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Corporations—Stockholders' Personal Liability—Application of Agency or Under-capitalization Theory to "Pierce Corporate Veil."—Walkovszky v. Carlton

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for the protection of the discharged debtor and a clear recognition of the duty to evaluate fully the practical adequacy of his remedy in the state forum. Consequently, *Fallick v. Kehr* represents not only a reaffirmation of the protective policy of the Bankruptcy Act, but also a prospective warning to creditors who abuse their traditional right to have the issue of dischargeability determined in the forum of their choice.

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Corporations—Stockholders' Personal Liability—Application of Agency or Undercapitalization Theory to "Pierce Corporate Veil."—*Walkovszky v. Carlton*.[1]—Seon Cab Corporation consisted of two taxicabs, each heavily mortgaged, each with the minimum $10,000 liability insurance required by New York law.[2] Carlton and two others were the organizers and principal stockholders of Seon Cab and of nine other cab corporations, each with similar assets. Plaintiff Walkovszky alleged that he sustained personal injuries when he was struck by a taxicab owned by Seon Cab. Since the corporate assets of Seon Cab were insufficient to cover plaintiff's damages, he attempted to gain the deficiency by joining as defendants the nine other corporations and the stockholders, in addition to the driver and Seon Cab.[3] The trial court's ruling, which had dismissed the complaint against the stockholders, was reversed by the New York Supreme Court, Appellate Division.[4] They therefore appealed to the Court of Appeals which HELD: The complaint is dismissed for failure to state a cause of action against the individual defendants,[5] since in New York a stockholder is not personally liable for the torts of his corporation unless there is a showing that he was conducting its business in his individual capacity without regard to the corporate entity.[6]

The holding of the Court of Appeals follows a long line of New York decisions based upon the precepts of Judge Cardozo in *Berkey v. Third Ave. Ry.*,[7] wherein he stated:

> [T]he corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an "alias" or "dummy." . . . [T]he essential term to be defined is the act of operation. Dominion may be so complete, interference

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1 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).

2 N.Y. Veh. & Traf. Law § 370(1)(a) (McKinney Supp. 1966).

3 This action was also brought against two other corporations, not important to the outcome of this case.

4 Walkovszky v. Carlton, 24 App. Div. 2d 582, 262 N.Y.S.2d 334 (1965).

5 The claim against Seon Cab and the other cab corporations is still pending.

6 See, e.g., African Metals Corp. v. Bullowa, 288 N.Y. 78, 41 N.E.2d 466 (1942); Natelson v. A.B.L. Holding Co., 260 N.Y. 233, 183 N.E. 373 (1932); Quaid v. Ratkowsky, 183 App. Div. 428, 170 N.Y.S. 812 (Sup. Ct. 1918), aff'd, 224 N.Y. 624, 121 N.E. 887 (1918).

7 244 N.Y. 84, 155 N.E. 58 (1926).

> so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.[8]

The New York courts have consistently adhered to this rule despite the fact that the ends of justice might otherwise require the disregarding of the separate entity of the corporate structure. Although the theory of agency, as described in *Berkey*, is used most often to hold a parent liable for the contracts or torts of a subsidiary,[9] it has also been occasionally extended to hold a stockholder liable for the debts of his corporation.[10] The latter occurs when the corporation is a "dummy" for its stockholders, who are really carrying on the business in their individual capacity.[11] It appears, then, that the New York courts will apply their "agency" rule to pierce the corporate veil to hold a stockholder or a parent corporation liable only in those situations in which its control over the corporation is so overwhelming that the court cannot reasonably ignore it.

In *Mangan v. Terminal Transp. Sys.*,[12] a managing corporation was established to control all the operational details of four operating cab corporations. The managing corporation was held liable for the negligence of a driver of one of the operating corporations. Since the managing corporation's control over the operating corporations was so dominant, the court was easily able to see a principal-agent relationship between the parent and subsidiary. In *Majestic Factors Corp. v. Latino*,[13] a corporation, without assets of any kind, was formed by five partners in an attempt to insulate themselves from personal liability occasioned in the partnership. The court found that because the corporation was completely dominated and controlled by the partners, the corporation was merely the "selling agent" for the partnership, and therefore did not insulate the individuals from personal liability. It should be noted that in both *Mangan* and *Latino* control was so great that the court was able to conclude that, in effect, a principal-agent relationship existed.

The New York courts do not seem to have too much difficulty in applying the *Berkey* agency theory where they can point to a parent-subsidiary relationship, such as that which existed in *Mangan*. However, a problem arises when, as in the *Walkovszky* case, there is no such preexisting parent-subsidiary situation. The courts do not seem willing to "construct" a principal-agent relationship where a group of stockholders organize and, as officers, direct many small corporations, even if the control exercised by them is very extensive, since this is legally protected operating procedure for close corporations.

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[8] Id. at 94-95, 155 N.E. at 61.

[9] Robinson v. Chase Maintenance Corp., 20 Misc. 2d 90, 190 N.Y.S.2d 773 (Sup. Ct. 1959); Mangan v. Terminal Transp. Sys., 157 Misc. 627, 284 N.Y.S. 183 (Sup. Ct. 1935), aff'd, 247 App. Div. 853, 286 N.Y.S. 666 (1936).

[10] Majestic Factors Corp. v. Latino, 15 Misc. 2d 329, 184 N.Y.S.2d 658 (Sup. Ct. 1959).

[11] Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942); Natelson v. A.B.L. Holding Co., supra note 6.

[12] 157 Misc. 627, 284 N.Y.S. 183 (Sup. Ct. 1935), aff'd, 247 App. Div. 853, 286 N.Y.S. 666 (1936).

[13] 15 Misc. 2d 329, 184 N.Y.S.2d 658 (Sup. Ct. 1959).

In *Walkovszky*, no managing corporation was ever organized; the three stockholders performed the necessary managerial functions in their capacities as the officers and directors of the ten cab corporations. The court would not analogize the stockholders in *Walkovszky* to the managing corporation in *Mangan* for purposes of constructing a principal-agent relationship and thereby holding the stockholders liable for the torts of their "agent," Seon Cab. In this regard the court was correct, for if stockholders observe the formalities of incorporation and exercise control in a manner which is usual for the close corporation, they should not be individually liable. Thus, reliance on the *Berkey* agency theory alone, without examining other theories upon which the corporate fiction may be disregarded, severely circumscribes the court from judging on its merits a case that otherwise demands piercing of the corporate veil.

In *Walkovszky*, the court was confronted solely with a motion to dismiss by the individual defendants. It is submitted that the court dismissed this case too soon, for it should have considered more carefully two other issues: (1) whether or not the ten corporations were in reality a single enterprise, and (2) whether or not either Seon Cab or the ten-cab enterprise was undercapitalized. The court should have determined whether the facts were sufficient to allow the tort claimant to go beyond the single cab corporation and combine all ten corporations as an enterprise entity. This might have been accomplished by analogizing the common stockholders in *Walkovszky* to the managing corporation in *Mangan*, but only for the purpose of establishing an enterprise entity—not for placing liability on the individual stockholders. The theory of an economic enterprise entity was first systematically established by Professor Berle.[14] His thesis is that the sovereign grants the status of "corporation" to a definable group, engaged in an enterprise.[15] Professor Berle, however, circumscribes the scope of his thesis by limiting its application to the situation where a principal-agent relationship is established. This seems to be an unduly severe restriction of the possible use of this theory. The courts are supposed to be able to "disregard the corporate fiction specifically because it has parted company with the enterprise-fact, for whose furtherance the corporation was created . . . ."[16] It is submitted that, as established by Berle, the enterprise theory does not promote a more workable guide for disregarding the corporate entity, since it fails to examine the actual economic facts in determining the enterprise entity. Thus, where there are many small corporations owned and controlled substantially by the same persons in the same or similar types of business, the corporations should be viewed as a single enterprise; this should not depend on the finding of a principal-agent relationship.

A close examination of the economic realities in *Walkovszky* might reveal that the enterprise was not Seon Cab but the ten cab corporations

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[14] Berle, The Theory of Enterprise Entity, 47 Colum. L. Rev. 343 (1947).

[15] Each individual corporation established under the laws of the state is presumed to be a separate enterprise. If, in fact, the corporation does not encompass the assets and liabilities of an enterprise, the courts should disregard it as a separate entity and judicially construct the actual entity. Id. at 344.

[16] Id. at 348.

together. If the court had examined the ten corporations under the literal meaning of the Berle theory, it could have determined that the stockholders had cleverly evaded its scope by not establishing a *controlling* partnership or corporation which could create a principal-agent relationship. Without the parent-subsidiary relationship which Berle envisioned for application of his "enterprise entity" theory, the New York courts will look no further. A realistic test requires the courts to look to the actual substantive enterprise without being constricted solely by agency rules.

Even if the court in *Walkovszky* could not find that all ten corporations formed a single enterprise, it could have gone further to determine whether the individual stockholders should be personally liable. Having found no agency, the court, in order to place liability on the stockholders, should then consider whether Seon Cab was undercapitalized.[17] New York courts, however, tend to avoid this issue,[18] despite the fact that many other courts consider whether or not a corporation is adequately capitalized before allowing it to reap the benefits of limited liability.[19]

The concept of adequate capitalization is not to be found in modern corporation statutes, although they may provide for a minimum amount of capital which must be subscribed and/or paid in before the corporation may legally begin to function. Provisions commonly permit the corporation to be formed with $500 or $1,000 stated capital.[20] While this is a statutory minimum to legal existence, many courts have imposed a more logical test by requiring each individual corporation to place at risk sufficient capital to meet the reasonably foreseeable expenses of the particular business.[21] One court put it this way:

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[17] All states today have laws which grant stockholders the privilege of putting needed capital at the risk of the business, while at the same time freeing from that risk their uninvested assets. Garrett & Garrett, Choosing the Form of Business Enterprise, 1954 U. Ill. L.F. 359. The allowance of limited liability has been consistent with the public interest in encouraging investment in risky enterprises while still protecting creditors. Douglas & Shanks, Insulation from Liability Through Subsidiary Corporations, 39 Yale L.J. 193 (1929). This privilege, however, is limited.

> Contribution of risk capital to respond to the corporation's debts is the required consideration for the stockholder's personal immunity. . . . [Many] courts will not tolerate any arrangement which would throw all the risks and hazards of the business upon the public who deal with it, and at the same time enable the stockholders to realize all possible gains while being secure against loss in the event the enterprise should prove unprofitable . . . .

Dix, Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation, 53 Nw. U.L. Rev. 478, 483-84 (1958).

[18] See Bartle v. Home Owners Coop., 309 N.Y. 103, 127 N.E.2d 832 (1955).

[19] See, e.g., Anderson v. Abbott, 321 U.S. 349 (1944); Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962); Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

[20] See, e.g., Ky. Rev. Stat. Ann. § 271.085 (1963); N.J. Stat. Ann. § 14:2-3(e) (1937); Ohio Rev. Code Ann. § 1701.04(A)(5) (Baldwin 1964); Wis. Stat. Ann. § 180.48 (1957); Model Bus. Corp. Act Ann. § 48(g) (1960).

[21] See, e.g., Weisser v. Mursam Shoe Corp., supra note 11; Arnold v. Phillips, 117 F.2d 497 (5th Cir.), cert. denied, 313 U.S. 583 (1941); Automotriz Del Golfo De California S.A. v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957). The test of adequacy of capitalization should not be applied in an exact sense. It would not be desirable to assess a figure of what is adequate capitalization for a particular business,

> If . . . a corporation is organized with an obviously inadequate capital setup, such fact may be considered in determining whether the corporate entity should be disregarded. . . .
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> . . . .
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> Inadequate financing . . . is . . . an important factor . . . in determining whether to remove the insulation to stockholders normally created by the corporate method of operation. But in such a case it is incumbent upon the one seeking to pierce the corporate veil to show by evidence that the financial setup of the corporation is just a sham, and accomplishes injustice.[22]

Whether a corporation is adequately capitalized will depend on the circumstances surrounding the corporation in each individual case.

> It may be that the popcorn man on the corner with little to anticipate in the way of credit for his immediate needs and with small danger of large tort liability would be adequately capitalized at the minimum of $500 or $1,000 . . . . But what of the owner of a fleet of taxis . . . ? If [he] . . . incorporate[s], what is the test of adequate capitalization so that [he] . . . can be sure that [he] . . . will not be held individually for the debts or tort claims of [his] . . . corporations?[23]

Though there are no settled rules to test the adequacy of capitalization, in *Abbott v. Anderson*[24] the United States Supreme Court did establish a workable formula: "An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in cases denying stockholders their defense of limited liability."[25] The courts look to whether the corporation had enough capital to meet the ordinary foreseeable risks of operation, including foreseeable tort liability. Posing the test in this manner, the courts try to avoid placing all the risk of incorporation on the public while giving all the benefits to the incorporators.

In *Walkovszky*, the plaintiff attempted to base his cause of action on a theory of undercapitalization. He contended that the public has a right to assume that the industry has taken adequate precautions to assure recovery for tort damages should an accident occur. He then alleged that Seon Cab was undercapitalized, since a $10,000 insurance policy was not sufficient to provide against reasonably foreseeable tort liability.[26] Plaintiff based his argument on a proposition stated in a previous New York case:

> Since the taxicab industry is vested with a public interest, and is one of considerable hazard, the attempt to subject injured persons

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and, merely because the corporation is below this figure, to deny the stockholders limited liability. Therefore, most courts will not employ adequacy of capitalization as the sole criterion for determining liability. See Annot., 63 A.L.R.2d 1051 (1959).

[22] Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 492-93, 197 P.2d 167, 173-74 (1948).

[23] Lattin, Corporations 71 (1959).

[24] 321 U.S. 349 (1944).

[25] Id. at 362.

[26] Brief for Plaintiff, p. 2.

> to the inadequate assets, ostensibly the operating capital of any of the operating corporations, as alleged works a *fraud, injustice and unjust enrichment*.[27] (Emphasis added.)

The *Walkovszky* court summarily dismissed this argument, stating that "whatever rights [the plaintiff] . . . may be able to assert against the parties other than the registered owner of the vehicle come into being not because he has been defrauded but because, under the principles of *respondeat superior*, he is entitled to hold the whole enterprise responsible for the acts of its agents."[28]

Judges Keating and Bergman, dissenting, wanted to go beyond the *Berkey* theory of agency, and questioned

> whether the policy of this State, which affords those desiring to engage in a business enterprise the privilege of limited liability through the use of the corporate device, is so strong that it will permit that privilege to continue . . . no matter how irresponsibly the corporation is operated, no matter what the cost to the public.[29]

They therefore considered factors other than control and respondeat superior, such as public policy and undercapitalization, and found that the stockholders had *intentionally* undercapitalized Seon Cab so as to avoid their public responsibility. From this the dissenters concluded that "a participating stockholder of a corporation vested with public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of the corporation's business, may be held personally responsible for such liabilities."[30]

One must inevitably wonder why someone in the position of the defendants would not acquire more than $10,000 worth of insurance, especially since such a corporation would be held liable for any judgment exceeding $10,000. The answer appears to lie in a curious loophole in the bankruptcy laws. Let us assume that damages from a tort action are so great that Seon Cab declares bankruptcy. Under the New York City Administrative Code, a taxicab medallion, the corporation's only other valuable asset, is not voluntarily transferable unless the transferee assumes the liabilities of the transferor; it is involuntarily transferable for one year only.[31] The trustee in bankruptcy, under Section 70(a) of the Federal Bankruptcy Act,[32] would take title to all property of the bankrupt. The rationale of the Supreme Court in *Board of Trade v. Johnson*[33] permits the trustee to succeed to the bankrupt's rights in the taxicab license, under section 70(a)(5), because the cab corporation had the right to voluntarily transfer the license, subject to the approval of the appropriate official, after showing that the transferee

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[27] Robinson v. Chase Maintenance Corp., 20 Misc. 2d 90, 92, 190 N.Y.S.2d 773, 775 (1959).

[28] 18 N.Y.2d at —, 223 N.E.2d at 10, 276 N.Y.S.2d at 591.

[29] Id. at —, 223 N.E.2d at 11, 276 N.Y.S.2d at 592.

[30] Id. at —, 223 N.E.2d at 14, 276 N.Y.S.2d at 595.

[31] N.Y.C. Admin. Code § 436-2.0. (1937).

[32] 30 Stat. 565 (1898), as amended, 11 U.S.C. § 110(a) (1964).

[33] 264 U.S. 1 (1924).

had assumed the liabilities of the transferor. Under the *Johnson* case, the trustee would not be entitled to use the license, but could only control the bankrupt's right to dispose of it; nor would the trustee be able to transfer the asset absent the restrictions placed on it.[34]

Although the trustee could acquire title to the medallion, the liability attached to it would make it very burdensome to him. Therefore, the trustee would be desirous of either not succeeding to the title or, once having assumed title, to get a court order allowing him to abandon the property. When the trustee abandoned the property, it would revert to the bankrupt.[35]

Since the tort claimant has no standing as a secured creditor, he would be considered a general creditor with a claim provable under sections 63a(7) and (8). Six months after the adjudication of bankruptcy, the corporation could petition the court for discharge. Since the claim of the judgment creditor (tort claimant) was allowable and provable, the bankrupt would be released from it by the court's discharge.[36]

In effect, then, Seon Cab would emerge from a bankruptcy proceeding with its medallion free from encumbrance and with the tort claimant's judgment extinguished. It can be presumed that the incorporators of Seon Cab knew of this result, and from such knowledge can be inferred the requisite intent to undercapitalize the corporation.

The dissent would have the majority accept the undercapitalization theory to disregard the corporate entity, at least as a rationale for curing the gross inequities in the taxicab industry.[37] Then, by establishing the measure of adequate capitalization for Seon Cab or the ten-cab enterprise, the court would have to determine whether either one was so undercapitalized as to warrant revocation of limited liability. Although the preceding discussion indicates that liability would be clearly warranted, this result may be precluded by certain New York legislation. Certainly in the instant case much weight would have to be placed on the New York statute which prescribed the minimum liability insurance required for taxicabs.[38] The court must determine whether the mandatory insurance set by statute is, absent other assets, sufficient capital to protect tort claimants, or whether a higher figure should be judicially established. The dissent viewed the mandatory insurance simply as a minimum figure set by statute to "provide at least *some small fund* for recovery against those individuals and corporations who just did not have and were not able to raise or accumulate assets sufficient to satisfy the claims of those who were injured as a result of their negligence."[39] (Emphasis added.)

It is difficult to agree with this view. The argument used by the dissent —that the statute established merely a minimum requirement—is similar to

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[34] Id. at 11.

[35] See Helvey v. United States Bldg. & Loan Ass'n, 81 Cal. App. 2d 647, 184 P.2d 919 (1947).

[36] That is, of course, unless the creditor's claim is not dischargeable. See Joslin, Torts and Bankruptcy—A Synthesis, 1 B.C. Ind. & Com. L. Rev. 185, 190-95 (1960).

[37] See Mull v. Colt Co., supra note 19, at 158-60.

[38] N.Y. Veh. & Traf. Law § 370 (McKinney Supp. 1966).

[39] 18 N.Y.2d at —, 223 N.E.2d at 13, 276 N.Y.S.2d at 594.

that which is generally accepted by courts holding that the amount of paid-in capital required by the incorporation statute is not conclusive of adequate capitalization, but merely a prerequisite to legal recognition of the corporation. However, this "minimum requirement" argument does not have the same validity when applied to the New York mandatory-insurance statute. In the latter case, the legislature has established a specific insurance figure for the taxicab industry, not a general figure applicable to all corporations, as is the paid-in capital figure.

The legislature must be deemed to have known that most cab operators are incorporated for the purpose of preventing personal responsibility, and the minimum-insurance statute must be regarded as a clear indication of what the legislature thought was adequate protection for the public. Thus, for the purposes of limited liability, a $10,000 insurance policy should be considered an adequate asset to compensate tort claimants. The legislature's intent to have it so is clear, especially when it is noted that the liability insurance was increased from $5,000 to $10,000 in 1959, and that the statute has been twice amended since then without further increases. It is extremely difficult to say that the court would be protecting legislative policy by judicially increasing the minimum amount of insurance needed by taxicabs. The incorporators are not using the corporate form to defeat or avoid any legislative policy, but are only taking advantage of a legitimate form of organization. If the $10,000 figure set by the legislature is not sufficient, it should be raised by the legislature.

ANDREW J. NEWMAN

Labor Law—Labor Management Relations Act—Section 9(b)(2)—Requirements for Severance of Craft Workers.—*Mallinckrodt Chem. Works.*[1]—Mallinckrodt Chemical Works, Uranium Division, Waldon Springs, Missouri, was engaged in the manufacture of uranium metal and in the purification of uranium ore under a cost-plus-fixed-fee contract with the Atomic Energy Commission. Of its 560 employees, 280 were engaged in production and maintenance, and were represented by the Independent Union of Atomic Workers. Local 1 of the International Brotherhood of Electrical Workers petitioned the National Labor Relations Board to sever twelve instrument mechanics from the unit represented by the Atomic Workers.

The IBEW claimed to have been a traditional representative of the type of craftsmen involved in the suit. Petitioner demanded severance on the basis of the need for separate representation of the instrument mechanics as a "functionally distinct and homogeneous traditional departmental group."[2] HELD: Petitioner does not qualify as a traditional representative of instrument mechanics of the type involved in this case, nor does the record indicate that the interests of the mechanics have been neglected by the Atomic Workers. Although the instrument mechanics do constitute a group of skilled journeymen mechanics,

[1] 162 N.L.R.B. No. 48, 64 L.R.R.M. 1011 (1966).
[2] Id., 64 L.R.R.M. at 1012.