. 240, 243 (S.D. Fla. 1967) (applying Florida law). The corporate fiction will be disregarded and the courts will look to the real party in interest, however, if the subsidiary is a mere jobber or distributor through which the parent sells its products in the state. *Id.* Similarly, if a principal officer of the parent corporation maintains an office in the state from which he controls the subsidiary, and many of the company affairs are handled in the state, the subsidiary will be considered the alter ego or instrumentality of the parent and the state will have jurisdiction. *Id.*

volves questions of judicial intent.[19] Such situations, although involving difficult constitutional problems, seldom present disputes unique to corporate law such as does conflict between limited liability and the doctrine of disregard of the corporate fiction.[20]

Mystical Metaphors

Analysis of the legal theories involved in the doctrine of disregard is complicated by the general nomenclature of the theories themselves as well as the judicial tendency to cite several theories in support of a single result.[21] The major legal devices used to apply the doctrine are: the instrumentality rule, the agency rule, the enterprise entity rule, the identity rule, and the alter ego rule. The basis of each of these rules is summarized in this section. It should be emphasized, however, that it is not as important to understand completely the intricacies of these various rules as it is to comprehend the basic nature of the doctrine itself and to recognize the conflicting policies that must be balanced to reach equitable results in divergent fact situations.

The Instrumentality Rule

The instrumentality "rule" is not an actual rule; rather, it is "a convenient way of designating the application, in particular circumstances, of the broader equitable principles that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice."[22] Thus, when a shareholder is held liable for the acts of the corporation, a judicial statement that the corporation is the instrumentality of the shareholder is conclusory and does not aid in the search for the substantive rationale of the decision.[23]

The instrumentality rule is generally divided into separate elements that combine to trigger its application.[24] The first element is abuse of corporate

---

19. Since these cases deal with legislative intent and due process and do not involve the legal roadblock of limited liability, courts are more likely to concentrate on reaching an equitable result. Justice Douglas emphasized this idea in Anderson v. Abbot, 321 U.S. 349 (1944). While discussing an attempt to create a corporation for the purpose of avoiding statutory restrictions, he stated: "[T]he courts will not permit themselves to be blinded or deceived by mere forms of law but will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require." *Id.* at 363. Florida courts have adopted this position and have concentrated on determining whether statutes have been circumvented rather than merely examining corporate relationships. See Aztec Motel, Inc. v. State *ex rel.* Faircloth, 251 So. 2d 849 (Fla. 1971).

20. *See generally* Note, *supra* note 7.

21. *See, e.g.,* House of Koscot Dev. Corp. v. American Line Cosmetics, Inc., 468 F.2d 64 (5th Cir. 1972) (applying Florida law); Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law).

22. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939).

23. E. Latty, Subsidiaries and Affiliated Corporations 3 (1936).

24. *See generally* Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 428, (Dist. Ct. App. 1957); Zaist v. Olson, 154 Conn. 563, 227 A.2d 552 (1967); Berkey v. Third Ave. Ry.,

organization resulting in shareholder domination of policies, finances, and business practices to such an extent that the corporation has no separate will of its own.[25] Control of management alone, however, is insufficient to justify invocation of the instrumentality rule.[26] Actual shareholder domination of corporate affairs must be so pervasive that the shareholder and the corporation are no longer separate entities.[27] In such circumstances, the corporation is merely an adjunct or instrumentality of the shareholder.

In one sense, all corporations are instrumentalities of their stockholders because the decision to incorporate is motivated by a desire to advance stockholders' interests. This fact, along with the difficulty of accurately defining the impermissible degree of control, indicates that evaluation of control factors alone will not clearly define the point at which the corporate fiction will be disregarded. In fact, courts have added to this confusion by emphasizing the overt factors that demonstrate abnormal shareholder control, while failing to enunciate the underlying legal policies that justify disregard of the corporate fiction.[28]

The second element of the instrumentality rule involves shareholder use of corporate power to commit fraud or violate a plaintiff's legal rights.[29] This aspect of the instrumentality rule emphasizes the nature of the wrong resulting from a misuse of the corporate entity. The resultant inequity must stand out in such a way that arguments favoring its correction through application of the doctrine of disregard overcome the policy considerations supporting the existence of the corporate fiction.[30]

---

244 N.Y. 84, 155 N.E. 58 (1926); W. FLETCHER, CYCLOPEDIA OF CORPORATIONS 41, 42 (perm. ed. rev. 1963); F. POWELL, PARENT AND SUBSIDIARY CORPORATION chs. 3, 5, 6, 14 (1931); Comment, *Disregard of Corporate Entity—Liability of Stockholders for Contractual Obligations of the Corporation,* 42 CONN. B.J. 127 (1968); Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases,* 48 B.U.L. REV. 123 (1968).

25. *See, e.g.,* Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 793, 306 P.2d 1 (1957); Zaist v. Olson, 154 Conn. 563, 227 A.2d 552 (1967).

26. *See* Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law); Advertects v. Sawyer Indus., 84 So. 2d 21 (Fla. 1955).

27. Powell has listed the following as factors to be considered in determining degree of control: (1) ownership of all or most of the corporations' stock; (2) common directors or officers; (3) parent financing of the subsidiary; (4) inadequate capitalizatin of the corporation; (5) payment of corporate expenses by the shareholder; (6) commercial dependence; (7) treatment of the corporation as a department of the defendant; (8) directors and officers of the corporation taking orders from the defendant; (9) irregularities in observing corporate formalities. F. POWELL, *supra* note 24, ch. 6. No single factor is sufficient to indicate the necessary control. Rather, it is a combination of these factors, viewed in light of the particular facts of each case, that creates the requisite control. In addition, there are factors that act as obstacles to application of the doctrine. For example, a difference in corporate powers, such as the held corporation's having power to do that which is beyond the power of the holding corporation, is an obstacle to complete disregard of the former entity. *See* Corsicana Nat'l Bank v. Johnson, 251 U.S. 68 (1919); Fisser v. International Bank, 282 F.2d 231 (2d Cir. 1960).

28. *See generally* Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection,* 45 N.D.L. REV. 363 (1968).

29. See authorities cited note 24 *supra.*

30. It is the second element that gives substance to the remedy. Without this element

The third element of the instrumentality rule, often implicit in the second, looks to the causal relationship between proscribed corporate control and a breach of legal duty resulting in provable injury or loss to a plaintiff. This third element emphasizes the fact that abnormal shareholder control does not by itself justify disregard of the corporate fiction through the instrumentality rule.

Florida courts have never explicitly defined the elements making up the instrumentality rule. Observance of the elements is shown, however, by the fact that circumstances indicative of abnormal dominance and control have resulted in application of the rule[31] in situations where fraud has produced inequities justifying disregard of the corporate fiction.[32] The purpose of the doctrine demands that fraud alone activate its application,[33] and the concept of a separate corporate entity may not be used to insulate crime or justify wrong.[34] Thus, if the controlling shareholder uses the corporation to perpetrate fraud on a third party, the corporate entity should be disregarded even if corporate formalities have been observed.[35]

In this regard, a Connecticut jurist has proposed a fraudulent purpose test to replace the instrumentality rule.[36] This test imposes liability on a shareholder for abuse of a corporate entity, thereby placing primary emphasis on the use of corporate control to violate the legal rights of other parties.[37] Under the fraudulent purpose test, use of the corporation in an unacceptable manner replaces the first element of the instrumentality rule. Thus, the presence of variables tending to show abnormal dominance is strongly indicative of the shareholder's abusive control of the corporation, but the variables are not essential to prove such control.[38] Because the fraudulent purpose test stresses the actual wrong rather than the variables, which are symptomatic or indicative of wrong, it is preferable to the instrumentality rule.[39]

---

a court would be emphasizing form only. Courts still improperly stress form in both the alter ego and instrumentality theories, however. See text accompanying notes 60-78 *infra*.

31. *E.g.*, Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law); Codomo v. Emanuel, 91 So. 2d 653 (Fla. 1956); Advertects, Inc. v. Sawyer Indus., 84 So. 2d 21 (Fla. 1955).

32. *E.g.*, Aztec Motel, Inc. v. State *ex rel.* Faircloth, 251 So. 2d 849 (Fla. 1971); Riley v. Fatt, 47 So. 2d 769 (Fla. 1950); Tiernan v. Sheldon, 191 So. 2d 87 (4th D.C.A. Fla. 1966).

33. "In cases of fraud, whether actual or constructive, the courts regard the real parties responsible, granting relief against them or denying their claims and defenses because of it; and this is especially true in equity. It is a principle older than the modern law of private business corporations, and does not depend on the regard or disregard of the corporation." 1 W. FLETCHER, *supra* note 24, §44, at 225.

34. FDIC v. Franchise Fin. & Management Co., 354 F. Supp. 1016 (S.D. Fla. 1973); Aztec Motel, Inc. v. State *ex rel.* Faircloth, 251 So. 2d 849 (Fla. 1971); Tiernan v. Sheldon, 191 So. 2d 87 (4th D.C.A. Fla. 1966).

35. *See generally* Comment, *Liability of Parent for Debts of Subsidiary*, 10 Sw. L.J. 77 (1956).

36. Zaist v. Olson, 154 Conn. 563, 580, 227 A.2d 552, 561 (1967) (Cotter, J., dissenting).

37. *See* Comment, *Disregard of Corporate Entity—Liability of Stockholders for Contractual Obligations of Corporation*, 42 CONN. B.J. 127 (1968).

38. *Id.*

39. See text accompanying notes 60-78 *infra*.

The Identity Rule and the Alter Ego

The identity rule applies when the actions of an individual stockholder are such that they tend to mislead an innocent party into believing he is dealing with the individual rather than with the corporation.[40] If the individual stockholder has created this impression by failing to clarify the capacity in which he is acting, the separate entity fiction will be ignored and thus the corporation and the individual stockholder will be considered as one.[41]

A corporation may cease to exist in several ways. The most common method is compliance with the state statutory scheme for dissolving corporations,[42] but the corporation will also be considered nonexistent when its formal structure has so completely deteriorated that it exists in name only. There exists a gray area, moreover, where deterioration is not complete, but the interrelation of individual and corporate activities is so great that a unity is created from the commingled entities.[43] Courts following this rationale often emphasize the misleading nature of the acts[44] rather than the fraud emphasized under the instrumentality rule.[45]

The alter ego theory may be described as a cross between the instrumentality and identity rules. This theory disregards the corporate fiction when the separate personalities of the individual stockholder and the corporation have ceased to exist, and therefore continued recognition of the corporate fiction would lead to inequitable results.[46] This concept of unity of personalities is similar to the identity rule.[47] To show the existence of the necessary degree of unity, however, there must be a merger of interest and ownership in excess of that evident in a normal corporation-shareholder relationship. The unity of interest and ownership required to bring into play the alter ego theory is indicated by the same factors that show abnormal control and dominance under the instrumentality rule.[48] This similarity indicates the difficulties en-

---

40. For example, because a corporation can act only through its agents, if a controlling stockholder is also an agent of the corporation, confusion can exist regarding the capacity in which that stockholder acts. *See* Comment, *supra* note 37, at 132. Although this article refers to the agency theory, Florida considers the identity and agency theories to be interchangeable. See text accompanying notes 52-56 *infra*.

41. *Id.*

42. FLA. STAT. §§ 608.041, .77 (1973).

43. *See* Note, *supra* note 7, at 463-65. This note mentions that the concept of creating a unity of theretofore separate entities is of doubtful validity in contract cases where the distinction was the original purpose of incorporation. *Id.* at 464.

44. *See* Automotriz del Golfo de California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 429 (Dist. Ct. App. 1957).

45. See text accompanying notes 23-39 *supra*.

46. *E.g.*, Minifie v. Rowley, 187 Cal. 481, 202 P. 673 (1921); Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (Dist. Ct. App. 1962). The latter case emphasized that actual fraud is not required but that the underlying inequity must be more than the dissatisfaction of a creditor.

47. See text accompanying notes 40 *supra* and 60 *infra*.

48. See note 28 *supra*.

countered in determining which theory is being employed by a particular court.[49]

The Agency Rule

"Agency" is a term used to describe various legal theories.[50] Courts often use the term in the technical sense, referring to the principal-agent relationship.[51] Agency, however, is also employed as a synonym for the instrumentality rule. Florida has adopted both approaches,[52] and has in addition used agency as an alternative means of describing the identity theory.[53] This interchangeable use of the term indicates the courts' confusion and supports the conclusion that comprehension of the general nature of the doctrine of disregard and recognition of the conflicting policies that are necessarily balanced in deciding whether to employ the doctrine in a particular instance are more important than memorization of technical distinctions among the various legal theories used to justify employment of the doctrine.

The Enterprise Entity Rule

The enterprise entity rule concerns itself with organizational fragmentation of a particular economic enterprise; specifically, it encompasses multiple close corporations engaged in identical or similar businesses under common ownership or control, and it also applies to parent-subsidiary relationships.[54] The rule does not operate to thrust personal liability on principal shareholders. Rather, it is used to look through organizational form to economic

---

49. Many authorities use the instrumentality and alter ego theories interchangeably. *See* 1 W. FLETCHER, *supra* note 24, §41.1. Considering a corporation a mere department in one case and identified with the shareholder in another seems an insignificant distinction. Although it may be said that the requirement of fraud applies to the instrumentality theory while the alter ego theory emphasizes the misleading nature of the defendant's acts, Florida courts have avoided this distinction by requiring that the corporation be shown to have misled creditors *or* perpetrated fraud upon them. *See, e.g.,* Advertects v. Sawyer Indus., 84 So. 2d 21 (Fla. 1955); Delta Air Lines v. Wilson, 210 So. 2d 761 (3d D.C.A. Fla. 1968).

50. *See generally* F. POWELL, *supra* note 24, at 23.

51. Although normally the relationship between stockholder and corporation is not considered to be that of principal and agent, Moline Properties v. Commissioner, 319 U.S. 436 (1943), a corporation and a shareholder or parent corporation clearly may form a technical agency relationship as both are separate legal entities. This relationship will not occur often, however, because one of the primary reasons for incorporation is the limitation of liability for the principal. If a technical agency relationship does exist, the principal may be held liable without fraud or wrongdoing on his part. Such a result follows from the nature of the law of agency and does not result from a disregard of the corporation as an independent entity. *See* Note, *supra* note 7, at 462-63.

52. Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) ("agency" a synonym for "instrumentality"); Thomkin Corp. v. Miller, 156 Fla. 388, 24 So. 2d 48 (1945) ("agency" used in the technical sense).

53. House of Koscot Dev. Corp. v. American Line Cosmetics, Inc., 468 F.2d 64 (5th Cir. 1972) (applying Florida law). For a discussion of the identity rule see text accompanying notes 40-45 *supra.*

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

reality in an endeavor to impose liability on an entire economic unit.[55] In the case of related corporations the entire economic family benefits from the successful efforts of one of its members, consequently equitable considerations often demand that the whole enterprise be held responsible for the debts of each individual corporate member.[56] The equities demanding this result are particularly acute in nonconsensual credit transactions.[57] When the corporate veil between brother-sister corporations is pierced under the entity theory, the shareholder is not denied the right to limited liability but only the benefit of dual protection or double limited liability.[58] When the corporate veil between a parent corporation and its subsidiary is pierced, the parent corporation is denied limited liability, but its stockholders are denied only one of the twin protections the parent-subsidiary organization was designed to provide.

The entity theory has not yet met with judicial approval in Florida, but it has been recognized in several other jurisdictions.[59] It should be noted that the unity of interest and ownership necessary for application of the entity theory may also justify utilization of the identity and instrumentality rules.[60]

---

55. *Id.*

56. *Id.*

57. The systematic fragmentation of an enterprise to minimize risk of loss may lead to the greatest abuse of the corporate privilege. *See generally* Gillespie, *supra* note 28, at 384-87. The famous taxicab cases involve the common practice in the taxicab industry of vesting ownership of a taxi fleet in many corporations, with each corporation owning only one or two cabs. Although the fleet operates as a unit in regard to financing, supplies, repairs, and garaging each individual corporation is organized with only the minimum required capital in order to avoid full liability for acts arising as a result of the operation of a taxi fleet. Thus, any tort victim seriously injured by a particular cab has little hope of being completely compensated for his injuries. *See* Walkovsky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966). *But see* Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962).

Although it seems inequitable that a large business can utilize a fragmented organizational structure to shift risk of loss to a tort victim less able to bear that risk, inequities also develop in schemes designed to correct the situation. While high minimum capital requirements could be imposed for all corporations regardless of size, such requirements would unduly restrict small businesses. It would be unfair and unwise to prohibit a small, one-man operation from competing in legitimate corporate form by requiring as a condition precedent to corporate status the contribution of an amount of capital that only a large business could afford.

58. The opposite argument is that as far as limited liability is concerned there should be no distinction between individual and corporate entities because each is equally likely to provide risk capital in needed enterprise.

59. *See In re* Pittsburgh Ry., 155 F.2d 477 (3d Cir. 1946); Hartford Steam Serv. Co. v. Sullivan, 26 Conn. 277, 220 A.2d 772 (1966); Hall v. John S. Isaacs & Sons Farm, 37 Del. Ch. 530, 146 A.2d 602 (Ch. 1958).

60. Under the identity and instrumentality theories, liability is imposed on the shareholder in his personal capacity. Under the enterprise entity rule, the corporate fiction is disregarded in relation to the individual corporations themselves, and they are regarded as a single corporation. Thus, under this latter rule personal liability is not imposed on the shareholder when the veil between brother and sister corporations is pierced.

SIGNIFICANCE OF THE CONTROL AND UNITY FACTORS

Legal theories that rely on a number of interacting variables to show extraordinary unity of interest and ownership or an unusual amount of dominance and control are of questionable utility when applied to credit transactions involving the close corporation. The Florida Legislature has followed the modern trend of distinguishing between closely held and public corporations.[61] The judiciary should similarly tailor application of the doctrine of disregard to the structural contours of the particular organization in question.[62] Specifically, judicial modifications in the employment of the doctrine with respect to close corporations are essential to give meaningful effect to the special legislative provisions concerning such organizations.

The instrumentality rule, for example, necessitates consideration of interacting variables to determine whether corporate control exceeds permissible limits.[63] The Florida Close Corporation Statutes simplify or eliminate corporate formalities and sanction internal control methods similar to those used in partnerships. By allowing corporations to operate as informal partnerships[64] with a single shareholder[65] and no directors,[66] the legislature has approved far more corporate control and informality than that allowed under traditional corporation law.[67] It is unrealistic to require the close corporation to have a mind or existence distinct from that of its controlling shareholders.[68] Judicial insistence on applying standards emphasizing abnormal restrictions on shareholders' actions to close corporations is an unjustifiable interference with the legislative scheme.

Judicial deemphasis of the control and unity of interest standards would not necessarily permit a close corporation to operate in a manner that misleads, defrauds, or violates reasonable expectations of third parties. Although

61. FLA. STAT. §§608.01-.77 (1973) are the Florida corporate statutes. FLA. STAT. §§608.70-.77 (1973) deal exclusively with close corporations. FLA. STAT. §608.70(2) (1973) defines a close corporation as "a corporation for profit whose shares of stock are not generally traded in the markets maintained by security dealers or brokers."

62. "Perhaps the chief difference between the publicly held and close corporation is that in the former there is a separation between ownership and control which in itself requires some statutory regulation. In the close corporation, ownership and control are identical, or it is the desire of the membership that they should be. The close corporation is in reality a partnership with the added benefit of limited liability, and it is managed and conducted informally as a partnership, and usually, harmlessly so from any standpoint of public policy or interest." Stevens, *Close Corporations and the New York Business Corporation Law of 1961*, 11 BUFFALO L. REV. 481-82 (1962).

63. For examples of the variables that courts consider, see note 27 *supra*.

64. FLA. STAT. §608.75(3) (1973).

65. FLA. STAT. §608.71 (1973).

66. FLA. STAT. §608.72 (1973).

67. *Compare* the corporate norm contemplated in FLA. STAT. §§608.01-.67 (1973), *with* that contemplated under the close corporation statutes, FLA. STAT. §§608.70-.77 (1971).

68. "Close corporations, although individual entities from a legal standpoint, are normally no more than vehicles for the goals and motives of their principals. The law is not necessarily advanced by adopting a rule which includes a presumption that this kind of corporation may have a 'separate mind, will or existence of its own.' " Zaist v. Olson, 154 Conn. 563, 582-83, 227 A.2d 552, 561 (1968) (Cotter, J., dissenting).

the lack of formality and supervision inherent in the close corporation[69] has been criticized as creating "excessive maneuverability that may adversely affect the rights of innocent parties,"[70] most small businesses operating under the close corporation act can be expected to operate in an acceptable manner because tax laws and economic realities demand it.[71] Furthermore, because management and ownership of a close corporation are usually identical, the ordinary management liability[72] thrust upon most close corporation stockholders serves as an additional protection against excessive maneuverability.[73] Finally, the doctrine of disregard of the corporate fiction offers reasonable protection if the corporate entity has been used to defraud or mislead creditors.[74] Regardless of the specific standards adopted to determine application of the doctrine, general emphasis will be placed on the requirements that the corporation be run in a business-like manner and that the separate identity of the corporate assets be preserved.[75] These requirements remain not because their violation is wrong per se, but because they are symptomatic of conditions that mislead or cause other legal wrongs.

The doctrine of disregard should be used as a judicial remedy for actual wrongs to innocent parties rather than as punishment for mere shareholder nonadherence to corporate formalities. If the plaintiff has dealt with the corporation as a corporation he should be estopped from denying its corporate existence.[76] To allow a plaintiff to recover when he has not been misled or wronged is to give him an indefensible windfall. Automatic application of individual shareholder liability based solely on his informal exercise of absolute corporate control is a triumph of form over substance.[77] Legal fictions focus on form only to accomplish certain specific purposes. Such fictions should not be employed unless their application will achieve the intended purpose. Imposition of individual shareholder liability based on failure to adhere to technical corporate formalities, when such failure does not cause any identifiable injury, flies in the face of the strong policies supporting

69. For a discussion of the nature of the Florida close corporation see Note, *Statutory Recognition of the Close Corporation in Florida*, 16 U. FLA. L. REV. 569 (1964).

70. Tennery, *The Potential of the Close Corporation: A Question of Economic Validity*, 14 How. L.J. 241, 253 (1968).

71. For an analysis of the necessity for adherence to acceptable business standards, see Cataldo, *supra* note 11.

72. *See generally* H. HENN, *supra* note 4, §§230-42, for a discussion of management liability.

73. *See generally* Gillespie, *supra* note 28, at 376-77.

74. *Id.*

75. *See* Tennery, *supra* note 70.

76. *See generally* H. BALLANTINE, CORPORATIONS 31 (rev. ed. 1946); H. HENN, *supra* note 4, §141; Comment, *Estoppel To Deny Corporate Existence*, 31 TENN. L. REV. 336 (1964).

77. Judge Learned Hand considered the important factors to be: "[R]ather in the form than in the substance of the control: in whether it is exercised immediately, or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises." Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265, 267 (2d Cir. 1929). He was not, however, considering a situation involving the informality of management and type of control presently allowed in a closely held corporation.

the corporate fiction. Failure to distinguish conduct violative of normal corporate structures from conduct harmful to creditors can result in the confusion of lawful business organizations with schemes that mislead or defraud.[78]

DISREGARD OF THE CORPORATE FICTION IN CREDIT TRANSACTIONS: THE FLORIDA POSITION

As previously indicated, Florida courts have not distinguished between public and close corporations in applying the doctrine of disregard of the corporate fiction. They have, however, required more than just complete control.[79] The precise extent and nature of the additional requirements are the cause of much confusion.

In *South Florida Citrus Land Co. v. Waldin*[80] the Florida supreme court attempted to dispel some of the confusion by articulating a general, but restrictive, description of the doctrine:

> The rule or fiction of law that a corporation is a separate entity . . . does not always obtain in a court of equity where to do so would result in enabling the shareholders of a private corporation who substantially own and control a corporation and its officers who are those identical shareholders to perpetrate frauds on those who deal with them.[81]

Subsequently, in *Biscayne Realty & Insurance Co. v. Ostend Realty Co.*[82] the court held that a corporate entity may not be used to mislead creditors, perpetrate frauds, or commit other illegal acts.[83] The court thus emphasized the use of the corporation and the result of that use rather than the mere abuse of corporate formalities. This functional approach is illustrated by the fact that observance of corporate formalities cannot insulate fraudulent acts. As the *Biscayne Realty* court observed: "[T]he absence of the formal evidence of the character of the act cannot preclude judicial inquiry on the subject. If it were otherwise, then in one department of the law fraud would enjoy immunity awarded to it in no other."[84]

---

78. Proponents of the idea that disregard of corporate formalities alone renders the stockholder liable base their arguments on the doctrine of estoppel. Estoppel applies because by disregarding the formalities the shareholder indicates that he does not consider the corporation to be a separate entity, and he should therefore be estopped from asserting separate entity as a defense. In addition, the grant of limited liability is a privilege, and if the shareholder himself violates the conditions upon which that privilege depends he should not be heard to complain. This second rationale is strongest in tort situations where the corporation cannot rely on arguments of assumption of the risk and estoppel. *See* notes 14-15 *supra*.

79. *See, e.g.*, Russell v. Gans, 275 So. 2d 270 (3d D.C.A. Fla. 1973); Delta Air Lines v. Wilson, 210 So. 2d 761 (3d D.C.A. Fla. 1968).

80. 61 Fla. 766, 55 So. 862 (1911).

81. *Id.* at 772, 55 So. at 864.

82. 109 Fla. 1, 148 So. 560 (1933).

83. *Id.* at 5, 148 So. at 564.

84. 109 Fla. 1, 5, 148 So. 560, 564 (1933), *quoting from* State *ex rel.* Watson v. Standard Oil Co., 49 Ohio St. 137, 30 N.E. 279 (1892).

In the 1950 decision of *Riley v. Fatt*[85] the Florida supreme court again stressed use of the corporation rather than mere abuse of corporate formalities. In *Riley* the defendant was the sole stockholder of Riley Builders, Inc. Substantial evidence indicated that the corporation had failed to keep any records at all and that checks payable to Riley Builders were often deposited in the defendant's personal bank account.[86] Despite this disregard for corporate formalities, the court found the facts insufficient to justify disregard of the corporate entity.[87] The *Riley* court was unwilling to pierce the corporate veil unless the corporation "was organized or used to mislead creditors or to perpetrate a fraud upon them."[88] The plaintiff in *Riley* was not misled because he knew he was dealing with a corporation. Thus, due to the "absence of pleading and proof that the corporation was organized for an illegal purpose or that its members fraudulently used the corporation," the court refused to disregard the corporate fiction.

Increased judicial contact with the doctrine of disregard added to confusion regarding the factors that determine its applicability. This confusion was aggravated by ambiguous decisional language as well as an inability to ascertain whether the courts' omission of certain factors in describing situations ripe for application of the doctrine was intentional or whether the omitted factors were merely not applicable to those particular situations. For example, the court in *Advertects v. Sawyer Industries*[89] held that an order directing shareholders to show cause why they should not be held personally liable for corporate debts would not be issued unless there had been a preliminary showing that:

> [T]he corporation is in actuality the alter ego of the stockholder *and* that it was organized or after organization was employed by the stockholder for fraudulent or misleading purposes or in some fashion the corporate property was converted or the corporate assets depleted for the personal benefit of the individual stockholders or that the corporate structure was not bona fidely established or, in general, that property belonging to the corporation can be traced into the hands of the stockholders.[90]

This statement indicates that more than a mere alter ego relationship is required to hold the shareholders personally liable; a showing of fraudulent or misleading purpose on the part of the defendant shareholders is a necessary element of the plaintiff's proof.[91]

The *Advertects* facts involved the mishandling of corporate assets rather than the abuse of control or management formalities. The mishandling of corporate assets is itself only an indication of abnormal control or unity and

85. 47 So. 2d 769 (Fla. 1950).
86. *Id.* at 771.
87. *Id.* at 773.
88. *Id.*
89. 84 So. 2d 21 (Fla. 1955).
90. *Id.* at 21 (emphasis added).
91. This is consistent with prior law. *See* Riley v. Fatt, 47 So. 2d 769 (Fla. 1950).

not proof of the existence of a substantive wrong.[92] Yet, because this type of corporate abuse is often detrimental to a creditor and also presents difficult problems of proof for the plaintiff,[93] it is logical for courts to consider it a substantive wrong justifying application of the doctrine when combined with an existing alter ego relationship.[94]

It is not clear, however, that the *Advertects* court adopted this rationale. The quoted statement concerned the imposition of personal liability, but the theory could be either the doctrine of disregard or the constructive trust theory[95] under which a defendant found guilty of misappropriating corporate assets may be held personally liable for the amount misappropriated.[96] The *Advertects* court's failure to identify the theory upon which it imposed personal liability thus contributed to the widespread confusion in this area.[97]

A more recent case, *Russell v. Gans*,[98] indicates that confusion concerning the legal theories underlying imposed shareholder liability still exists. The court in *Russell* quoted *Delta Air Lines v. Wilson*[99] for the proposition that the corporate veil may not be pierced without a showing that creditors[100] have been misled or that fraud has been perpetrated. But the court also stated that before it would issue an order to show cause why personal liability should not be imposed, it would require a showing of fraud *or* a showing that corporate funds had been misappropriated for personal use.[101] Thus, the *Russell* opinion did not include intermingling of assets in a list of factors justifying application of the doctrine of disregard,[102] but implied that intermingling alone would justify imposition of personal liability. *Russell,* like *Advertects,* failed to mention the constructive trust theory or any specific limitation on total personal liability that would exist under such theory. Thus,

92. *See generally* Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law); F. POWELL, *supra* note 24.

93. Shareholder manipulation of corporate assets is likely to be detrimental to the creditor as it is these assets that the creditor normally tries to attack. If assets have been removed from the corporation, the creditor will be required to prove that the removal was improper. This could present difficult proof problems, especially if the corporation has failed to keep adequate records.

94. Although it is reasonable for the courts to consider this type of corporate abuse to be the substantive wrong, the doctrine of disregard of the corporate fiction should not be applied unless the abuse is the cause of the injury to the plaintiff. See text following note 29 *supra.*

95. "A constructive trust is one raised by equity in respect of property which has been acquired by fraud or where though acquired originally without fraud it is against equity that it should be retained by him who holds it." Quinn v. Phipps, 93 Fla. 805, 809, 113 So. 419, 422 (1927).

96. *See* Smith v. Smith, 108 So. 2d 761 (Fla. 1959); Spicer v. Erpenback, 112 Fla. 285, 150 So. 585 (1933); Quinn v. Phipps, 93 Fla. 805, 113 So. 419 (1927).

97. In addition, because of the courts' use of the disjunctive *"or"* it is arguable that the courts consider this category of corporate abuse sufficient in itself to justify application of the doctrine of disregard or the estoppel theory.

98. 275 So. 2d 270 (3d D.C.A. Fla. 1973).

99. 210 So. 2d 761 (3d D.C.A. Fla. 1968).

100. 275 So. 2d at 271.

101. *Id.*

102. *Id.*

while stockholder abuses of the corporate entity involving mishandling of corporate assets occupy a special position with regard to the imposition of personal liability on individual shareholders, the exact significance of this factor is as yet unclear.[103]

Florida case law also indicates confusion regarding other aspects of the doctrine. For example, in *Tiernan v. Sheldon*[104] the court stated:

> [C]ourts will look through the screen of corporate entity to the individuals who compose it in cases in which the corporation . . . is a mere instrumentality or agent of another corporation or individual owning all or most of its stock, *or* where the purpose is to evade some statute or to accomplish some fraud or illegal purpose *or* where the corporation was employed by the stockholders for fraudulent or misleading purposes, was organized or used to mislead creditors or to perpetrate a fraud upon them or to evade existing personal liability.[105]

This language suggests that the existence of a corporation as a mere instrumentality is sufficient to justify application of the doctrine of disregard. Because of the strong policies favoring limited liability, the estoppel and assumption of risk aspect of consensual credit transactions,[106] and the inequities involved in imposing liability upon an individual for actions not resulting in identifiable injuries, this would be a highly undesirable result.[107]

As a practical matter, courts interpreting prior case law have in the past placed greater reliance on a specific enumeration of factors that, when combined, mandate application of the doctrine, rather than on the general statements suggesting that mere proof of excessive control is sufficient.[108] In

---

103. See note 94 *supra.*

104. 191 So. 2d 87 (4th D.C.A. Fla. 1966).

105. *Id.* at 89 (emphasis added).

106. See note 14 *supra.*

107. See text accompanying notes 10-16 *supra.*

108. This statement may not be universally true given the degree of inconsistency present in the Florida courts' interpretation of the doctrine. House of Koscot Dev. Corp. v. American Line Cosmetics, Inc., 468 F.2d 64 (5th Cir. 1972), illustrates this problem. *Koscot* involved a plaintiff, Development, and three defendants. The first defendant, American Line, was controlled by Koscot, which was in turn controlled by defendant, Turner. Plaintiff, in an attempt to hold both Turner and Koscot liable for the act of American Line, alleged first that American Line was the alter ego of Turner and Koscot, and second that Turner and Koscot tortiously interfered with and induced the breach of Development's contract with American Line. Although the body of the opinion employed the terms "alter ego, agency," and "identity," a footnote stated: "In light of our holding that Turner could be held liable under the conduit or instrumentality theory [there was evidence of abuse of corporate formalities involving both the management and control and the mishandling of assets], we do not need to decide whether the evidence was also sufficient to establish that American Line Cosmetics was operated as a fraud upon its creditors." *Id.* at 66 n.1. This language could mean either that the court considered abuses of the corporate formalities sufficient justification for disregarding the corporate fiction, or that the court recognized that the instrumentality theory can be used not only when fraud is present but also when the corporation is used to perpetrate other illegal acts. The latter interpretation is supported by Biscayne Realty & Ins. Co. v. Ostend Realty Co., 109 Fla. 1, 148 So. 560 (1933). Of the three cases the *Koscot* court cited to support its proposition, two

the wake of the recent case of *Levinstein v. Sapiro*,[109] however, this may no longer be true. *Levinstein* involved a one-man corporation having as its sole asset a tract of land. The contract under which the corporation sold this realty to the assignor of the plaintiff contained a guarantee that adequate sewage facilities would be available. Because the sale totally depleted its assets, the corporation was dissolved. Subsequently, the local pollution control officer imposed a stop order, which prevented the extension of water or sewage disposal service to the land. Plaintiff sued defendant, the sole shareholder of the dissolved corporation, alleging that he had personally guaranteed the contract and that the corporation had been his alter ego.[110] The trial court rendered judgment for the plaintiff. Reversing, the district court of appeal stated that the record showed no evidence supporting the conclusion that defendant had abused the corporate entity.[111] Additionally, the district court found no evidence of use of the corporation by the defendant to perpetrate a fraud.[112] The Florida supreme court quashed the district court's opinion and held that fraudulent use of the corporation was not the only factor sufficient to curtail a shareholder's limited liability.[113] The supreme court stated:

> We do not believe the rule of limited individual liability is this restrictive. There may be cases such as this one where the nature of the relationship between the individual and his alter ego, his corporation, and their activity is so completely personalized that the ingredient of actual fraud is unnecessary in order for the individual to be held liable . . . .[114]

Because the alter ego theory requires fraud *or* the misleading of the creditor by the defendant's abuse of corporate formalities, the Florida supreme court did not make new law by holding that actual fraud is not always required.[115] The facts of *Levinstein* indicate that the defendant was innocent of actual fraud.[116] In addition, the evidence was apparently insufficient to establish that plaintiff's assignor was misled into believing he was dealing with an individual rather than a corporation. Normally, when a party contracts with a corporation it is assumed the parties contemplate that the corporation alone will be liable for warranties contained in the contract. This expectation invokes the doctrines of estoppel and assumption of the

---

invoked similar problems of interpretation while only one, Riley v. Fatt, 47 So. 2d 769 (Fla. 1950), clearly indicated that abuse of corporate formalities is by itself insufficient to justify application of the doctrine.

109. 279 So. 2d 858 (Fla. 1973).

110. *Id.* at 859.

111. 266 So. 2d 40 (3d D.C.A. Fla. 1972).

112. *Id.* at 43.

113. 279 So. 2d 858 (Fla. 1973).

114. *Id.* at 860.

115. See text accompanying notes 40-46 *supra.*

116. *Levinstein* did not involve actual fraud because the defendant could not be charged with knowledge of the breach of warranty resulting from the superseding intervention of the ordinance.

risk against a potential party plaintiff.[117] The agreement in the *Levinstein* case was improvident on the part of the plaintiff, but as the court stated in *Tiernan*: "Courts can and will set aside fraudulent schemes perpetrated upon innocent parties, but it is not a proper judicial function to relieve one from the consequences of a bad bargain."[118]

In this context, the doctrine of constructive fraud[119] might distinguish *Levinstein* from a mere bad bargain situation, thereby precluding the defenses of estoppel and assumption of the risk.[120] Constructive fraud does not require actual knowledge or intent to defraud; it encompasses breaches of equitable duties that, contrary to good conscience, operate as virtual frauds to the injury of others.[121] Due to the immediate dissolution of the corporate vendor, the plaintiff vendee in *Levinstein* would have had no one to provide compensation for his injuries unless the corporate fiction was disregarded. In such cases it would be meaningless for the parties to include warranties in their contract if immediately after execution of the contract the corporate party could dissolve and thereby avoid all potential liability. Should the corporation continue to exist and operate in good faith, the plaintiff will have some hope of recovery. Should the corporation dissolve immediately, however, compensation for breach of warranties will no longer be possible and the bargain will become impossible rather than improvident. Such a result certainly could not be within the reasonable contemplation of the vendee and therefore it constitutes misrepresentation sufficient to support the doctrine of constructive fraud. If the *Levinstein* court considered either constructive or actual fraud alone sufficient to activate the doctrine of disregard, it followed the judicial trend of other jurisdictions.[122] A problem exists, though, because the court referred to the "nature of the relationship *between the individual and his alter ego*," and activity that was "completely personalized."[123] Previous applications of the doctrine of disregard involved excessive shareholder control or actual unity between the individual shareholder and his corporate alter ego.[124] Perhaps the personalized relationship mentioned in *Levinstein* refers to situations involving these same factors. If the court

---

117. See note 14 *supra*.

118. 191 So. 2d 87, 89 (4th D.C.A. Fla. 1966).

119. "Constructive fraud is simply a term applied to a great variety of transactions which equity regards as wrongful, [and] to which it attributes the same or similar effects as those which follow from actual fraud." Douglas v. Ogle, 80 Fla. 42, 45, 85 So. 243, 244 (1920).

120. The idea that application of the doctrine can be justified by general equitable considerations was first expounded in Fickling Properties, Inc. v. Smith, 123 Fla. 556, 167 So. 42 (1936), where the court discussed applying the doctrine where the corporation was used as a "convenience for accomplishing an unconscionable transaction." *Id.* at 558, 167 So. at 43.

121. *See* note 119 *supra*.

122. *See, e.g.,* Mayo v. Pioneer Bank & Trust Co., 270 F.2d 823, 830 (5th Cir. 1959), *cert. denied,* 362 U.S. 962 (1960); Woodbury v. Pickering Lumber Co., 10 F. Supp. 761 (W.D. Mo. 1933), *modified,* 77 F.2d 473 (6th Cir. 1935); Platt v. Billingsley, 234 Cal. App. 2d 577, 44 Cal. Rptr. 476 (Dist. Ct. App. 1965).

123. 279 So. 2d 858 (Fla. 1973) (emphasis added).

124. See text accompanying notes 22-49 *supra*.

considered shareholder control or entity unity alone to be sufficient justification for application of the doctrine, it would be an abrupt change from prior law[125] that could lead to undesirable results.[126] It is to be hoped that *Levinstein* does not portend such a direction.

THE SPECIAL PROBLEM OF INADEQUATE CAPITALIZATION

The abuses of corporate formalities that activate both the instrumentality and alter ego theories are usually symptoms of a wrong.[127] Inadequate capitalization, on the other hand, is often viewed as merely indicative of the corporation's financial dependence on the shareholder.[128] Many jurisdictions have distinguished this factor from fraud or other injuries sufficient in themselves to support relief.[129] In Florida, inadequate capitalization is simply one of several factors that courts consider in justifying application of the doctrine.[130] Even if a corporation is shown to be inadequately capitalized or to have transferred assets while insolvent, there must also be proof of fraud in the organization of the corporation or in the transfer of its assets, not simply proof of a fraudulent result, to support the doctrine's application.[131] Such an approach is improper. Inadequate capitalization by itself should in certain circumstances be enough to trigger the doctrine of disregard.[132] Limited liability is a privilege granted to corporate shareholders to encourage risk capital investment.[133] There is no *quid pro quo* for the privilege where shareholders fail to provide the minimal level of corporate capitalization. This principle of reciprocity has been stated as follows:

---

125. *See* note 113 *supra.*

126. See text accompanying notes 106-07 *supra.*

127. For examples of these abuses, *see* note 25 *supra.*

128. *See, e.g.,* Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law); Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (Dist. Ct. App. 1970).

129. *E.g.,* Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 197 P.2d 167 (Dist. Ct. App. 1948); Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937).

130. Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law). For a discussion of the significance of inadequate capitalization in the alter ego theory, *see* Note, *Attorney-Director-Officer as Alter Ego of Undercapitalized Corporation,* 1962 DUKE L.J. 450.

131. Delta Air Lines v. Wilson, 210 So. 2d 761 (3d D.C.A. Fla. 1968).

132. California has come closest to considering the element of undercapitalization as the wrong itself. In Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961), holding the defendant shareholder personally liable to a tort creditor, Justice Traynor stated the rule: "The equitable owners of a corporation . . . are personally liable [1] when they treat the assets of the corporation as their own . . . [2] when they hold themselves out as being personally liable for debts of the corporation; or [3] when they provide inadequate capitalization and actively participate in the conduct of corporate affairs." *Id.* at 579, 364 P.2d at 475, 15 Cal. Rptr. at 643. Of these three reasons, only the latter was present in the *Minton* case. California has apparently retreated from this position, however. In Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (Dist. Ct. App. 1970), inadequate capitalization was considered only a factor, by itself insufficient to render the shareholder personally liable. Although *Minton* involved a tort creditor, no mention was made of this distinction. *See* Note, *supra* note 11, at 825-30.

133. *See* note 11 *supra.*

> The corporation is meant to be a device whereby, among other things, one may do business with the risk of losing not all of one's possessions but only that portion thereof which one invests in the business in question. There is of itself, on the part of those persons who may be adversely affected by the limited liability privilege, a considerable forced concession – a compromise in the interests of business and presumably of society. But it is a compromise, a mutual give and take, not a license to the owners of a business to take all and give nothing. When the law substitutes a special fund as a source from which creditors are to be paid, in place of a general fund (*i.e.*, unlimited responsibility), it presupposes not only that the special fund exists, but it is such a fund as normally answers the requirements of the business, and that those who create the fund have not the unrestricted power arbitrarily to fix the fund at practically zero.[134]

Clearly, the problem of inadequate capitalization involves an assessment of the extent to which shareholders should be allowed to avoid the risks of doing business.[135] This assessment requires an analysis of the distinction between tort and contract creditors. Granting limited liability to shareholders of inadequately capitalized corporations is most inequitable in the case of a tort creditor with an unsatisfied judgment.[136] The objectives of modern tort law are just compensation, deterrence, and, to some extent, punishment.[137] Limited liability hinders realization of these objectives and encourages low capitalization in businesses, particularly those that are inherently dangerous.[138] Therefore, to promote rather than to hinder the goals of tort law, shareholders' liability should be contingent upon adequate capitalization at the corporation's inception. Such an approach would reduce this inherent conflict between commercial goals and tort law principles.

The compelling inequities that often result from limited shareholder liability in contests between a tort victim and an undercapitalized corporation are not as prevalent in cases involving contract creditors. By consenting to do business with a corporation, the contract creditor may be said to have assumed the risk of inadequate capitalization. Unlike the tort victim whose contact with the corporation is usually unexpected and involuntary, the contract creditor has an opportunity to discover and protect against thin capitalization.[139]

The advantage ostensibly possessed by a contract creditor in his relationship with a corporation is a specious one, however, when evaluated in light of the previously discussed rationale underlying limited shareholder liability and the equities of proper loss allocation.[140] If shareholders have not supplied

134. E. LATTY, *supra* note 23, at 120.

135. *See generally* Note, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938).

136. *See generally* Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190 (1967).

137. W. PROSSER, THE LAW OF TORTS 4 (4th ed. 1971).

138. *See* Note, *supra* note 11.

139. *See* notes 14-15 *supra*.

140. Note, *supra* note 11.

adequate risk capital, the *quid pro quo* for their limited liability is absent. In addition, it is improper to place upon the creditor the burden of discovering inadequate capitalization. There is no justification for permitting shareholders to shift an even greater portion of the risk of corporate loss to the creditor. Granting limited liability to shareholders who fail to provide an adequate "special" fund to cover contingencies arising from their contracts permits them to avoid a greater portion of risk than that envisioned by statutes permitting the existence of corporations. Thus, if adequate capital has not been provided, the stockholders merit limited liability only if creditors are estopped from asserting the doctrine of disregard by actual knowledge of the corporation's financial condition. If shareholders choose to provide inadequate corporate capitalization, they should be required to inform potential creditors of their corporation's financial condition or risk loss of their limited liability.[141] This would prevent creditors from relying on assumed corporate solvency and permit them instead to rely on actual corporate financial conditions. If a corporation becomes insolvent as a result of normal business losses rather than inadequate initial capitalization, then the corporation's creditors cannot argue that they have been misled; they must instead bear the consequences of a situation they may reasonably be expected to have anticipated.

There is, of course, no exact formula for determining adequate capitalization, and even general standards present difficult problems.[142] Factors such as corporate size as well as foreseeable hazards and risks of the particular business should be considered.[143] Few businesses are entirely unique; consequently accountants can examine the financial structures of similar corporations to arrive at a realistic determination of adequate capitalization for a particular business.[144] In the past, courts have been called upon to determine adequate capitalization for businesses in utilizing the instrumentality rule[145] and applying the Uniform Fraudulent Conveyance Act.[146] Although the problem of measurement is difficult it is no harder than determining the reasonableness of standard business conduct in negligence suits. Therefore, because of its inherent unfairness to creditors, inadequate capitalization should be considered a substantive wrong sufficient to justify application of the doctrine of disregard in the absence of actual knowledge by the creditors.

141. E. LATTY, *supra* note 23, at 128.

142. *See* note 144 *infra*.

143. E. LATTY, *supra* note 23, at 128.

144. *See* Auer v. Frank, 227 Cal. App. 2d 396, 409-10, 38 Cal. Rptr. 684, 692 (Dist. Ct. App. 1964). The problem of defining inadequate capitalization is discussed in Note, *supra* note 11, at 840-44. *See also* Morris, *Enterprise Liability and the Actuarist Process: The Insignificance of Foresight*, 70 YALE L.J. 554 (1961). Similar business practice will not, however, always be sufficient proof of adequate capitalization, especially if undercapitalization is a common practice in an industry. *See* note 57 *supra*.

145. Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966) (applying Florida law).

146. The Uniform Fraudulent Conveyance Act provides: "Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent."