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CASTLEBERRY V. BRANSCUM: A DIVIDED TEXAS SUPREME COURT INCREASES SHAREHOLDER LIABILITY FOR CORPORATE CONTRACTUAL OBLIGATIONS

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I. INTRODUCTION

In *Castleberry v. Branscum*,[1] the Texas Supreme Court blurred the distinction between the standards required to impose personal liability on shareholders for corporate torts and corporate contracts by creating a new remedy which may become known as a sham to perpetrate a constructive fraud.[2] The Texas Supreme Court previously differentiated between the requirements necessary to disregard the general rule that a shareholder is not personally liable for the corporation's separate obligations in cases involving claims under tort and contract. A tort claimant need not prove an intent to defraud in order for the court to hold the shareholders liable for the corporate tort; whereas a contract claimant is required to prove actual fraud in order to render shareholders liable for the corporate contract.[3] The *Castleberry* decision creates uncertainty as to when, but increases the possibility that, a contractual creditor of a corporation may impose personal liability on a corporation's shareholders, directors, or officers for corporate contractual obligations.[4]

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1. 721 S.W.2d 270 (Tex. 1986).

2. *See* Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986).

3. *Compare* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1985)(fraud required in contract case) *with* Gentry v. Credit Plan Corp., 528 S.W.2d 571, 573 (Tex. 1975)(unnecessary to show fraud in tort case). *See also* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968).

4. The court, in *Castleberry* stated, "To prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud." Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986). *Compare* Riquelme Valdes v. Leisure Re-

Castleberry, Branscum, and Byboth were the incorporators and sole shareholders of Texan Transfer, Inc. (TTI).[5] Subsequent to the incorporation of TTI dissension developed among the shareholders, especially between Castleberry and Branscum, with the result that Castleberry sold his stock back to TTI.[6] The terms of the sales contract provided that TTI would buy back Castleberry's stock, with part of the consideration to be paid in cash in July, part due the following month, and the remainder, provided for in a promissory note, payable in monthly installments.[7] The promissory note was executed by the corporation and signed by Branscum as president.[8] Byboth and Branscum did not sign the note in their individual capacities, nor did they personally guarantee the indebtedness.[9] Castleberry received the first cash payment, but neither the August payment nor any of the payments due pursuant to the note were ever paid.[10]

Castleberry filed suit against TTI, Byboth, and Branscum to recover both the August payment and the amount due on the promis-

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source Group, Inc., 810 F.2d 1345, 1352-53 (5th Cir. 1987)(seller's alter ego claim unsuccessful against purchaser's lender corporation because there was no evidence of knowing participation in fraud) *and* Robbins v. Robbins, 727 S.W.2d 743, 744-45 (Tex. App.—Eastland 1987, writ ref'd n.r.e.)(failure to disregard corporate fiction in alter ego case, remanded for new trial because factual insufficiency to establish nexus between corporation and individual) *with* Francis v. Beaudry, 733 S.W.2d 331, 334-35 (Tex. App.—Dallas 1987, writ ref'd n.r.e.)(court found sufficient evidence to pierce corporate veil based on inequitable result test applied in alter ego case where alternate "denuding theory" also espoused to support court's conclusion). Under Texas law, a veil-piercing claim, such as alter ego, is a remedy, not a cause of action, because the fact that a corporation may be an alter ego of a control entity does not create a substantive cause of action against either the corporation or the control entity. *See* Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co., 456 S.W.2d 476, 480 (Tex. Civ. App.—Fort Worth 1970, no writ). *But see* S.I. Acquisition, Inc. v. Eastway Delivery Serv., 817 F.2d 1142, 1153 (5th Cir. 1987)(alter ego action is right of action or remedy belonging to debtor corporation in bankruptcy for purposes of automatic stay provision).

5. *See* Castleberry v. Branscum, 721 S.W.2d 270, 274 (Tex. 1986). In June, 1980, Branscum, Byboth, and Castleberry formed a partnership to engage in the furniture moving business. When they incorporated three months later as TTI, they each received an equal amount of shares in the company. *See id.*

6. *See id.* After Branscum formed Elite Moving as a sole proprietorship, Castleberry sold his stock back to TTI pursuant to a stock purchase agreement. *See id.; see also* Shearn, *Must Contract Creditors Only Show Inequity to Pierce the Corporate Veil?*, 6 CORPORATE COUNSEL REVIEW 43, 44 (1987).

7. *See* Branscum v. Castleberry, 695 S.W.2d 643, 644-45 (Tex. App.—Dallas 1985), *rev'd*, 721 S.W.2d 270 (Tex. 1986).

8. *See id.* at 645.

9. *See id.*

10. *See id.*

sory note.[11] In the meantime, TTI's annual net income fell dramatically, while Branscum's other company, Elite Moving, prospered.[12] Byboth and Branscum then formed another furniture moving company, Custom Carriers, Inc. (CCI), concededly because of the lawsuit filed against them.[13] As the remaining shareholders and directors of TTI, they sold the corporation's assets, and with the money received from the sale, paid themselves "back salaries."[14] At trial, Castleberry argued, and the court found, that TTI was the alter ego of Byboth and Branscum, and that each was jointly and severally liable for the remaining purchase price of Castleberry's stock.[15]

The Dallas Court of Appeals reversed the judgment of the trial court, holding that there was no evidence to justify "piercing the corporate veil" and found the defendants not liable.[16] The court found that the special issue submitted by the plaintiff was fatally defective because it allowed the jury to find the corporation to be the alter ego of the shareholders based upon only one element of the alter ego doctrine.[17] Additionally, the court of appeals held that the determination of whether the corporation is the alter ego of an individual is not an issue for the jury but rather, is a question of law.[18]

Initially, the Texas Supreme Court, by per curiam opinion, affirmed the judgment of the court of appeals because it found no reversible error.[19] However, the court disagreed with the holding of the court of appeals that the issue of disregarding the corporate fiction through alter ego is solely a question of law.[20] A subsequent motion for re-

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11. *See id.*

12. *See* Castleberry v. Branscum, 721 S.W.2d 270, 274 (Tex. 1986).

13. *See id.*

14. *See id.* at 275. TTI's sole asset and its primary means of doing business was its trucks, and these were sold to and leased from "independent contractors" of CCI. *See id.*

15. *See* Branscum v. Castleberry, 695 S.W.2d 643, 645 (Tex. App.—Dallas 1985), *rev'd,* 721 S.W.2d 270 (Tex. 1986). The following special issue was submitted separately for both Byboth and Branscum: "Do you find from a preponderance of the evidence that Texan Transfer, Inc. was the alter ego of the defendant?" Castleberry v. Branscum, 721 S.W.2d 270, 275 (Tex. 1986).

16. *See* Branscum v. Castleberry, 695 S.W.2d 643, 645 (Tex. App.—Dallas 1985), *rev'd,* 721 S.W.2d 270 (Tex. 1986).

17. *See id.* After listing the different elements required to establish that a corporation is an alter ego in its instructions to the jury, the court stated, "You are instructed that the existence of one or more of these factors may or may not make Texan Transfer, Inc., the alter ego of Byron Branscum." *Id.*

18. *See id.* (whether corporation is alter ego not question for jury).

19. *See* Castleberry v. Branscum, 29 Tex. Sup. Ct. J. 61 (Nov. 13, 1985).

20. *See id.* In its per curiam opinion on the application for writ of error, the Texas

hearing was granted[21] and ultimately a sharply divided court found in favor of Castleberry.[22]

In its five-to-four decision, a majority of the Texas Supreme Court held that since there was some evidence of a sham to perpetrate a fraud, the court would disregard the corporate entity in order to hold defendants Byboth and Branscum personally liable on the promissory note.[23] The Court found that the corporate veil may be pierced when a corporation is found to be a sham to perpetrate a constructive fraud.[24] The Court relied upon the proposition that "neither fraud nor an intent to defraud need be shown as a prerequisite to disregarding the corporate entity; it is sufficient if recognizing the separate corporate existence would bring about an inequitable result."[25]

The new constructive fraud doctrine was not needed for the plaintiff to recover in *Castleberry* because alternative remedies were available.[26] The majority of the court, while trying to do justice, developed a novel method of granting the plaintiff relief, and in so doing, took away the protection the statutorily-created corporation was designed to give its shareholders.[27] The new sham to perpetrate a constructive

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Supreme Court stated, "The court of appeals opinion incorrectly states that alter ego is a question of law, not one of fact. Alter ego becomes a question of law if the material facts are undisputed." *Id.*

21. *See* Castleberry v. Branscum, 29 Tex. Sup. Ct. J. 123 (Jan. 8, 1986).

22. *See* Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986). Byboth and Branscum's later motion for rehearing was overruled and the Supreme Court's opinion was allowed to stand. *See* Castleberry v. Branscum, 30 Tex. Sup. Ct. J. 150 (Jan. 17, 1987).

23. Castleberry v. Branscum, 721 S.W.2d 270, 272-75 (Tex. 1986). It appears that the court, in *Castleberry*, derived the phrase "sham to perpetrate a fraud" from *Pace Corp. v. Jackson*. *See id.* at 272 n.2; *see also* Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(courts disregard corporate fiction only where corporation being used as sham to perpetrate fraud, to avoid personal liability, or in few other "exceptional" situations).

24. Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986). The court stated, "To prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud." *Id.*

25. *Id.* at 272-73 (quoting W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 30 (Supp. 1985)).

26. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1987); TEX BUS. CORP. ACT ANN. art. 241.A(3)(Vernon Supp. 1987); TEX. TAX CODE ANN. § 171.255 (Vernon 1982); TEX. BUS. & COM. CODE ANN. §§ 24.03(a), 27.01 (Vernon 1968); Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459; *see also* Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576-77 (Tex. 1963)(usurpation of corporate opportunity); Cardwell v. Wilson Trophy Co., 622 S.W.2d 651, 653 (Tex. Civ. App.—Fort Worth 1981, writ ref'd n.r.e.)(usurpation of corporate opportunity).

27. *See* TEX. BUS. CORP. ACT. ANN. art. 2.02 (Vernon 1980 & Supp. 1987); *see also* LATTIN, THE LAW OF CORPORATIONS § 62, at 201 (2d ed. 1971).

fraud remedy penalizes shareholders by imposing unlimited personal liability on them and broadens remedies available to contract claimants by reducing their burden of proof to merely showing an unfair result.

This article will argue that the new rule promulgated in *Castleberry* ignores not only legal precedents, but also the policies behind those precedents and the social purpose of the corporate entity. The article will first emphasize the purpose behind the statutorily-created corporate entity. Second, the article will enumerate and explain several theories under which shareholders may be held personally liable, namely the alter ego doctrine, the sham to perpetrate a fraud doctrine, and the trust fund doctrine. Lastly, the article will critique four major weaknesses of the *Castleberry* holding: (1) application of an apparent tort standard to a contract case, (2) misuse of a constructive fraud standard to disregard the corporate fiction, (3) grant of equitable relief to a plaintiff who had adequate legal remedies available but failed to allege them, and (4) imposition of joint and several liability on corporate shareholders in excess of the value of corporate assets in the hands of the shareholders.

II. BACKGROUND

A. *Establishment of the Corporate Entity*

In creating the corporate entity, the Texas legislature intended to limit shareholders' personal liability for the separate obligations of the business incurred by the corporation as a separate legal person.[28] The United States Supreme Court noted that one of the main purposes for separating corporate rights and liabilities from shareholder rights and liabilities is ". . . to interpose a nonconductor, through which, in matters of contract, it is impossible to see the men behind."[29] Maintaining a business as a distinct entity encourages investors to contribute to a business venture without subjecting all of their personal wealth to the risk of the business.[30] Consequently, limited shareholder liability

28. *See* Branscum v. Castleberry, 695 S.W.2d 643, 646 (Tex. App.—Dallas 1985)(Texas legislature intended corporate entity to protect shareholders and to be integral part of Texas' economic system), *rev'd,* 721 S.W.2d 270 (Tex. 1986). *See generally* R. HAMILTON, BUSINESS ORGANIZATIONS §§ 233-39 (Texas Practice 1973).

29. Donnell v. Herring-Hall-Marvin Safe Co., 208 U.S. 267, 273 (1908); *see also* N. LATTIN, THE LAW OF CORPORATIONS § 12, at 66 (2d ed. 1971).

30. *See* Latty, *Inadequate Capitalization as a Basis for Shareholder Liability: The Califor-*

serves as an inducement to invest and to create new jobs and produce the goods and services that are demanded by society.[31]

B. *Piercing the Corporate Veil*

The equitable doctrine of piercing the corporate veil is a broadly-stated, imprecise area of law.[32] Furthermore, the factual situations that will allow a court to impose liability on shareholders, directors and officers are wide-ranging.[33] By applying various theories, the corporate entity may be disregarded even where the corporate formalities have been kept. As the court noted in *Roylex, Inc. v. Langson Bros. Constr. Co.*:[34]

> Generally, the corporate form will be disregarded (1) where it is used as a means for perpetrating fraud; (2) where the corporation is organized and operated as the mere tool or business conduit of another corporation; (3) where resort is made to the corporate fiction in order to avoid an existing legal obligation; (4) where the corporate form is used to achieve or perpetuate monopoly; (5) where the corporate structure is used as a vehicle for circumventing a statute; or (6) where the fiction is invoked in order to protect crime or justify wrong.[35]

1. Required Standards for Piercing the Corporate Veil

The standard used to pierce the corporate veil in order to find shareholders personally liable depends upon whether the cause of action lies in tort or contract.[36] Generally, the courts have held that

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nia Approach and a Recommendation, 45 S. CAL. L. REV. 823, 833 (1972)(fundamental purpose of corporate status is to provide incentive to stockholders to contribute capital without risk of individual liability).

31. *See id.* at 834. "Limited liability, then, is not a natural or necessary consequence of incorporation and was extended primarily to encourage capital investment in needed enterprise." *Id.* Limited shareholder liability has therefore been considered a beneficial trade-off for society.

32. *See* N. LATTIN, THE LAW OF CORPORATIONS § 14, 72-73 (2d ed. 1971)(veil-piercing rule may be too broad for practical use, but puts moral content in law); *see also* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 431 (rev. ed. 1983)(no "precise formula" to determine when court will pierce veil).

33. *See generally* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30 (rev. ed. 1983)(impossible to classify evidential facts courts use to pierce corporate veil).

34. 585 S.W.2d 768 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.).

35. Roylex, Inc. v. Langson Bros. Constr. Co., 585 S.W.2d 768, 771 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.).

36. *See* Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964)(actual fraud distinguished

tort claimants may more easily demonstrate equity to pierce the corporate veil.[37] In a tort action an intent of shareholders to defraud generally need not be shown,[38] however, in a contract action the plaintiff must show fraud in order to pierce the corporate veil.[39] Thus, when the plaintiff in a contract action fails to make such a showing, ". . . the risk of loss is apportioned by virtue of relative bargaining power."[40] Further, as the Dallas Court of Appeals stated in *Tigrett v. Pointer*:[41]

> . . . a party who has contracted with a financially weak corporation and is disappointed in obtaining satisfaction of his claim cannot look to the dominant shareholder or parent corporation in the absence of additional compelling facts.[42]

2. Alter Ego Doctrine

Until *Castleberry*, the general rule in Texas was that the corporate fiction will not be disregarded except under extraordinary circumstances.[43] The alter ego doctrine is one example of an exception to the

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from constructive fraud); Tigrett v. Pointer, 580 S.W.2d 375, 394 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.)(Akin, J., dissenting)(acknowledging tort/contract distinction and discussing justification for stricter standard in contract action).

37. *See* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984). The courts' willingness to disregard the corporate entity in tort cases and reluctance to do so in contract cases is demonstrated by the proof required under the two causes of action. *Compare id.* at 375 (fraud or deception required in contract cases) *with* Gentry v. Credit Plan Corp. 528 S.W.2d 571, 573 (Tex. 1975)(unnecessary to establish fraud in tort actions).

38. *See* Gentry v. Credit Plan Corp. 528 S.W.2d 571, 573 (Tex. 1975)(problem in tort case is not establishing fraud, but allocating loss); *see also* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984)(financial strength or weakness of corporation important factor in tort case).

39. *See, e.g.,* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984); Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340-41 (Tex. 1968); Tigrett v. Pointer, 580 S.W.2d 375, 394 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

40. Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984).

41. 580 S.W.2d 375 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

42. *Id.* at 382.

43. *See* Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(court will disregard corporate fiction only in exceptional situations); *see also* Lucas v. Texas Indus., 696 S.W.2d 372, 374 (Tex. 1984)(corporate fiction disregarded only where used as sham to perpetrate fraud, to avoid liability, to circumvent statute, or other "exceptional" circumstances); Torregrossa v. Szelc, 603 S.W.2d 803, 804 (Tex. 1980)(courts hold corporate officers and directors individually liable only in exceptional situations). It was succinctly stated in *First National Bank v. Gamble*:

> It is the rule that the legal fiction of corporate entity may be disregarded where the fiction is used as a means of perpetrating fraud or is relied upon to justify wrong . . . . [T]o

general rule.[44] The alter ego doctrine applies where the shareholders disregard the separate corporate entity by their own acts, including failure to observe statutory and other formalities which tend to show separateness of the corporation from the personal activities of the shareholders. The court is then entitled to disregard the corporate entity.[45] Thus, the alter ego doctrine, as the name suggests, applies when the shareholder uses the corporation as "another self."[46]

To establish the alter ego theory, four requirements must be met: (1) the shareholders must have ignored corporate formalities, (2) they must have treated the corporation as if it were only an instrumentality for conducting their personal business, (3) there must be such unity of ownership and interest that the separate "personalities" of the individual and the corporation have vanished, and (4) the court must find that recognizing the corporation as a separate legal person would cause an injustice.[47] The plaintiff will not sustain this burden merely by showing that one individual owns all the stock and controls the corporation.[48] Rather, the control must be exercised in such a way

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observe that this rule is an exception to the general rule which forbids disregarding corporate existence or entity and is not to be applied unless it is made to appear that there is such unity that the separateness of the corporation has ceased and 'the facts are such that an adherence to the fiction . . . would, under the particular circumstances, sanction a fraud or promote injustice'. . . .

First Nat'l Bank v. Gamble, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted).

44. *See* First Nat'l Bank v. Gamble, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted); *see also* Lucas v. Texas Indus., 696 S.W.2d 372, 374 (Tex. 1984)(disregard of corporate fiction by means such as alter ego exception to general rule that corporate fiction should not be disregarded).

45. *See* First Nat'l Bank v. Gamble, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted); *see also* Castleberry v. Branscum, 721 S.W.2d 270, 278 (Tex. 1986)(Gonzalez, J., dissenting); Gentry v. Credit Plan Corp. 528 S.W.2d 571, 573 (Tex. 1975); Mortgage and Trust, Inc. v. Bonner & Co., 572 S.W.2d 344, 348 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.).

46. *See* Pac. Am. Gasoline Co. v. Miller, 76 S.W.2d 833, 851 (Tex. Civ. App.—Amarillo 1934, writ ref'd); *see also* Castleberry v. Branscum, 721 S.W.2d 270, 278 (Tex. 1986)(Gonzalez, J., dissenting)(corporation operated as "mere tool or business conduit" of individual).

47. *See, e.g.*, Torregrossa v. Szelc, 603 S.W.2d 803, 804 (Tex. 1980); Gentry v. Credit Plan Corp., 528 S.W.2d 571, 573 (Tex. 1975); Pace Corp. v. Jackson, 155 Tex. 179, 185, 284 S.W.2d 340, 351 (1955); First Nat'l Bank v. Gamble, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted).

48. *See* Gentry v. Credit Plan Corp., 528 S.W.2d 571, 573 (Tex. 1975)(control is mere incident of ownership); *see also* Mortgage and Trust, Inc. v. Bonner & Co., 572 S.W.2d 344, 348 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.); *accord* Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(corporate fiction not disregarded unless entity being used as sham).

that the corporation functions only to carry on the personal business of the individual.[49]

3. Sham to Perpetrate a Fraud Doctrine

"Sham to perpetrate a fraud" is another theory developed by the courts for piercing the corporate veil in appropriate cases.[50] Two requirements must be met before the theory can be applied. First, the corporation must be found to be a sham ab initio.[51] Second, there must be fraud or an intent to defraud by the directors, officers, or shareholders.[52]

Traditionally, when applying the sham to perpetrate a fraud doctrine, Texas courts have held that the corporation must have been created for a fraudulent purpose—a sham.[53] Actual fraud involves

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49. *See* First Nat'l Bank v. Gamble, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted)(only disregard entity when separateness of corporation ceases); *see also* Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986)(separateness disregarded by shareholders will be disregarded by courts); Francis v. Beaudry, 733 S.W.2d 331, 334 (Tex. App.—Dallas 1987, writ ref'd n.r.e.)(corporation manipulated to serve personal interests pierced to hold directors personally liable).

50. *See* Pace Corp. v. Jackson, 155 Tex. 179, 194, 284 S.W.2d 340, 351 (1955)(corporate entity disregarded when used as sham to perpetrate fraud, to avoid personal liability, to avoid effect of statute, or few other "exceptional" circumstances).

51. *See, e.g.,* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968)(no sham if corporation not originally incorporated for improper purpose); Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. App.—Dallas 1982, writ ref'd n.r.e.)(failure to keep proper records and preventing creditors from collecting not sufficient to find sham because corporation not organized for illegal purpose); State v. Nevitt, 595 S.W.2d 140, 143 (Tex. Civ. App.—Dallas 1980, writ ref'd n.r.e.)(no sham when corporation operated previous to questionable event without any hint of using corporation for personal benefit). *But see* Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939)(corporate entity not recognized if result would work fraud or injustice). *Cf.* Francis v. Beaudry, 733 S.W.2d 331, 335-36 (Tex. App.—Dallas 1987, writ ref'd n.r.e.)(allegation of sham not essential element for proving alter ego theory because alter ego theory separate from sham to perpetrate fraud theory).

52. *See, e.g.,* Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. App.—Dallas 1982, writ ref'd n.r.e.); Hanson Southwest Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 716-17 (Tex. Civ. App.—Dallas 1977, writ ref'd n.r.e.). "Fraud . . . is something more than inducing others to contract with a corporate entity which lacks the ability to pay even though the corporate agent knew such fact." Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

53. *See, e.g.,* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968)(court refused to pierce veil because no evidence corporation originally incorporated for improper purpose); Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(parties dealt with proper financial structure of corporation from beginning of relationship); Hanson Southwest Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 716-17 (Tex. Civ. App.—Dallas 1977, writ ref'd n.r.e.)(subsidiary corporation separate entity from parent if created in good faith); Minchen v. Van Trease, 425 S.W.2d 435, 438 (Tex. Civ. App.—Houston [14th

dishonesty or an intent to deceive.[54] On the other hand, constructive fraud involves grossly unfair acts or the breach of some legal or equitable duty.[55] The breach of these legal or equitable duties is understood to be constructively fraudulent because of its tendency to deceive, violate confidences, or injure public interests.[56]

In *Hickman v. Rawls*,[57] creditors who were unable to recover from an insolvent corporation attempted to recover from corporate officers personally, based on the sham to perpetrate a fraud theory. The *Hickman* court concluded, however, that the corporation was not a sham organized to perpetrate some illegal scheme but, rather, a legitimate corporation that had failed.[58] The Dallas Court of Appeals thus refused to "resort to the drastic exception to the general rule that the corporate entity must remain inviolate."[59] The court held, "[f]raud as used in the exception is something more than inducing others to contract with the corporate entity which lacks the ability to pay even though the corporate agent knew such fact."[60] Although the court did not define the "something more" required to sustain the action, it suggested that "additional compelling facts" beyond the prevention of creditors from collecting their debts from the corporation would be necessary.[61]

C. *Trust Fund Doctrine*

Since 1893, the Texas Supreme Court has recognized the trust fund doctrine. In *Lyons-Thomas Hardware Co. v. Perry Stove Mfg. Co.*,[62] the court extensively reviewed the law on the trust fund doctrine in

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Dist.] 1968, writ ref'd n.r.e.)(lack of original intent to defraud by creating corporation prevented shareholder from being personally liable, despite questionable use of corporation).

54. *See* Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964)(actual fraud requires intent to deceive; constructive fraud only requires breach of legal or equitable duty).

55. *See id.*

56. *See, e.g.*, Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964)(constructive fraud should be determined as matter of law); Tigrett v. Pointer, 580 S.W.2d 375, 385 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.)(transfer of all assets of corporation to dominant shareholder when corporation insolvent found to be "so grossly unfair as to amount to constructive fraud").

57. 638 S.W.2d 100 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

58. *See id.* at 102.

59. *Id.*

60. *Id.*

61. *See id.*

62. 86 Tex. 143, 24 S.W. 16 (1893). The Court held: "The condition of the corporation, set forth in the questions propounded, under the long-recognized rules of equity, conferred

other jurisdictions,[63] and decided to adopt the doctrine. It held that unsecured creditors of an insolvent corporation are entitled to a pro rata share of the proceeds of the corporation's assets, but that such creditors are not entitled to preferences, even if the creditors are shareholders, directors, or officers of the corporation.[64] Based on the presumption that it is the assets of the corporation upon which a voluntary contractual creditor relies for payment or performance, the trust fund theory permits corporate creditors to recover a pro rata share of corporate assets misappropriated by officers, directors or shareholders.[65]

Two requirements must be met before the trust fund doctrine may be applied. First, the corporation must be insolvent.[66] Second, the corporation must have ceased doing business.[67] When these criteria are met, the corporation's officers, directors, and shareholders become the trustees of the corporate assets and owe a fiduciary duty to the corporation's creditors.[68] As trustees, they are required to distribute ratably the corporate assets for the benefit of the corporation's creditors.[69] If the directors, officers, or shareholders breach this duty, then the creditors have a direct cause of action against them.[70] Although shareholders may be personally liable under the trust fund theory, their liability under the doctrine is limited to the value of the corpo-

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upon every unsecured creditor of the corporation the right to a ratable share of the proceeds of all the assets of the corporation . . . ." *Id.* at 25.

63. *See id.* at 21-25.

64. *See id.* at 25.

65. World Broadcasting Sys. v. Bass, 160 Tex. 261, 264, 328 S.W.2d 863, 864. The creditors are entitled to the same share of the assets because their debt relates to the total outstanding debt of the corporation. *See* Henry I. Siegel Co. v. Holliday, 663 S.W.2d 824, 828 (Tex. 1984). The creditors are then entitled to a share of the assets equivalent to their debt in proportion to the total outstanding debt of the company. *See id.*

66. *See* Fagan v. LaGloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ)(first of two requirements for trust fund doctrine to apply is that corporation be insolvent).

67. *See id.*; *see also* Henry I. Siegel Co. v. Holliday, 663 S.W.2d 824, 828 (Tex. 1984)(directors and officers liable as trustees for corporate assets of dissolved corporation).

68. *See* Henry I. Siegel Co. v. Holliday, 663 S.W.2d 824, 828 (Tex. 1984)(directors and officers act as trustees of dissolved corporation). As a general rule, corporate officers and directors owe a fiduciary duty to the corporation, but not to its creditors. The trust fund doctrine, however, is a well-established exception to this rule. *See* Fagan v. LaGloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ).

69. *See* Fagan v. LaGloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ).

70. *See id.*

rate assets *wrongly* received by them.[71] Under alter ego and other veil-piercing doctrines, however, joint and several liability is imposed on shareholders without regard to the value of corporate assets received by them.[72]

III. ANALYSIS

A. *Application of an Apparent Tort Standard to a Contract Case*

Since 1939, it has been settled law in Texas that, in order for a contract claimant to pierce the corporate veil and hold the corporate shareholders liable on the corporation's contract obligation, the contract claimant must show fraud.[73] Although *Castleberry* clearly involved a contract claim, the majority disregarded the traditional tort/contract distinction.[74] Such disregard ignores the carefully constructed statutory framework which, while favoring the corporate form, balances and protects the interests of contractual creditors of corporations.[75] The *Castleberry* decision also erodes the implied policy underlying the tort/contract distinction. Parties are capable of limiting the risks involved in the performance of a corporate contract

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71. *See* World Broadcasting Sys. v. Bass, 160 Tex. 261, 267, 328 S.W.2d 863, 866 (1959)(where corporate shareholders had depleted corporate assets, they were individually liable to creditors to extent of funds received).

72. *See* Gentry v. Credit Plan Corp. 528 S.W.2d 571, 572-73 (Tex. 1975)(officers and directors found liable where corporation alter ego).

73. *See* First Nat'l Bank v. Gamble, 134 Tex. 112, 119, 132 S.W.2d 100, 103 (Tex. Comm'n App. 1939, opinion adopted)(sets forth requirements for plaintiff to disregard corporate entity in contract cases); *see also* Edwards Co. v. Monogram Indus., 730 F.2d 977, 980-83 (5th Cir. 1984)(discussing Texas law in regard to requirement that fraud be shown in order to pierce corporate veil in contract case); Miles v. Am. Tel. & Tel. Co., 703 F.2d 193, 195 (5th Cir. 1983)(Texas courts less reluctant to disregard corporate entity in tort cases); Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984)(in tort case, not necessary to show intent to defraud, instead, corporation's financial strength important in deciding whether to pierce corporate veil).

74. *See* Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986)(court stated that both tort and contract claimants need only show constructive fraud under sham to perpetrate fraud doctrine).

75. *See, e.g.,* TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1987); TEX BUS. CORP. ACT ANN. art. 241.A(3)(Vernon Supp. 1987); TEX. TAX CODE ANN. § 171.255 (Vernon 1982); TEX. BUS. & COM. CODE ANN. §§ 24.03(a), 27.01 (Vernon 1968); Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459; TEX. BUS. CORP. ACT ANN. art. 2.02 (Vernon 1980 & Supp. 1987). *Cf.* Latty, *Inadequate Capitalization as a Basis for Shareholder Liability: The California Approach and a Recommendation,* 45 S. CAL. L. REV. 823, 835 (1972)(providing adequate capitalization for corporation justifies limited liability of directors, shareholders, officers). *See generally* 19 R. HAMILTON, BUSINESS ORGANIZATIONS § 236 (Texas Practice 1973).

through negotiation of personal guarantees, and such risks may be allocated according to the parties' bargaining power.[76] In addition, contracting parties voluntarily choose with whom they contract, whereas tort victims generally cannot choose their tortfeasors.[77]

In *Lucas v. Texas Industries, Inc.*,[78] the Texas Supreme Court specifically noted, "[I]n a tort case, it is not necessary to find an intent to defraud."[79] The court also noted that in a contract case where there is no deception or actual fraud, the contract between the corporation and the claimant determines the apportionment of risk.[80] The court applied existing precedent and found that an *intent* to defraud is required in a contract case in order to disregard the corporate entity.[81]

B. *Misuse of a Constructive Fraud Standard to Pierce the Corporate Veil*

1. Sham

The *Castleberry* majority created a "sham to perpetrate a *constructive* fraud" doctrine, which appears capable of being invoked whenever there is some evidence to suggest that corporate shareholders, officers or directors used the corporation or its assets in an inequitable manner at any time *following* the organization of the corporation.[82] Under the facts of *Castleberry*, it is evident that the corporation that would have had to have been a sham was TTI, as TTI was the only

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76. *See, e.g.*, Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984); Atomic Fuel Extraction Corp. v. Slick's Estate, 386 S.W.2d 180, 190-91 (Tex. Civ. App.—San Antonio 1965, writ ref'd n.r.e.); Moore & Moore Drilling Co. v. White, 345 S.W.2d 550, 551-52 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.).

77. *Cf.* W. PROSSER AND W. KEETON, HANDBOOK ON THE LAW OF TORTS § 92, at 664-65 (5th ed. 1984)(contract involves promises between parties for liability; tort requires only proximate cause of injury by any party).

78. 696 S.W.2d 372 (Tex. 1984).

79. *Id.* at 375 (courts more likely to disregard corporate entity in tort action than breach of contract action).

80. *See id.*

81. *See id.* The court noted, "Unlike in a tort case, however, the plaintiff in a contract case has had prior dealings with the parent corporation. Absent some deception or fraud, the risk of loss is apportioned by virtue of relative bargaining power." *Id.; see also* First Nat'l Bank v. Gamble, 134 Tex. 112, 119, 132 S.W.2d 100, 103 (1939).

82. *See* Castleberry v. Branscum, 721 S.W.2d 270, 275 (Tex. 1986). The majority's new result-oriented standard for constructive fraud is merely that the corporate entity will be disregarded "when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." *Id.* at 271.

corporation to have dealt with the plaintiff.[83] Since the corporation had been operating successfully as a furniture moving business, it is obvious that TTI was not created for an intentionally, nor constructively fraudulent purpose.[84]

No prior Texas case has been found to suggest that inability or failure to meet contractual obligations renders the corporate structure a sham. The logical conclusion to be drawn from the *Castleberry* decision, however, is that a corporation may be incorporated for a valid business purpose but later, because of a disagreement among the shareholders, lose its valid business purpose and become merely a sham.[85] Disregarding the corporate entity as a sham used for fraudulent purposes is appropriate only where a corporation is created ab initio to promote or to perpetrate a fraud.[86] However, if the sham ab initio rule had been properly applied in *Castleberry*, the plaintiff, as an incorporator, would have been precluded from invoking the equitable doctrine.[87]

2. Fraud

The second element of the sham to perpetrate a fraud theory is that the directors, officers, or shareholders must have created the corporation solely for a fraudulent purpose.[88] The majority opinion in *Castleberry* held that constructive fraud, rather than actual fraud, satisfies

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83. *See id.* at 274. Under the sham theory, the original corporation must have been incorporated to further an illegal or fraudulent purpose. *See supra* notes 53-56 and accompanying text. In *Castleberry*, however, the court recognized that TTI, the original corporation, was formed as a legitimate endeavor. *See* Castleberry v. Branscum, 721 S.W.2d 270, 274 (Tex. 1986). Furthermore, Castleberry recognized TTI as a legitimate corporation because he helped to form it, he contracted with it when he sold his stock back to the corporation, and he accepted a promissory note issued by the corporation to repurchase his shares. *See id.*

84. *See id.* TTI was formed as a furniture moving business, and each of the three owners in the closely-held corporation owned one third of the shares. *See id.*

85. *See id.* at 274-75.

86. *See* Minchen v. Van Trease, 425 S.W.2d 435, 437-38 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.)(entity not disregarded when no original scheme to create corporation for fraudulent purpose).

87. *See* Castleberry v. Branscum, 721 S.W.2d 270, 278 (Tex. 1986)(Gonzalez, J., dissenting). As the court in *Minchen v. Van Trease* noted, "There was no initial purpose on the part of the [defendant] . . . in incorporation that could justify setting aside the corporate structure" and the sham to perpetrate a fraud theory could not be used to impose liability on the shareholders, directors or officers. Minchen v. Van Trease, 425 S.W.2d 435, 438 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.).

88. *See, e.g.*, Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986); Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(courts will not hold shareholders

the fraud requirement of the sham to perpetrate a fraud theory.[89] However, as discussed earlier, actual fraud has been the standard required under any theory of piercing the corporate veil in a contract case.[90] Furthermore, in the application of its sham to perpetrate a constructive fraud doctrine to the facts of the case, the *Castleberry* majority failed to apply Texas precedent, which requires additional factors indicating an injustice to the creditors, and instead merely applied a result-oriented "inequitable result" test as satisfying the constructive fraud standard.[91]

In evaluating the level of fraud required to apply the sham to perpetrate a fraud doctrine, the majority misconstrued a portion of section 41.30 of *Fletcher's Cyclopedia of the Law of Private Corporations*.[92] The section begins:

> For the doctrine traditionally known as 'piercing the corporate veil' to apply, two dominant requirements must be met - there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and circumstances must indicate that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.[93]

In reference to the second requirement, the section goes on to say:

> Neither fraud nor an intent to defraud need be shown as a prerequisite to disregarding the corporate entity; it is sufficient if recognizing the separate corporate existence would bring about an inequitable result.[94]

The majority misinterpreted section 41.30 because the section is not

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liable on corporate obligations unless shareholders using corporation as sham to perpetrate fraud).

89. *See* Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986). The majority does not cite any case which uses the sham theory to disregard the corporation and hold the shareholders liable. *See id.*

90. *See supra* notes 73-81 and accompanying text. Adequate proof of fraud should be required before a court is permitted to disregard the corporate entity. *See, e.g.,* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984); Castleberry v. Branscum, 721 S.W.2d 270, 279 (Tex. 1986)(Gonzalez, J., dissenting); Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968); Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

91. *See* Castleberry v. Branscum, 721 S.W.2d 270, 277 (Tex. 1986)(Gonzalez, J., dissenting)("inequitable result" standard fails to give ascertainable basis for cause of action).

92. *See id.* at 272-73 (quoting W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 30 (Supp. 1985)).

93. W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 428 (rev. ed. 1983).

94. *Id.* § 41.30, at 163-64 (Supp. 1986).

an analysis of the sham to perpetrate a fraud theory. Rather, it contains a *general* discussion of factors to be considered by a court when determining whether or not to pierce the corporate veil.[95] Unity of interest and fraud are considered under *any* theory of piercing the corporate veil, although each element may be given greater or lesser emphasis in particular circumstances.[96] Where the corporate formalities have been kept, as was the case with TTI, stronger proof is required of fraud or injustice.[97] An "inequitable result" standard should be used only where there is proof that the shareholder and the corporation share a common existence and personality (unity of interest).[98]

As has already been established, TTI was created and maintained for a legitimate business purpose.[99] Additionally, the failure to pay the corporate note was not in itself fraudulent. Mere breach of a contract may never be considered fraud, unless a party had no intention of performing from the time the contract was made, which would constitute actual fraud.[100] Moreover, sale of the TTI assets, on its face, was not fraudulent, as fair value appears to have been received by TTI for the conveyance.[101] Even though the defendants paid themselves "back salaries" with the cash from the sale of the assets, in doing so, they were merely preferring one creditor over another.[102]

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95. *See id.* § 41.30, at 428-46 (rev. ed. 1983 & Supp. 1986). Section 41.30, entitled "Determination factors," is within the chapter entitled "The Corporate Entity or Personality" and within the section entitled "Disregard of the corporate entity-In general." *See generally id.*

96. *See* Van Dorn v. Future Chem. & Oil Corp., 753 F.2d 565, 569-70 (7th Cir. 1985)(Illinois courts adhere to two requirements of unity of interest and fraud); *see also* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 428 (rev. ed. 1983)(unity of interest and fraud are two dominant prerequisites to piercing corporate veil).

97. *See* Roylex, Inc. v. Langson Bros. Constr. Co., 585 S.W.2d 768, 772 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.)(emphasized failure to follow corporate formalities in deciding whether to pierce corporate veil); *see also* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30, at 430 (rev. ed. 1983).

98. *See generally* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.30 (rev. ed. 1983)(factors for determining when veil-piercing remedies apply).

99. *See* Castleberry v. Branscum, 721 S.W.2d 270, 278 (Tex. 1986)(Gonzalez, J., dissenting). TTI was first formed as a partnership to deliver furniture. Later, it was incorporated, with Branscum, Byboth, and Castleberry each owning a one third interest in the newly-formed corporation. *See id.*

100. *See* Southwestern Bell Tel. Co. v. Meader Constr. Co., 574 S.W.2d 839, 843 (Tex. Civ. App.—El Paso 1978, writ ref'd n.r.e.). The court stated, "The mere breach of the promise is never enough in itself to establish the fraudulent intent." *Id.*

101. *See* Castleberry v. Branscum, 721 S.W.2d 270, 279 (Tex. 1986)(Gonzalez, J., dissenting).

102. *Cf.* Pepper v. Litton, 308 U.S. 295, 308-09 (1939). The United States Supreme

Such a preference of one creditor over another may be inequitable, but it does not rise to the level of constructive fraud.[103] Any "inequitable result" as described in the *Castleberry* majority's opinion arises primarily from Castleberry's own business judgment and negotiating skills.[104] As Justice Gonzalez pointed out in his dissent,

> The court never states, nor can I determine how Texan Transfer [TTI] . . . was used to perpetrate a fraud. I agree with the court that Castleberry was wronged. However, he should not recover under the theories pleaded and submitted to the jury. Castleberry simply did not assert the proper cause of action . . . . [T]he court of appeals reached the correct result since there was no evidence on any theory for piercing the corporate veil . . . .[105]

Because disregarding the corporate entity imposes unlimited personal liability on shareholders, an actual fraud standard is necessary to protect innocent shareholders from personal liability for mere breach of contract by corporations.[106] A standard that is higher than that of the *Castleberry* majority's lowered constructive fraud standard

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Court, in *Litton*, explained that bankruptcy courts have disallowed or subordinated salary claims of shareholders in small or family corporations when allowance or preference of such claims would be inequitable to other creditors of the corporation. *See id.*

103. *Cf.* Hanson Southwest Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712, 718 (Tex. Civ. App.—Dallas 1977, writ ref'd n.r.e.). The *Hanson* court asserted:

> . . . [C]ourts will not disregard a corporate entity unless it is employed to defraud existing creditors of the shareholder, to evade an existing obligation, to circumvent a statute, to achieve or perpetrate a monopoly or to protect crimes.

Id. By paying themselves back salaries, the defendants in *Castleberry* were preferring themselves over the other corporate creditors, not attempting to defraud existing creditors. *See infra* notes 170-83 and accompanying text (discussion of trust fund doctrine as alternative remedy). *Cf.* Pepper v. Litton, 308 U.S. 295, 308-10 (1939).

104. *See, e.g.*, Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984)(in contract situations, risk of loss apportioned according to relative bargaining power); Atomic Fuel Extraction Corp. v. Slick's Estate, 386 S.W.2d 180, 190-91 (Tex. Civ. App.—San Antonio 1965, writ ref'd n.r.e.)(court refused to pierce corporate veil where plaintiff never confused about with whom it was contracting). In *Hickman*, the court held that even though the defendants failed to maintain adequate corporate records and knew when the plaintiff contracted with the corporation that it did not have sufficient funds to pay the plaintiff's fee, such evidence did not rise to the level of fraud necessary to pierce the corporate veil in a contract case. *See* Hickman v. Rawls, 638 S.W.2d 100, 101-02 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

105. Castleberry v. Branscum, 721 S.W.2d 270, 280 (Tex. 1986)(Gonzalez, J., dissenting).

106. *See* Hickman v. Rawls, 638 S.W.2d 100, 101-02 (Tex. App.—Dallas 1982, writ ref'd n.r.e.). The court asserted,

> The general rule is that a corporate entity may not be ignored. An exception to this rule exists only under the most extraordinary circumstances where the corporate entity is used to perpetrate a fraud against the public or against public policy such as to achieve a monopoly or to circumvent a statute or to protect crime. Fraud, as used in the exception

would minimize the possibility of judicially-created windfall recoveries for contract creditors of corporations against shareholders where corporate assets are insufficient to satisfy all corporate creditors.[107] Instead, the new doctrine conceivably provides a safety net for creditors, allowing them to circumvent the consequences of their own business judgment or negotiating skills whenever a judge or jury believes recognition of the corporate entity would result in an inequitable result for creditor claimants.

3. Other Authorities

States with a developed body of corporate law generally do not use constructive fraud as the test for piercing the corporate veil.[108] In the absence of actual fraud, courts in other states require a combination of elements that tip the scale of equity in favor of disregarding the corporate entity.[109] Delaware courts have held that, absent fraud, equity does not require piercing the corporate veil.[110] The Delaware Supreme Court, for example, has required actual fraud or some combination of the other elements, such as commingling of funds and disregard of the corporate formalities before it ignored the corporate entity.[111]

The reluctance of other jurisdictions to adopt the constructive fraud approach taken by the majority in *Castleberry*[112] may be based

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is something more than inducing others to contract with a corporate entity which lacks the ability to pay even though the corporate agent knew such fact.

Id. at 102 (citations omitted).

107. *See id.* at 102.

108. *See, e.g.*, Van Dorn v. Future Chem. & Oil Corp., 753 F.2d 565, 569-70 (7th Cir. 1985)(Illinois law requires unity of interest before corporate entity will be disregarded); Gartner v. Snyder, 607 F.2d 582, 586 (2d Cir. 1979)(New York courts disregard corporate entity when used for fraud or as alter ego); Terry Apartments Assocs. v. Associated-East Mortgage Co., 373 A.2d 585, 588 (Del. Ch. 1977)(mere fact that corporation funding activity of second corporation not enough to pierce corporate veil).

109. *See* Gallagher v. Reconco Builders, 415 N.E.2d 560, 564 (Ill. App. Ct. 1980)(absent fraud, must be element of fundamental unfairness or injustice to pierce veil); Pauley Petroleum Inc. v. Continental Oil Co., 239 A.2d 629, 633 (Del. 1968)(veil pierced only if fraud, contravention of contract or law, public wrong, or equitable considerations among corporate members require it).

110. *See* Pauley Petroleum Inc. v. Continental Oil Co., 239 A.2d 629, 633 (Del. 1968); Terry Apartments Assocs. v. Associated-East Mortgage Co., 373 A.2d 585, 588 (Del. Ch. 1977).

111. *See* Pauley Petroleum Inc. v. Continental Oil Co., 239 A.2d 629, 633 (Del. 1968).

112. *See, e.g.*, Pauley Petroleum Inc. v. Continental Oil Co., 239 A.2d 629, 633 (Del. 1968)(court found no showing of fraud or any other elements to disregard corporate entity);

upon recognition that a key purpose of commercial law is to provide both reasonable fairness and certainty in commercial dealings.[113] At least two Texas cases prior to *Castleberry* which used constructive fraud as the basis for disregarding the corporate entity did so in combination with other elements.[114] *Tigrett v. Pointer*[115] involved an undercapitalized corporation, breach of the trust fund doctrine, and a loan by the dominant shareholder.[116] *Cupples Coiled Pipe, Inc. v. Esco Supply Co.*[117] was a products liability case which also involved inadequate capitalization and loose financial arrangements between the parent and the subsidiary.[118] The existence of factors other than

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Terry Apartments Assocs. v. Associated-East Mortgage Co., 373 A.2d 585, 588-89 (Del. Ch. 1977)(no showing of fraud to justify piercing veil); Gallagher v. Reconco Builders, 415 N.E.2d 560, 563-64 (Ill. App. 1980)(disregard of corporate entity involves consideration of many factors); Walkovszky v. Carlton, 223 N.E.2d 6, 9 (N.Y. 1966)(corporate form not disregarded where corporation's assets and insurance of its taxis insufficient to compensate plaintiff).

113. *See* UNIFORM COMMERCIAL CODE § 2-302 comment 1 (1987). The purpose of provisions such as section 2-302 of the Uniform Commercial Code (U.C.C.) is to prevent oppression and unfair surprise in contractual dealings. *See id.* (listing of cases illustrating prevention of oppression or unfair surprise). Two of the underlying purposes of the U.C.C. are to "clarify and modernize the law" and "make uniform the law among the various jurisdictions." *Id.* § 1-102(1)(a) & (c). As the National Conference of Commissioners on Uniform State Laws and the American Law Institute stated, "Uniformity throughout American jurisdictions is one of the main objectives of this Code; and that objective cannot be obtained without substantial uniformity of construction." UNIFORM COMMERCIAL CODE, 1962 OFFICIAL TEXT 1 (American Law Institute 1962).

114. *See, e.g.,* Cupples Coiled Pipe, Inc. v. Esco Supply Co., 591 S.W.2d 615, 617 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.); Tigrett v. Pointer, 580 S.W.2d 375, 382-83 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

115. 580 S.W.2d 375 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

116. *See id.* at 382-83. In *Tigrett*, the plaintiff's claim of alter ego was based upon a transfer of all the assets of the corporation to the dominant shareholder when the corporation was insolvent, in violation of the dominant shareholder's duty to preserve the assets for the benefit of creditors. *See id.* at 378. The court characterized this action as "so grossly unfair as to amount to constructive fraud even though the corporation may not have been organized originally for a fraudulent purpose and even though no specific fraudulent intent is shown." *Id.* at 385. The *Tigrett* court noted the facts that the sole shareholder operated the business with funds provided by unsecured loans from himself, transferred all of the corporate assets to himself when the corporation was practically insolvent, and failed to provide for payment to the other corporate creditors ". . . demonstrat[ing] conclusively that while [the defendant] observed the form of the corporate enterprise, he ignored his substantive duties as a corporate officer and director and acted solely in his own interest." *Id.* at 387. The court therefore held the defendant personally liable for the corporation's debts because of the breach of duty owed to corporate creditors. *See id.*

117. 591 S.W.2d 615 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.).

118. *See id.* at 617. In this case, Cupples Coiled Pipe, Inc., a wholesale plumbing company, brought a tort action in strict liability against Esco Supply Company, a pipe manufacturer. *See id.* at 618. The suit arose out of a contractual arrangement where the plaintiff, as

constructive fraud, coupled with the strong public policies in favor of predictability and stability, support these holdings.

4. Texas Authority

The *Castleberry* majority relied on *Pace Corp. v. Jackson*'s use of the phrase "a sham to perpetrate a fraud."[119] *Pace*, although it contains the foregoing phrase, stands for a far different proposition than what the *Castleberry* majority suggests.[120] The court in *Pace* did not permit recovery for post-incorporation fraud.[121] Pace Corporation and its two major stockholders sought declaratory judgment construing a contract with a former stockholder, Jackson,[122] and he filed a cross-action for breach of contract.[123] Jackson had sold his shares back to the corporation for, among other things, the corporation's promise to supply Jackson with cigarettes for business outside of Bexar County.[124] It was this provision that the plaintiffs sought to

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the purchaser, dealt solely with the defendant, as seller, and not the seller's parent company. *See id.* The court described the parent-subsidiary arrangement as "grossly unfair and could be labeled constructive fraud" in light of the following facts: (1) the subsidiary served as a branch warehouse of the parent and the parent provided needed capital in response to telephone calls, not negotiated loan agreements, from the subsidiary, (2) the parent and the subsidiary were not adequately capitalized, (3) the advance of funds from the parent to the subsidiary as accounts, rather than loans, was not consistent with independent corporate entities, (4) there was some commonality of directors and officers between the parent and subsidiary, and (5) the subsidiary sold its assets for a promissory note which was assigned to the parent as a credit for the debt owed by the subsidiary to the parent. *See id.* at 616-18. The court found the parent corporation liable, however, in light of *Lucas v. Texas Industries, Inc.*, constructive fraud was not necessary to find liability in *Cupples* because the *Lucas* court stated that fraud is not a necessary element in a tort case. *See id.* at 618; *see also* Lucas v. Texas Indus., 696 S.W.2d 372, 375 (Tex. 1984).

119. *See* Castleberry v. Branscum, 721 S.W.2d 270, 272 n.2 (Tex. 1986). The *Pace* court asserted that individual shareholders should not be held personally liable for breach of a corporate contract unless:

> . . . it appears that the individuals are using the corporate entity as a *sham to perpetrate a fraud*, to avoid personal liability, avoid the effect of a statute, or in a few other *exceptional* situations.

Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(emphasis added).

120. *Compare* Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986)(sham to perpetrate fraud should not be confused with intentional fraud) *with* Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(shareholders, officers, directors will be held personally liable on corporate obligations only in "exceptional situations").

121. *See* Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955).

122. *See id.* at 183, 284 S.W.2d at 343.

123. *See id.*

124. *See id.* Besides the corporation's promise to supply Jackson with cigarettes outside of Bexar County, Jackson also sold his shares back to the corporation for: (1) a sum to be paid

have declared unenforceable because of vagueness and lack of mutuality.[125] Despite the fact that the shareholders had covenanted individually with Jackson and had joined with the corporation in filing suit and perfecting the appeal, the Texas Supreme Court refused to hold them personally liable for the corporation's breach of its contract to supply Jackson with cigarettes outside of Bexar County.[126] The Court reasoned that Jackson, as a former shareholder, was as well acquainted with the financial structure of the corporation as the other two shareholders.[127] In addition, the Court could find no basis for the conclusion that the two shareholders had created the corporation solely to defraud or deceive Jackson.[128] The facts in the present case are similar to those in *Pace* and should preclude recovery under the sham to perpetrate a fraud theory.[129]

The *Castleberry* majority also relied on *Bell Oil & Gas Co. v. Allied Chemical Corp.*[130] for the proposition that piercing the corporate veil is appropriate "when the corporate form has been used as part of a basically unfair device to achieve an inequitable result."[131] In *Bell Oil*, however, the court refused to hold a corporate shareholder individually liable for debts incurred by the subsidiaries owned by that shareholder.[132] While there was evidence of close connections and

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in installments over five years, (2) a promise not to sell cigarettes in Bexar County for seven years, and (3) the corporation's promise not to sell cigarettes in Kerr County or Bandera County. *See id.*

125. *See id.* at 183-86, 284 S.W.2d at 343-45 (provision enforceable because not separate from contract and because sufficiently certain).

126. *See id.* at 194-95, 284 S.W.2d at 351 (absent fraud, courts will not pierce corporate veil when shareholders join in filing suit).

127. *See id.*

128. *See id.* (no evidence of fraud found).

129. Following the holding in *Pace* would mean that Castleberry could not recover in the absence of stating a claim under the trust fund doctrine. For cases employing the trust fund doctrine, see, e.g., *Whisenhunt v. Park Lane Corp.*, 418 F. Supp. 1096, 1098 (N.D. Tex. 1976); *Henry I. Siegel Co. v. Holliday,* 663 S.W.2d 824, 828 (Tex. 1984); *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547, 551 (Tex. 1981); *World Broadcasting Sys. v. Bass*, 160 Tex. 261, 266-67, 328 S.W.2d 863, 866 (1959); *Lyons-Thomas Co. v. Perry Stove Mfg. Co.*, 86 Tex. 143, 166, 24 S.W. 16, 22 (1893); *Hixson v. Pride of Texas Distributing Co.*, 683 S.W.2d 173, 176 (Tex. App.—Fort Worth 1985, no writ); *Fagan v. LaGloria Oil & Gas Co.*, 494 S.W.2d 624, 628-29 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ).

130. 431 S.W.2d 336 (Tex. 1968).

131. Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986); *see also* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 340 (Tex. 1968)(noting that formulating general rule for when corporate entity should be disregarded in contract case "troublesome").

132. *See* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 341 (Tex. 1968)(subsidiary corporation held not agent of parent corporation).

overlapping between directors and officers among Bell and its subsidiary development and oil companies,[133] the Court held that there was no evidence that the subsidiaries were incorporated for a fraudulent purpose, even though it recognized that the corporation was both undercapitalized and insolvent.[134]

The *Castleberry* majority's reliance on *Pace* and *Bell* appears to be misplaced. Neither of these cases holds that constructive fraud is the proper standard to apply in disregarding the separate existence of a corporation, particularly in a breach of contract case.[135] On the contrary, both of these precedents suggest that the corporation itself, not its shareholders, is liable for any contract it undertakes, regardless of subsequent corporate financial difficulties.[136]

In addition to misplaced reliance on the *Pace* and *Bell* decisions, the *Castleberry* majority ignored established precedent. For example, in *Torregrossa v. Szelc*,[137] the Texas Supreme Court refused to hold shareholder Torregrossa liable for corporate obligations[138] because Szelc, a voluntary creditor, had knowingly dealt with the corporation from the beginning of his contractual transaction, without shareholder guarantees.[139] Despite the fact that the corporation was minimally capitalized and had forfeited its corporate charter subsequent to the time the cause of action arose, the Court did not pierce the corporate veil.[140]

Similarly, in *Dunn v. Growers Seed Association*,[141] the Amarillo Court of Appeals refused to hold the majority shareholder liable for

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133. *See id.* at 337.

134. *See id.* at 340. The court specifically stated, ". . . we find no evidence that Mid-Tex was originally incorporated for an illegal, improper or fraudulent purpose." *Id.* Justice Norvell asserted that a fraudulent purpose would be "one which is likely to be employed in achieving an inequitable result by bringing into operation a basically unfair device" which will result in prejudice to those dealing with the corporation. *Id.*

135. *See id.* at 339 (no finding of fraud); Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(no evidence that shareholders using corporation to defraud party with whom corporation contracted).

136. *See* Bell Oil & Gas Co. v. Allied Chem. Corp., 431 S.W.2d 336, 341 (Tex. 1968)(even though subsidiary corporation undercapitalized, separate corporate entities maintained, therefore, parent not liable); Pace Corp. v. Jackson, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955)(parties to contract familiar with financial structure of corporation; no personal liability on shareholders).

137. 603 S.W.2d 803 (Tex. 1980).

138. *See id.* at 805 (corporate entity found not to be alter ego of shareholder).

139. *See id.* at 804.

140. *See id.* at 805.

141. 620 S.W.2d 233 (Tex. Civ. App.—Amarillo 1981, no writ).

the debts of the corporation, despite its financial difficulties.[142] To do so, the court reasoned, would impose liability "on every stockholder of a financially troubled corporation."[143] Such a result would emasculate the business and social purpose of corporations to limit corporate liability to the corporation's assets and to shield the personal assets of shareholders from corporate obligations.[144] As in *Torregrossa*, in *Dunn*, the claimant "fully knew and understood it was dealing with a corporation. It knew the essential facts and accepted the situation."[145]

Although courts, on occasion, may be persuaded to pierce the corporate veil in favor of creditors in a weak bargaining position, such a remedy can hardly be justified when all parties possess equal knowledge about the corporation and its financial structure.[146] Castleberry, as an incorporator, shareholder and insider, was in a position to know the financial condition of TTI at the time he negotiated to sell his stock back to TTI in exchange for an unsecured TTI note that was not guaranteed by the remaining shareholders.[147] As the dissenting opinion noted, "Castleberry was more fully aware than other creditors of the potential viability of the corporation; still, he chose to contract only with the corporation and not with Branscum and Byboth in their individual capacities."[148] If a non-affiliate may not complain, as demonstrated in the *Dunn* and *Torregrossa* cases, certainly an insider may not complain that he was constructively defrauded by the corporation concerning its ability to pay at the time the agreement was negotiated.

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142. *See id.* at 237 (attempt to hold majority shareholder liable for debt after corporation's financial difficulties invalid).

143. *Id.*

144. *See* N. LATTIN, THE LAW OF CORPORATIONS §§ 11, 12, at 65-69 (2d ed. 1971).

145. Dunn v. Growers Seed Ass'n, 620 S.W.2d 233, 237 (Tex. Civ. App.—Amarillo 1981, no writ); *see also* Torregrossa v. Szelc, 603 S.W.2d 803, 804-05 (Tex. 1980)(parties knowingly contracted with corporation; alter ego not allowed).

146. *See* Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 543 (1977)(corporate veil of undercapitalized entities may be pierced when creditor in weak bargaining position).

147. *See* Castleberry v. Branscum, 721 S.W.2d 270, 279 (Tex. 1986)(Gonzalez, J., dissenting). In the six months preceding Castleberry's sale of his stock back to the corporation, TTI's income fell dramatically. *See id.*

148. *Id.* at 280.

C. *Failure to Allege Adequate Legal Remedies*

The *Castleberry* majority granted extraordinary equitable relief even though there may have been more than one adequate remedy at law. However, the plaintiff waived such remedies at trial by failing to allege them.[149] Applying the facts as a whole, remedies for damages and individual liability theoretically could have been alleged by the plaintiff under several legal theories and statutes, obviating the need for a broad and vague constructive fraud remedy to pierce the corporate veil.[150]

The alleged inequitable result to the plaintiff in *Castleberry*, failure to pay the unsecured corporate promissory note, did not arise from TTI's failure in "recognizing the separate corporate existence," but rather from the failure of Castleberry to seek remedies available at law. As Justice Gonzalez stated, "Castleberry did not sue because . . . [TTI] was a sham, he sued because it stopped doing business and he did not get paid. The corporate entity . . . did not cause Castleberry's legal injury."[151] Although the *Castleberry* majority does not claim to rely upon the alter ego theory as its basis for piercing the corporate veil, it in fact relied upon the alter ego findings of the jury to support its judgment.[152] The court's basis for disregarding the corporate fiction was the sham to perpetrate a fraud theory.[153] However, as the

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149. *See id.* Even though Texas has a blended system of law and equity, the distinction between them is absolute. Therefore, in order for a plaintiff to obtain equitable relief, he must show that his cause of action is properly within the court's equitable jurisdiction by exhausting all remedies at law. *See* Rogers v. Daniel Oil & Royalty Co., 130 Tex. 386, 392, 110 S.W.2d 891, 894 (1937).

150. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1987); TEX. BUS. CORP. ACT ANN. art. 2.41.A(3) (Vernon Supp. 1987); TEX. TAX CODE ANN. § 171.255 (Vernon 1982); TEX. BUS. & COM. CODE ANN. §§ 24.03(a), 27.01 (Vernon 1968)(section 24.03(a) recodified and expanded at The Uniform Fraudulent Conveyance Act, ch. 1004, § 1, 1987 Tex. Sess. Law Serv. 6805, 6809-10 (Vernon)(expanding definition of fraudulent conveyance as to creditors)); Texas Miscellaneous Corporation Law Act, ch. 205, § 1, 1961 Tex. Gen. Laws 408, 410-11, *repealed by* Act of May 14, 1987, ch. 93, § 45, 1987 Tex. Sess. Law Serv. 417, 472 (Vernon), *recodified at* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon); *see also* International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576-77 (Tex. 1963)(usurpation of corporate opportunity); Cardwell v. Wilson Trophy Co., 622 S.W.2d 651, 653 (Tex. Civ. App.—Fort Worth 1981, writ ref'd n.r.e.)(usurpation of corporate opportunity).

151. Castleberry v. Branscum, 721 S.W.2d 270, 280 (Tex. 1986)(Gonzalez, J., dissenting).

152. *See* Castleberry v. Branscum, 721 S.W.2d 270, 275 (Tex. 1986). The court stated, "A jury could find that Byboth and Branscum manipulated a closely-held corporation, Texan Transfer, and formed competing businesses to ensure that Castleberry did not get paid." *Id.*

153. *See id.* at 272.

majority itself stated, "[a] sham to perpetrate a fraud . . . is separate from alter ego."[154] Yet, the only finding of the jury upon which judgment was based was that TTI was the alter ego of Branscum and Byboth.[155] If the doctrines of alter ego and sham are separate, how can the one jury finding of alter ego support the judgment of the Court inasmuch as there was no finding under the sham to perpetrate a fraud doctrine?

The *Castleberry* majority relied on a number of inappropriate cases which do not involve the same or similar factual situations in support of its novel application of the sham to perpetrate a fraud doctrine.[156] Many of these actually involve the theory of continuation of a corporate predecessor's business by a successor corporation.[157] For example, in *Dairy Co-operative Association v. Brandes Creamery*,[158] an Oregon case, the corporation was a party to a contract with a union and decided to dissolve and to distribute its assets to the shareholders.[159] The shareholders then contributed those assets for shares in a new corporation which conducted the same business as the previous corporation.[160] The union claimed that the second corporation was merely a continuation of business of the original company and that the new corporation, from its inception, was designed merely to avoid the contract.[161] The Oregon Supreme Court agreed with the union, holding that the new corporation was a continuation of the previous corporation, formed solely to evade the previous corporation's agreement with the union.[162] Such a theory would make the new corpora-

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154. *Id.*

155. *See id.* at 271, 275-76.

156. *See, e.g.*, Blank v. Olcovich Shoe Corp., 67 P.2d 376, 377-79 (Cal. App. Dep't Super. Ct. 1937); Plaza Express Co. v. Middle States Motor Freight, 189 N.E.2d 382, 384-85 (Ill. App. Ct. 1963); Team Central, Inc. v. Teamco, Inc., 271 N.W.2d 914, 923 (Iowa 1979); Addison v. Tessier, 335 P.2d 554, 557 (N.M. 1959); Dairy Co-Operative Ass'n v. Brandes Creamery, 30 P.2d 338, 342 (Or. 1934); Culinary Workers & Bartenders Union v. Gateway Cafe, 588 P.2d 1334, 1343 (Wash. 1979); Dummer v. Wheeler Osgood Sales Corp., 88 P.2d 453, 458 (Wash. 1939); Soderberg Advertising, v. Kent-Moore Corp., 524 P.2d 1355, 1361-62 (Wash. Ct. App. 1974); *see also* Castleberry v. Branscum, 721 S.W.2d 270, 275 (Tex. 1986).

157. *See, e.g.*, Blank v. Olcovich Shoe Corp., 67 P.2d 376, 377-78 (Cal. App. Dep't Super. Ct. 1937); Plaza Express Co. v. Middle States Motor Freight, 189 N.E.2d 382, 384-85 (Ill. App. Ct. 1963); Culinary Workers & Bartenders Union v. Gateway Cafe, 588 P.2d 1334, 1342-43 (Wash. 1979).

158. 30 P.2d 338 (Or. 1934).

159. *See id.* at 342.

160. *See id.* at 341 (new corporation merely added "Inc." to name).

161. *See id.*

162. *See id.* at 342.

tion liable for the debts of the old corporation.[163]

However, in *Castleberry*, the plaintiff was not suing CCI, the new corporation that conducted a business similar to that of TTI. Because Castleberry sued Branscum and Byboth under the alter ego theory,[164] the mere continuation of business theory cited by the *Castleberry* majority is inapplicable.[165] Additionally, the continuation of business theory does not support elimination of the requirement that actual fraud must be shown in order to hold shareholders personally liable for corporate contracts.[166] At most, the continuation of business cases would support the assumption of the TTI promissory note by CCI in its corporate capacity and would not support per se liability on its individual shareholders.[167]

The court of appeals was correct in holding that there was no evidence of alter ego because there was no evidence that Branscum and Byboth disregarded TTI's corporate formalities.[168] The "injustice to a claimant" element of the alter ego doctrine should not be based on a creditor's loss which is a possible or foreseeable consequence of dealing with a corporation.[169] If a purpose of a corporate entity is to limit financial liability of its shareholders, then it is unfair to rely upon a corporation's inability to pay a creditor's voluntarily negotiated debt as the sort of "injustice" which would permit recovery under the alter ego doctrine. However, by asserting the precedent established in *Cas-*

163. *Id.* It should be noted that CCI was not in the typical position of a company usually pursued under the mere continuation theory because it existed prior to TTI's demise. *See* Castleberry v. Branscum, 721 S.W.2d 270, 275 (Tex. 1986). However, Castleberry may have been able to bring an action for usurping a corporate opportunity. *See, e.g.,* International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963); Cardwell v. Wilson Trophy Co., 622 S.W.2d 651, 653 (Tex. Civ. App.—Fort Worth 1981, writ ref'd n.r.e.).

164. *See* Castleberry v. Branscum, 721 S.W.2d 270, 280 (Tex. 1986)(Gonzalez, J., dissenting).

165. *See* Blank v. Olcovich Shoe Corp., 67 P.2d 376, 379 (Cal. App. Dep't Super. Ct. 1937)(employed continuation of business theory to pierce corporate veil).

166. *See* Plaza Express Co. v. Middle States Motor Freight, 189 N.E.2d 382, 384 (Ill. App. Ct. 1963)(in continuation of business cases, issue not whether fraud occurred, but whether new corporation merely continuation of old corporation).

167. *See* Culinary Workers & Bartenders Union v. Gateway Cafe, 588 P.2d 1334, 1343 (Wash. 1979)(under continuation of business theory, new corporation may be liable for former corporation's obligations).

168. *See* Branscum v. Castleberry, 695 S.W.2d 643, 645 (Tex. App.—Dallas 1985), *rev'd,* 721 S.W.2d 270 (Tex. 1986).

169. *Cf.* Clark, *The Duties of the Corporate Debtor to its Creditors,* 90 HARV. L. REV. 505, 543 (1977)(corporations often attacked for being undercapitalized even though no deception practiced on creditors).

tleberry, a contractual claimant of a corporation may be able to persuade a judge and jury to hold the shareholders of a corporation jointly and severally liable for the contractual debt, thereby eliminating limited financial liability. Thus, *Castleberry* permits the creditor to renegotiate the contract between the creditor and the corporation in the courtroom by allowing terms to be read into a contract where the parties expressly disclaimed provisions, such as personal guarantees by shareholders. Such a result undermines the law of contract.

D. *The Trust Fund Doctrine as an Alternative Remedy*

The facts of *Castleberry* do not justify creation of a new doctrine of alter ego or any other veil-piercing theory. "Rather, it involves an altogether different doctrine . . . a doctrine long known in Texas jurisprudence as the 'trust fund doctrine.' "[170] After Castleberry agreed to sell his stock back to TTI in 1981, the corporation's net income fell dramatically, and in 1982 it lost over $16,000.00.[171] Furthermore, TTI's only asset, its trucks, were sold, and the proceeds from the sale were used to pay Byboth and Branscum "back salaries."[172] Since TTI was unable to pay the salaries, it should have been considered insolvent.[173] Additionally, since the main customer of TTI became CCI's customer, and TTI's assets were sold, TTI, arguably, ceased doing business.[174]

Under a codification of the trust fund theory, the Texas Miscellaneous Corporation Laws Act, article 1302-2.07.B[175] and the Texas Busi-

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170. Henry I. Siegel Co. v. Holliday, 663 S.W.2d 824, 828 (Tex. 1984)(Ray, J., dissenting). It is interesting to note that Justice Ray made the statement quoted in the text in his dissent in *Siegel*, but voted with the majority in *Castleberry*.

171. *See* Castleberry v. Branscum, 721 S.W.2d 270, 274 (Tex. 1986).

172. *See id.* at 279 (Gonzalez, J., dissenting).

173. *See* Lyons-Thomas Co. v. Perry Stove Mfg. Co., 86 Tex. 143, 165-66, 24 S.W. 16, 25 (1893)(if corporation's assets insufficient to pay debts and has practically or actually ceased doing business, then corporation is insolvent); *see also* Wortham v. Lachman-Rose Co., 440 S.W.2d 351, 354 (Tex. Civ. App.—Houston [1st Dist.] 1969, no writ)(directors, who paid themselves salaries out of assets of insolvent corporation found liable to corporation's creditors under trust fund doctrine).

174. *See* Lyons-Thomas Co. v. Perry Stove Mfg. Co., 86 Tex. 143, 165-66, 24 S.W. 16, 25 (1893)(corporation must practically or actually have ceased doing business for trust fund doctrine to apply).

175. Texas Miscellaneous Corporation Law Act, ch. 205, § 1, 1961 Tex. Gen. Laws 408, 410-11, *repealed by* Act of May 14, 1987, ch. 93, § 45, 1987 Tex. Sess. Law Serv. 417, 472 (Vernon), *recodified at* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon).

ness Corporation Act, articles 6.04.A(3)[176] and 7.12[177] were available to diminish or avoid the "inequitable result" suffered by Castleberry. For example, article 1302-2.07.B of the Texas Miscellaneous Corporation Laws Act provided that during the three year period following dissolution of a corporation, personal liability may be imposed upon corporate directors and officers as trustees, to the extent of the value of corporate assets received by them at dissolution for persons having valid claims against the corporation.[178] Also, the Texas Business Corporation Act, article 6.04.A(3) directed that if the assets of a dissolved corporation are inadequate to pay all of the corporation's debts, then those assets must be applied, to the furthest extent possible, to the payment of those debts.[179] Texas Business Corporation Act, article 7.12, while not impairing the trust fund remedy, expressed a legislative policy to restrict the use of the theory to pre-dissolution claims of a corporation, and to protect shareholders, officers and directors of a dissolved corporation from a "prolonged and uncertain liability" by requiring claims to be filed within three years of dissolution.[180]

The uncertainty created by the broad sham to perpetrate a constructive fraud doctrine announced by the majority in *Castleberry*

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176. Act of June 17, 1967, ch. 657, § 14, 1967 Tex. Gen. Laws 1717, 1725, *amended by* Act of June 11, 1987, ch. 355, § 1, 1987 Tex. Sess. Law Serv. 3527, 3527 (Vernon).

177. Texas Business Corporation Act, ch. 64, 1955 Tex. Gen. Laws 239, 294, *amended by* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon).

178. *See* Texas Miscellaneous Corporation Law Act, ch. 205, § 1, 1961 Tex. Gen. Laws 408, 410-11, *repealed by* Act of May 14, 1987, ch. 93, § 45, 1987 Tex. Sess. Law Serv. 417, 472 (Vernon), *recodified at* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon). Before article 1302-2.07 was repealed, to be incorporated into article 7.12 of the Texas Business Corporation Act, it read, in relevant part,

> the directors and officers shall be trustees for the benefit of creditors, shareholders, members, or other distributees of the corporation and shall be jointly and severally liable to such persons to the extent of the corporate property and assets that shall come into their hands.

TEX. REV. CIV. STAT. ANN. art. 1302-2.07B (Vernon 1980).

179. *See* Act of June 17, 1967, ch. 657, § 14, 1967 Tex. Gen. Laws 1717, 1725, *amended by* Act of June 11, 1987, ch. 355, § 1, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon).

180. *See* Texas Business Corporation Act, ch. 64, 1955 Tex. Gen. Laws 239, 294, *amended by* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon). Before the May 14, 1987 amendment, the article read,

> [t]he dissolution of a corporation . . . shall not take away or impair any remedy available or against such corporation, its officers, directors, or shareholders, for any right, or claim existing, or any liability incurred, prior to such dissolution if action or other proceeding thereon is commenced within three years after the date of such dissolution.

TEX. BUS. CORP. ACT ANN. art. 7.12 (Vernon 1980); *see also* Hunter v. Fort Worth Capital Corp., 620 S.W.2d 547, 551 (Tex. 1981)(recognizing codification of trust fund doctrine).

could have been avoided had Castleberry sought statutory or common law relief under the foregoing statutory provisions or the common law trust fund doctrine. The sales proceeds of the assets of TTI could have been traced to Branscum and Byboth.[181] The problem is "Castleberry simply did not assert the proper cause of action."[182] While the trust fund doctrine does not support piercing the corporate veil, if the proceeds had been traced to the defendants, the plaintiff could have sued them directly for breach of their fiduciary duties as trustees of the proceeds of TTI's assets.[183]

IV. CONCLUSION

Uncertainty will arise from inconsistent jury verdicts attempting to interpret and apply the unclear "inequitable result" standard of the constructive fraud element of the new *Castleberry* doctrine. The new rule suffers the same vagueness and shortcomings which Professor Hamilton attributed to the original *Pace* decision in that, "[T]he sheer breadth of this statement renders it almost useless."[184] Because of

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181. The usurpation of a corporate opportunity doctrine, the trust fund doctrine, the fraudulent conveyance statute and Act of May 14, 1987, ch. 93, § 3, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon) permit corporate creditors to trace corporate assets and their proceeds. *See, e.g.,* TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1987); TEX BUS. CORP. ACT ANN. art. 2.41.A(3)(Vernon Supp. 1987); TEX. TAX CODE ANN. § 171.255 (Vernon 1982); TEX. BUS. & COM. CODE ANN. §§ 24.03(a), 27.01 (Vernon 1968)(section 24.03(a) recodified and expanded at The Uniform Fraudulent Conveyance Act, ch. 1004, § 1, 1987 Tex. Sess. Law Serv. 6805, 6809-10 (Vernon)); Texas Miscellaneous Corporation Law Act, ch. 205, § 1, 1961 Tex. Gen. Laws 408, 410-11, *repealed by* Act of May 14, 1987, ch. 93, § 45, 1987 Tex. Sess. Law Serv. 417, 472 (Vernon), *recodified at* Act of May 14, 1987, ch. 93, § 31, 1987 Tex. Sess. Law Serv. 417, 459 (Vernon); *see also* International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576-77 (Tex. 1963)(usurpation of corporate opportunity); Cardwell v. Wilson Trophy Co., 622 S.W.2d 651, 653 (Tex. Civ. App.—Fort Worth 1981, writ ref'd n.r.e.)(usurpation of corporate opportunity).

182. Castleberry v. Branscum, 721 S.W.2d 270, 280 (Tex. 1986)(Gonzalez, J., dissenting).

183. *See* Tigrett v. Pointer, 580 S.W.2d 375, 397 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.)(Akin, J., dissenting).

> [i]f . . . the majority relies upon the trust fund doctrine as the primary ground for piercing the corporate veil, they err. This theory [trust fund] was neither pleaded by the plaintiff-garnishor nor presented to the trial judge. Secondly, it is impermissible to use this separate and distinct doctrine to support an alter ego theory of recovery. . . . The disparate remedies provided by the trust fund doctrine and the alter ego theory mandate that the former should not be used as a crutch in applying the latter.

Id.

184. *See* 19 R. HAMILTON, BUSINESS ORGANIZATIONS § 234, at 224 (Texas Practice 1973). Another shortcoming of the *Castleberry* doctrine is that the court held that piercing the corporate veil is a fact question for the jury, rather than a mixed question of law and fact for the judge and jury. *See* Castleberry v. Branscum, 721 S.W.2d 270, 277 (Tex. 1986).

existing statutory and common law remedies, the new rule serves no useful public purpose and may burden or discourage business transactions.

The effect of the majority opinion in *Castleberry* will likely reach far beyond the facts of the case. The handful of cases decided after *Castleberry* appear to use the inequitable result/sham to perpetrate a constructive fraud concept to support an alter ego theory.[185] The decision, which did not distinguish between directors, officers, and shareholders, encourages litigation by contractual claimants against shareholders (as well as against directors and officers) in state court when the shareholders' corporation has sought protection from creditors in federal bankruptcy court.[186] The new doctrine further appears to permit a contractual claimant to unilaterally modify the contract after the complete understanding of the parties is set forth in the written contract, by including shareholder guarantees of payment or performance which were specifically excluded in the contract.

The new rule propounded by the majority of the court could ultimately lead to per se shareholder liability for corporate contractual obligations. For example, the recent interpretation of *Lucas v. Texas Industries, Inc.*[187] by the Houston Court of Appeals stated, "in a tort case where the issue of alter ego is to be determined, the test is 'whether the corporation responsible for the plaintiff's injury is capable of paying a judgment upon proof of liability.' "[188] Consequently, the logical extension of this language is that any corporate contractual claimant may be entitled to seek collection of corporate debts from shareholders because the tort/contract distinction identified in *Lucas* has been blurred or eliminated by the *Castleberry* majority.

Per se shareholder liability may also arise because every contractual creditor of a corporation will normally be able to show that default in

185. *See, e.g.,* Riquelme Valdes v. Leisure Resource Group, Inc., 810 F.2d 1345, 1352-53 (5th Cir. 1987); Robbins v. Robbins, 727 S.W.2d 743, 744-45 (Tex. App.—Eastland 1987, writ ref'd n.r.e.); Francis v. Beaudry, 733 S.W.2d 331, 335 (Tex. App.—Dallas 1987, writ ref'd n.r.e.).

186. *See* S.I. Acquisition, Inc. v. Eastway Delivery Serv., 817 F.2d 1142, 1153 (5th Cir. 1987)(alter ego veil-piercing remedy belongs to debtor corporation in bankruptcy as against corporate shareholders, directors, and officers). The approach taken in *Acquisition* ignores the possible agent status of a corporation with respect to directors, officers, and shareholders. *See generally* R. HAMILTON, BUSINESS ORGANIZATIONS § 234 (Texas Practice 1973).

187. 696 S.W.2d 372 (Tex. 1984).

188. O'Berry and O'Berry v. McDermott, Inc., 712 S.W.2d 206, 207 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

payment of a contractual obligation constitutes an inequitable result, thus satisfying the constructive fraud element of the *Castleberry* doctrine. Moreover, default itself may be evidence that the corporation may not be "capable of paying a judgment upon proof of liability."[189] Such a per se result would be inconsistent with the legislative intent embodied in Texas law governing corporations. If the trend continues, can the corporation survive? What will be the economic impact of the uncertainty raised by *Castleberry*?

The plaintiff's petition ignored more than one cause of action that could have provided a basis for the plaintiff to recover, in whole or in part, from the two remaining TTI shareholders. Instead, the *Castleberry* majority incorrectly granted the plaintiff a new remedy to pierce the corporate shield and hold the shareholders jointly and severally liable for the full amount of the corporate note. Breach of the trust fund doctrine alone may not be used to support piercing the corporate veil.[190] However, the trust fund doctrine would have provided an adequate remedy to the plaintiff as to the proceeds from the sale of TTI's assets taken by the defendants.

V. APPENDIX

To reduce the uncertainties and inappropriate effects arising from the new *Castleberry* doctrine, enactment of legislation by the Texas Legislature will likely be necessary. Shareholder protection deserves the same protection extended by the Texas Legislature in 1979 to protect limited partners when Section 8 of the Texas Uniform Limited Partnership Act was amended to overrule the Texas Supreme Court decision of *Delaney v. Fidelity Lease Limited*, 526 S.W.2d 543 (Tex. 1975).

The following is offered as a model to clarify when a shareholder may be held by a court to be personally liable for a contractual obligation of the shareholder's corporation:

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189. *Id.*

190. *See* Tigrett v. Pointer, 580 S.W.2d 375, 397 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.)(impermissible to use trust fund doctrine as sole means of supporting alter ego theory of recovery).

Proposed Article 1302-2.11 of the Texas Miscellaneous Corporation Laws Act

Art. 1302-2.11 Liability of Shareholders for Agreements of Corporations.

A. In this article, "corporation" means any corporation, domestic or foreign, including without limitation a corporation that is organized, or qualified as a foreign corporation, under the Texas Business Corporation Act, the Texas Non-Profit Corporation Act (Article 1396-1.01 et seq., Vernon's Texas Civil Statutes), the Insurance Code of Texas, the Electric Cooperative Corporation Act (Article 1528b, Vernon's Texas Civil Statutes), any agricultural cooperative marketing association organized under the Co-operative Marketing Act (Article 52.001 et seq., Vernon's Texas Civil Statutes), the Telephone Cooperative Act (Article 1528c, Vernon's Texas Civil Statutes), and any association organized under the Texas Savings and Loan Act (Article 852a et seq., Vernon's Civil Statutes).

B. A record or beneficial owner of shares of a corporation is not liable for any obligation arising out of any agreement by the corporation unless (i) the owner has expressly assumed, guaranteed or otherwise agreed with the obligee to be liable for the obligation, (ii) the obligee demonstrates by a preponderance of the evidence that the owner caused the corporation to be used for the purpose of perpetrating, and did perpetrate, an actual fraud on the obligee primarily for the direct personal benefit of the owner, or (iii) the owner is liable for the obligation under another applicable statute.

C. If an owner of shares is found to be liable to an obligee under clause (ii) of part B of this article, the owner's liability is limited to the value of the direct or indirect personal benefit actually received by the owner as a result of the fraud.