Regulation of Abuse of the Corporate Form and Disregard of the Corporate Entity

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I. INTRODUCTION

Much of the industrial and commercial development of the nineteenth and twentieth centuries has been made possible by the corporate mechanism. The business corporations have far-reaching effects on the national economy, and their social functions are diversified and enormous.

But this mechanism brings many unexpected defects, among which is the abuse of the corporate form. The most characteristic attribute of the corporation is the separate corporate personality. A corporation is a distinct and separate entity from its members. It is a legal unit with a capacity to hold property and make contracts like a person, to sue and be sued and to continue to exist, notwithstanding changes of its shareholders. The concept of corporate personality has frequently been used as a vehicle for illegal or unjust practices which can harm both society and the individual. A typical example is the undercapitalized corporation. It is essential that such practices be effectively regulated.

Two methods of regulation are available. One is the preventive measure. Thus setting the minimum limit of capital and preserving the capital at all times would be a solution in the case of the example above. The other method is to take corrective measures. This can be done in two ways. Either the abused corporate entity may be eliminated completely, or its separate entity may be disregarded in particular legal situations leaving intact its general existence. Korean commerical law adopts the former approach (dissolution order of Art. 176 of the Commerical Code), but

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many legal systems apply the latter one. The so-called doctrine of the disregard of corporate entity is a solution based on the latter approach. As will be shown later, this doctrine, though it is not restricted to the United States, has been formed and developed mainly by the courts of that country. But this doctrine is still in the process of refinement. There is no rule of thumb which can be applied equally in all cases.

This paper will survey how the courts of different countries try to correct the abuse of the corporate form, with emphasis on the American doctrine of disregard of the corporate entity and the so-called "Durchgriffslehre" which was developed by the German courts. It will then study whether these approaches can be applied to Korean situations.

This paper will not indulge in the conceptual controversy on the nature of the corporate personality. Those who regard it as a reality may be more reluctant to disregard the corporate entity than those who regard it as a fiction. But the above doctrine circumscribes the activities of a corporation and the actual result reached in a given case does not have much to do with which position one takes on the nature of the corporate personality.

Second, this survey will be generally limited to the problems of the private law, especially corporation law. The doctrine has met with a great deal of attention in numerous special fields, as, for example, the law of taxation, of trading with the enemy, criminal law, economic law, procedural law, etc. But in all these fields special considerations apply, which are absent from the realm of the private law which is the chief domain of the doctrine of the corporate personality. The paper is devoted to this central field alone.

II. THE DOCTRINE OF THE DISREGARD OF THE CORPORATE ENTITY

In general a corporation may exist and act as an entity or legal unit separate and apart from its shareholders. When a corporation acquires property, the title vests in it as a distinct legal person and if it incurs liability, this must be paid out of the corporate assets. To quote Justice Holmes' statement, "the corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest

in its property to its members."[1] But when the corporate form has been used for an illegal or inequitable purpose, the courts will place limitations upon the privilege and regard the corporation as a mere collection of persons. These decisions are usually expressed in terms of "disregarding the corporate entity or fiction", or "piercing the corporate veil", or "lifting the veil". But as Professor Ballantine properly pointed out, the problems involved in these cases are to be solved not by "disregarding" the corporate personality, but by a study of the just and reasonable limitations upon the exercise of the privilege of separate capacity under particular circumstances. If the separate capacity is perverted to dishonest uses, the courts will interpose to correct the abuse.[2] Many scholars have tried to systematize the courts' decisions,[3] but so far none of them has been fully successful.

This essay will survey those typical cases where the courts applied the above doctrine, study the theoretical grounds suggested, and examine the factors which lead the courts to discard the separate entity concept. Finally, a brief review on the effects when the corporate entity is disregarded will be given. Since this field is full of legal metaphors and epithets, often obscuring the real issues involved, it is very difficult to find a principle behind various lines of decisions.

1. TYPICAL CASES

A. Cases in which the separate entity concept of a corporation has been limited abound. It is almost impossible and certainly fruitless to explain these cases exhaustively without any attempt to systemize them. We can arrange those cases by many criteria; some will be adopted in the following explanation.

Professor Wormser, who first made a comprehensive study of this subject in 1912, had this to say:

"When the conception of corporate entity is employed to defraud creditors, to

1) Klein v. Board of Tax Supervisors, 282 U.S. 19 at 24 (1930).
2) Ballantine, Corporations (rev. ed., 1946). 292—293.
3) Important works are: Wormser, Piercing the veil of corporate entity, 12 Colum. L. Rev. 496 (1912); Douglas and Shanks, Insulation from liability through subsidiary corporations, 39 Yale L. J. 193 (1929); Latty, Subsidiaries and Affiliated Corporations (1936); Fuller, The incorporated individual: A study of the one-man company, 51 Harv. L.Rev. 1373(1938). Berle, The theory of enterprise entity, 47 Colum. L. Rev. 343 (1947); Cataldo, Limited liability with one-man companies and subsidiary corporations, 18 Law & Contemp. Prob. 473 (1953).

evade an existing obligation, to circumvent a statute, to achieve or perpetrate monopoly or to protect knavery or crime, the courts will draw aside the web of entity, will regard the corporate company as an association of live, up-and-doing, men and women shareholders, and will do justice between real persons."[4]

His generalization, although too broad, gives some examples where the concept of separate corporate entity is ignored by the courts. Let us first briefly scan these examples.

(1) Attempts to hinder, delay or defraud creditors.

The corporate device has often been employed in order to hamper, delay or defraud creditors. The decision of the New York Court of Appeals in Booth v. Bunce[5] is one of the earliest cases which dealt with this problem. In that case the members of a financially embarrassed partnership united in forming a manufacturing corporation. They then transferred to it the stock, property and machinery of the partnership. Booth was a bona fide creditor of the partnership, while Bunce was a creditor of the corporation. Booth issued an execution upon his judgment against the partnership to the sheriff, who levied upon a steam engine in the corporation's machine shop. Bunce also issued an execution upon his judgment to the sheriff, who levied upon the same steam engine. The issue was, in substance, a contest between the two creditors to secure their respective claims out of the steam engine transferred by the partnership to the corporation. The court held that the property transferred might be taken on execution by Booth, since it appeared that the corporation was organized to defraud the creditors of the partnership and the property was transferred in furtherance of that fraudulent purpose. The court considered the corporate entity to be a nullity.

The case of First National Bank of Chicago v. Trebin Company,[6] will make it clear that the courts ignore the concept of legal corporate entity when it is used as a shield for fraudulent attempts to swindle creditors. In that case, an insolvent individual, F. C. Trebin, together with his wife, his daughter, his son-in-law, and his brother-in-law, formed a corporation and then conveyed to it every tangible property which Trebin owned. His creditors averred and proved that the purpose in creating the

4) Wormser, Piercing the veil of corporate entity, 12 Colum. L. Rev. 496, at 517 (1912).
5) 33 N.Y. 139 (1865).
6) 59 Ohio St. 316 (1898).

corporation was to hinder and defraud them. The court held that "the corporation was in substance another F.C. Trebin", and that "his identity as owner of the property was no more changed by his conveyance to the company than it would have been by taking off one coat and putting on another." To give further cases would be redundant.[7]

(2) Attempts to evade contractual obligations.

Corporations have sometimes been organized to evade contractual obligations. In more than one case the corporate device was employed to circumvent a contract in restraint of trade. In Beal v. Chase,[8] defendant Chase, for a large and adequate consideration, sold his printing and publishing business together with certain newsaper copyrights to the plaintiff, and agreed not to engage directly or indirectly in the business of printing and publishing in the state of Michigan so long as Beal should remain in the same business in Ann Arbor, Michigan. Later, the defendant formed a corporation of which he became a principal shareholder, president and business manager, and began a general printing and publishing business. He also started a newspaper. The court held that Chase could not compete with Beal under the guise of a corporation.

In Higgins v. California Petroleum & Asphalt Co.,[9] a lessee corporation attempted to evade the payment of royalties under a lease by the following scheme. The plaintiff and Ashely were owners in severalty of two adjoining tracts of land. They jointly executed a written lease to Sheerer for the term of twenty years assigning to him all bituminous rock and liquid asphaltum removed. Later defendant California Petroleum & Asphalt Co. (hereinafter referred to as Cal. P. & A. Co.) became the sole owner of the lease by assignment and also purchased the tract of land owned by Ashley. After several months, defendent Cal. P. & A. Co. refused to pay one half of the stipulated royalty (twenty-five cents per ton) on the ground that it was mining only in that part of the deposit lying within the tract formerly owned by Ashley. In a prior suit, the court had said that Cal. P. & A. Co. had the right to mine under both pieces of land and that the fact that it mined only under Ashley's tract did not prevent the plaintiff from demanding the full rent. After that decision, the Cal. P.

7) For further examples, see Wormser, op. cit. n. 20, at 502.
8) 31 Mich. 490 (1875); Accord, A. Booth & Co. v. Seibold, 74 N.Y.S. 776 (1902).
9) 147 Cal. 363 (1905).

& A. Co. formed a new corporation and conveyed to it the tract purchased from Ashley without the lease. The new corporation mined only in the tract which it owned, and claimed it was not liable to the plaintiff. Thereafter plaintiff brought another action to recover from both corporations for royalties due and got a judgment. After this decision, a third corporation was formed, and the land formerly owned by Ashley was conveyed to it by the second corporation. Rock was taken out as before. The three corporations had substantially the same identity. They had been formed by the same person, used the same premises, and had substantially the same officers. Higgins brought his third action against all three corporations for the royalties due. The court found a constructive fraud in the formation of each of the succeeding corporations and the transfers of title, and decreed that all of the corporations were jointly liable for the royalties to the lessor. The three corporations defendant were really the same.[10]

A further illustration is Donovan v. Purtell.[11] In this case, Joseph T. Donovan, a clever and unscrupulous real estate operator, organized a number of different realty companies, all of which were no more than straw. They all had their offices in the same room, they all had substantially the same officers, and the main purpose of the organization of each was to keep the various properties owned by the operator out of judgement. He controlled and managed all the corporations. He would use the property of any of these corporations indiscriminately. The sum and substance of the whole operation was that the corporations were really the real estate operator under different cloaks. Purtell, plaintiff, gave $1,200 to one of these real estate companies for investment. A note and a trust deed were given to the plaintiff by the corporation, but they turned out to be worthless. The court held that Donovan should be personally liable for the transaction, saying that he was using a corporate entity for the transaction of his own business.

(3) Attempts to circumvent statutes.

Oftentimes the corporate form of organization is adopted in an endeavor to evade a statute or to modify the intent. The commodities clause of the Hepburn Act provides that "It shall be unlawful for any railroad company to transport from any State

10) For a similar case, see Pepper v. Litton, 308 U.S. 295 (1939).
11) 216 111. 629 (1905).

……to any other State……any article……manufactured, mined or produced by it, or under its authority, or which it may own in whole or in part, or in which it may have any interest direct or indirect……." The Lehigh Valley Railroad Company owned stock in a coal company whose goods it was carrying. The government filed a suit for an injunction and averred that the railroad company was using the coal company merely as a vehicle to evade the provisions of the Act. The court held that such evasion should not succeed, and issued an injunction.[12]

There are many other examples. Thus where a holding company held controlling stock in two competing railroad corporations, it was held to be in violation of the Sherman Antitrust Act.[13] Similary, the use of a holding company to avoid a statutory double liability provision placed upon shareholders in banking and trust corporations was held not to relieve the shareholders in the holding company from this double liability.[14] In United States v. Milwaukee Refrigerator Transit Co.,[15] a dummy corporation was formed in order to evade the provisions of the Elkins Act making rebates from carriers illegal. The controlling shareholders of the Pabst Brewing Company used the Transit Company, an affiliated corporation, to secure payments of rebates from carriers who shipped the products of the Brewing Company. The court held this to be a violation of the Elkins Act. Use of the corporate device to evade tax was not permitted.[16]

Strangely enough, the use of the corporate form to get an usurious loan has been held legitimate.[17] This would seem to permit evasion of statutory provisions by use of the veil of incorporation…… Professor Lattin.[18]

(4) Attempts to protect knavery or crime.

It goes without saying that the corporate entity cannot be used to defend crime or knavery. In Meily Co. v. London & L. Fire Insurance Co.,[19] a corporation tried to recover on a fire insurance policy, although the fire was set by its sole shareholder.

12) U.S. v. Lehigh Valley R. R. Co, 220 U.S. 257 (1911).
13) Northern Securities Co. v. U.S., 193 U.S. 197 (1904).
14) Anderson v. Abbott, 321 U.S. 349, 804 (1944).
15) 142 F. 247 (C.C. Wis. 1905).
16) U.S.v. Barwin Realty Co., 25 F. 2d 1003 (E.D.N.Y. 1928).
17) Jenkins v. Moyse, 254 N.Y. 319 (1930).
18) Lattin, Corporations (2nd ed, 1971) 81—82; Contra, Ballantine, op. cit. 306.
19) 148 F. 683 (3rd Cir. 1906).

The court rejected the claim.

B. In the cases presented above, the notion of corporate personality was invoked for some improper purpose. To cite Judge Sanborn's statement, "When the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."[20] But it would be erroneus to assume that this general rule states the limits of judicial action in the matter. There is a marked tendency to disregard the corporate personality in those cases where adherence to the concept of corporateness will result in inequity or will prevent a full settlement of the dispute between the real parties in interest in a given situation.[21] This might be paraphrased thus:"……[the] entity will be disregarded when it is necessary to promote justice or to obviate inequitable results."[22] Now let us turn to cases falling under this category.

(5) When the corporate concept results in inequity or injustice.

Any rule which takes such an indefinable concept as justice as its yardstick is obviously unsatisfactory. However, this is a useful category in which to group a miscellany of diverse cases. Many cases where this rule has been applied arose out of situations having their origin in the intent of the contracting party or the spirit of the legislation. In Keokuk Electric Railway Co. v. Weisman,[23] as a result of negotiations for the sale of certain electric light properties belonging to a one-man company, the sole shareholder created a new corporation, the plaintiff, in order to facilitate the sale. He then caused the electric light properties to be transferred to the plaintiff company in exchange for all of its shares and bonds. These securities were transferred to the purchasers. The former sole shareholder also owned residential property adjacent to the lighting plant, and this property was crossed both by electric light wires from the plant to the town and by a substantial sidewalk giving access to the plant. However, no easement for the wires or sidewalk had been conveyed to the plaintiff company. The former sole shareholder requested the plaintiff to discontinue using his property for wires or as a means of access to the lighting plant.

20) U.S. v. Milwaukee Refrigerator Transit Co., 142 F. 247, at 255(1905).
21) Cataldo, Limited liability with one-man companies and subsidiary corporations, 18 Law & Contemp. Prob. 473, at 481—482 (1952).
22) Warner Fuller, The incorporated individual: A study of the one-man company, 51 Harv. L. Rev. 1373, at 1402; Ballantine, op. cit. 293.
23) 146 Iowa 679 (1910).

In the ensuing litigation the court agreed with the plaintiff's contention that if the former sole shareholder had owned the lighting plant in his own name, an easement by implied grant would have been created, and that the facts of the case were such as to make it appropriate to disregard the corporate entity and to regard him as the owner of the property. Although the transaction took the form of a transfer of corporate shares, the circumstances of the sale would naturally cause the parties to regard it as a purchase and sale of an electric light plant.

Generally, shareholder obligations may not be set off against company obligations, nor may obligations to a corporation be set off against those of its shareholders. But the courts have sometimes permitted a sole shareholder of a one-man corporation to set off a private claim against the plaintiff. In State Trust & Savings Bank v. Hermosa Land and Cattle Company,[24] the sole shareholder was permitted to set off his personal claim. The court cut through legal barriers to reach a sound result. Viewed realistically, an action arising in these circumstances involved no more than a controversy between the plaintiff and the sole shareholder. The net result was to avoid circuity of action. To have adhered to the corporate fiction in these circumstances would have served little useful purpose.

In the above situations, there was no abuse of the corporate form, yet the separate entity concept was ignored in order to reach an equitable result.[25]

C. While, conceptually, the same principles for disregarding corporateness apply whether the corporation has one shareholder or many,[26] the factors necessary for the application of such principles are most frequently encountered in cases of one-man, family, and other close corporations,[27] and subsidiary or other affiliated corporations. In such corporations, the strict separateness between the corporation and its shareholder(s) is more likely to be ignored.

(6) One-man, family and other close corporations.

The legitimacy of the one-man company was established by Salomon v. A.Salomon & Co. Ltd.[28] The evolution of the one-man company and the family corporation is

24) 30 N.M. 566 (1925).
25) For more examples, see Ke Chin Wang, The corporate entity concept (or fiction theory) and the modern business organization, 28 Minn. L. Rev. 341, 368 ff (1944).
26) The general rule becomes less subject to exceptions as the number of shareholders increases.
27) The so-called strawman corporation belongs to this category.
28) [1897] A.C. 22 (House of Lords).

found in the desire to combine limited liability with the complete dominion of the sole proprietorship. Here the sole or principal shareholder, like Janus, represents and constitutes an incorporated venture, on one side, and an individual, on the other side. His complete dominion and superior knowledge carry opportunities for manipulation and maneuvering.[29] "In all the experience of the law, there has never been a more prolific breeder of fraud than the one-man corporation."[30]

Of course, the limited liability of a shareholder is not lost merely because he owns all or almost all of the shares, nor because of the control he may have incident to the share ownership. His privilege of limited liability, however, is conditional. He must comply with two requirements, even when the corporate device is not perverted for improper purposes. First, he must conduct the business on a corporate footing, and maintain and preserve the separate identity of the venture. Second, he must establish the corporate venture on an adequate financial basis. When he fails to meet these requirements, he will be personally liable for the corporate obligations.[31]

Wittmann v. Whittingham[32] involved an action against a principal shareholder for breach of an employment contract entered into between the plaintiff and the defendant's company. The evidence showed that before the formation of the company, the plaintiff had worked as a part-time employee of the defendant. The latter decided to incorporate in order to accommodate an expanding business. It was agreed that plaintiff was to devote full time to the business, and he was to be a director of the new company "for convenience." After the company was formed, the defendant continued to run the business on the same personal basis as had formerly prevailed. Although a jury found that the plaintiff had been hired and discharged by the corporation, the court held the principal shareholder liable for the corporate obligation on the ground that he was the company's alter ago.

In Dixie Coal Mining Co. v. Williams,[33] an action was brought against the sole shareholder to recover for the negligent death of plaintiff's decedent. The company for which the deceased was working at the time of his death was bankrupt and

29) Cataldo, op. cit. 482.
30) Douglas. J., quoting a dictum of the trial court judge in Pepper v. Litton, 308 U. S. 295, at 313 note (1939).
31) Cataldo, op. cit. 482—485; Fuller, op. cit. 1379—1383.
32) 85 Cal. App. 140 (1927).
33) 221 Ala. 331 (1930).

admitted liability. This company was one of several which the defendant owned and which he had formed to carry on different aspects of his business. The assets with which the company employing the deceased commenced business apparently were relatively insignificant. Personal liability was imposed upon the sole shareholder upon the ground that his company was a mere simulacrum formed for the dual purpose of avoiding personal liability and of reserving to his own use and benefit the profits which might arise from the business.

Sound policy considerations support these requirements. The shareholder who refuses to draw a line between his individual and corporate affairs is in a poor position to ask that the court effect what he failed to do. Moreover, there is an obvious reason for demanding an adequate financial structure as part of the price for the privilege of limited liability.

(7) Subsidiary and affiliated corporations.

The subsidiary corporation is extensively used in the United States. Among the many reasons for its adoption and use is the desire for the greater facility in financing, the avoidance of taxation, and the elimination of cumbersome management structures. Another factor has been restrictions imposed in some states on foreign corporations. A further potent motive has been the desire for limited liability. A corporation which wishes to risk only a portion of its assets in a particular sphere of the business may form a subsidiary for this purpose and may dedicate only a part of its assets to that particular segment of the business.

Two factors appear as constants in the parent-subsidiary relationship:

① The parent corporation owns all, or a controlling interest in the subsidary's shares or the same persons own all, or a controlling interest in the shares of both corporations.

② Both corporations have common, or identical, directors and officers.

The presence of these two factors is not per se sufficient ground for disregarding their separate corporate entities. Generally speaking, the principles which govern the one-man and family corporations are applicable in the parent-subsidiary relationship. It is clear that the corporate personality will be disregarded, and the two units will be considered as one, wherever the notion of legal entity is used for improper or illegal purposes. Apart from such abuses, the activities of a parent corporation and

its subsidiary should conform to the following four standards, if they are to be treated as separate units. First, the subsidiary should be established as a separate unit sufficiently capitalized to meet the normal obligations and usual strains foreseeable in a busness of its size and character. Second, the business transactions of the two units should be kept distinct; separate accounts and records should be maintained. Third, the formalities of separate corporate procedures such as separate meetings of the board of directors or shareholders should be carefully observed. Fourth, the two units should not be held out to the public as being merely one.[34]

A failure to keep one or more of these requirements may be fatal and the court may disregard the separate corporate personality and consider the parent end subsidiary as one unit for legal purpose. Consequently, liability may be imposed upon the parent for contracts and torts of the subsidiary.

In Herman v. Mobile Homes Corp.,[35] a subsidiary with a capital of $5,000 embarked on a large scale home construction project requiring a credit of $1,000,000. The parent corporation was held liable for the contractual obligations of its subsidiary. In Ross v. Pennsylvania R.R.,[36] a person was struck and killed in New Jersey by a negligently operated train of West Jersey & Seashore Railroad Company, which employed and paid the wages of the engineers and the other members of the train crew. This company was a subsidiary of the Pennsylvania Railroad Company. The name "West Jersey and Seashore R.R. Co.", formerly on the fenders of the locomotive, had been removed and the word "Pennsylvania" substituted; the word "Pennsylvania" appeared on the coaches of the train; the letters "P.R.R." appeared on the uniforms of some of the crew; a time table captioned "Pennsylvania Railroad System" listed the train on the schedules therein contained. The decedent's administrator wrote two letters concerning the accident to the Pennsylvania Railroad Company and the latter's district claim agent answered both. In a suit by the administrator to recover damages from the Pennsylvania Railroad Company, the lower court submitted to the jury the issue whether that company was controlling and operating the train at the time of the accident. The jury returned a verdict for the plaintiff, and the

34) William O. Douglas and Carrol M. Shanks, Insulation from liability through subsidiary corporation, 19 Yale L.J. 193—218 (1929). Cataldo. op. cit. 492—498.
35) 317 Mich. 233, 26 N.W. 2d 757 (1947).
36) 106 N.J.L. 536, 148 Atl. 741 (1930).

lower court entered judgment on the verdict. On appeal it was held proper to submit the issiue to the jury and the judgment was affirmed.

In Costan v. Manila Electric Co.,[37] Manila Electric Company held title to and operated a street railway in Manila. All its shares, except those necessary to qualify directors, were held by Manila Electric Corporation. The directors of the latter company, acting through a committee, appointed a manager. He managed the Manila property and had broad powers (hiring of employees, purchase of supplies, etc), subject to such general supervision and control as might be exercised by the directors of the parent corporation. A person was injured by the negligent operation of a car on the Manila Street Railway. He sued the holding company for damages. It was held that the lower court committed reversible error in entering a compulsory nonsuit. Liability was imposed on the parent corporation because by an obtrusive act of intervention it had entrusted complete control over the subsidiary's property to a third party who was subject only to the will of the parent's directorate.

D. The disregard theory has four different forms. First, and most common, is the form in which the creditors of a corporation want to set aside the corporate entity and hold the shareholders liable. The second form is the opposite of the first. Here the creditors of a shareholder try to disregard the corporate personality and pursue the corporate assets for their claims. Cases previously cited as examples fall into one of these forms. In either of these forms the liability of a shareholder or a corporation will not be limited in any way. In the third form, shareholders(or the parent corporation) appear as creditors of the corporation(or subsidiary), and compete for satisfaction from the corporate assets with the other creditors. The claims of the shareholders will be disallowed or subordinated to those of the other creditors where this is equitable and required to enhance the possibility of the satisfaction of the outside claims. In this form, the liability of the shareholders is limited to their claims. The fourth form is where the shareholders of double liability corporations form a holding company. They cannot relieve themselves from the double liability by incorporating. Their liability is limited to the double amount of the investment.[38]

The disregard doctrine has played an important role in the third form to which

37) 24 F. 2d 383(2d Cir. 1928).
38) See note 14, supra.

we now turn.[39]

(8) The sole or principal shareholder as creditor.

Having provided a corporation with capital sufficient for its ordinary needs, there may be no reason why a sole or controlling shareholder should not lend money to his corporation, with or without security on its assets, and later compete with the outside creditors.

In the famous case of Salomon v. A. Salomon & Co., Ltd.[40], Salomon, a prosperous bootmaker, formed a limited company with an authorized capital of 40,000 pounds(40,000 shares with a par value of 1 pound each). He surrendered his solvent business at the overvalued price of 39,000 pounds to the corporation. In return the corporation assumed the obligation of paying off the debts of the old business, amounting to 1000 pounds, and Salomon received 20,001 shares and 100 debentures. The latter had a par value of 100 pounds each and represented a lien on the corporate assets. His wife and five children, who served as the other shareholders along with him, were allotted one share each, and no other shares were ever issued. Salomon and two sons constituted the board of directors, and Salomon was appointed chairman of the board and managing director. On the security of his debentures Salomon borrowed from Broderip 5,000 pounds, which were paid into the corporate treasury as a loan from Salomon. As part of the transaction, the debentures held by Salomon were cancelled and new debentures in the same amount were issued to Broderip, with the understanding that Salomon was the beneficial owner of the new debentures, subject only to Broderip's prior security interest. Business adversities, in the form of strikes in the trade, and the government's failure to give the number of orders anticipated, caused the corporation to become insolvent. In liquidation proceedings some fourteen months after incorporation, Salomon presented his claim for payment of his debentures. If Salomon's claim were allowed, the unsecured creditors of the company would obtain nothing on their claims. The trial court held that the company was Salomon's agent and that company creditors could have sued him personally. The Court of Appeals took the view that the corporation was a kind of trustee created for an illegal purpose, namely, to pervert the corporate form to defraud creditors. With

39) Professor Drobnig adopts this classification in his book. Haftungsdurchgriff bei der Kapitalgesellschaften, 24—25 (1959).

40) [1897] A.C. 22.

either view prevailing, Salomon would have lost his case. But the House of Lords held that, although it was a one-man company formed to obtain limited liability (a legitimate purpose) and that the stockholders, other than Salomon, were dummies, nevertheless it was a corporation and a different person from its sole shareholder. Hence, the court allowed Salomon to keep his secured claim for 10,000 pounds just as if he had been an outsider lending this sum to the corporation.

There are many similar decisions,[41] but almost without exception, these cases indicate that courts will scrutinize carefully the good faith and fairness of the sole shareholder's dealings with his corporation before they will let him compete with other creditors.[42]

Thus the corporate device, in the absence of other factors, operates efficiently to preserve in a single person the dual status of creditor and entrepreneur. The sole shareholder may, however, lose his creditor status, if the amount of capital employed is inadequate for the size and type of the company's operations, or if he has failed to keep accurate and honest accounts of the personal transactions which he has made with his conpany. In Arnold v. Philips.[43] an entrepreneur who wished to operate a brewery formed a corporation with an authorized capital of $50,000 and paid cash for the shares. He then advanced $75,000 as a loan in order to enable the company to begin business. For two years the business prospered, but then the business fell off and a few months later Arnold had to make further advances which amounted to about $47,000. Upon the subsequent insolvency of the enterprise it was held that the first advance of $75,000 should be treated as a capital contribution, a sort of interest-bearing redeemable stock, not recoverable by him, but that the later advances should be treated as genuine loans, for which he could consider himself a corporate creditor. This case illustrates well the principle of adequate capitalization as a condition to limited liability.

In re Burntside Lodge,[44] there were several persons associated with the company.

41) Accord, Wheeler v. Smith, 30 F. 2d 59(9th Cir. 1929). Contra, Dollar Cleansers & Dryers, Inc. v. McGregor, 163 Md 105, 161 A. 159 (1932).

42) New York Trust Co. v. Island Oil & Transport Corp., 56 F. 2d 580 (2nd Cir. 1932).

43) 117 F. 2d 497 (5th Cir. 1941).

44) 7 F. Supp. 785 (D. Minn. 1934). In Vennerbeck & Chase Co. v. Juergens Jewelry Co., 53 R.I. 135, 164 A. 509 (1933), the court allowed the sole shareholder's claim for salary emphasizing the fact that he had kept his accounts accurately and honestly.

They filed claims for salary and money advanced in the bankruptcy proceedings. The court, after carefully scrutinizing those claims, rejected them because adequate accounts of accrued salaries and amounts loaned to the company had not been kept. Obviously, if this requirement concerning accounts were not insisted upon, a wide field would be open for simulated charges upon corporate insolvency.

The separate personality of the corporation was disregarded and the corporation and its shareholder were treated as one unit in the above two cases.

(9) Parent corporation as a creditor of its subsidiary.

A bona fide loan may be made by a parent corporation to its subsidiary. But the fact that the two corporations are under the same management and control requires careful scrutiny of such claims for the protection of third parties. If competition of the parent with outside creditors is inequitable, the parent's claim must be deferred to the claims of outsiders.

In the cases which reject the parent corporation's claim against the insolvent subsidiary, there are present such facts as intermingling, failure to observe the formalities of separate corporate action and inadequate financing of the subsidiary as a separate unit, which justify treating the subsidiary as a mere department of the parent.

In Taylor v. Standard Gas & Electric.,[45] the Standard Gas & Electric Company, the parent corporation, had undercapitalized the Deep Rock Oil Corporation, its subsidiary, and allowed it to become greatly in debt. Mismanagement and spoliation by the parent was glaring. Insolvency resulted and, in a reorganization procceding under the statute, the parent corporation presented its claim for huge advances in competition with other creditors, and security holders. The court subordinated the parent's claim not only to the claims of other creditors of the subsidiary but also to those of its preferred shareholders. The separateness of the subsidiary was disregarded and it was treated as a part of the parent's enterprise. The principle of this case is now known as the "Deep Rock Doctrine".[46]

E. So far typical cases where the separate entity of a corporation was disregarded have been presented. These cases arose principally in the fields of contracts

45) 306 U.S. 307 (1939).

46) Of the numerous articles on this subject, see particularly Israels, The implications and limitations of the "Deep Rock" doctrine, 42 Colum. L. Rev. 376 (1942).

and torts, and there were a few concerning statutes. But the scope of this theory is much wider. The doctrine is applied in tax law, social welfare legislation and criminal law. It is also adopted in meeting jurisdictional requirements and determining the enemy character of a corporation in wartime.[47]

But in these areas, special policy considerations which are absent in ordinary cases come into play, and the limited liability of a shareholder is not an issue. Many of these problems can be handled as questions of statutory interpretation.

In most of the disregard cases, the disregard was permitted for the benefit of the outside creditors. It can, however, be allowed for the benefit of the shareholders.[48]

2. THEORETICAL GROUNDS

A. Various theories are advanced by the courts when they disregard the corporate personality. The most commonly adopted are the following three theories.

(1) Agency theory.

When the corporation is merely an agent of the shareholder, whether he be a natural or a legal person, he will be personally liable for the corporate obligations as a principal. Judge Cardozo(later Justice of the U.S. Supreme Court), in explaining the parent corporation's liability for the contracts or torts of its subsidiary, elucidated this rule, saying:

"The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it. We say at times that the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an "alias" or a "dummy". All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.

47) See generally Lattin, Jennings, Buxbaum, Corporations, Cases and Materieials, 169—182 (4th ed. 1968).

48) See Raoul Berger, Disregarding the corporate entity for stockholders' benefit, 55 Colum. L. Rev. 808 (1955).

When control is less than this, we are remitted to the tests of honesty and justice."[49] The same theory can be used when individual shareholders are held liable for corporate obligations.

But as Judge Learned Hand aptly put it, the agency is consensual, and this is seldom true in parent-subsidiary relationships.[50] Moreover, when legal liability is predicated on principles of agency, the existence and entity of the agent are not ignored or set aside but affirmed. The very opposite is true when the subsidiary's corporate entity is set aside and the parent held liable.[51] Therefore, except in cases of express agency, the so-called agency theory cannot explain why the shareholder (or the parent corporation) is liable for the obligations of his corporation (or its subsidiary). When it is said that the corporation became an agent of the shareholder, the term "agent" refers to a particular relationship between them.[52] But the use of the term "agent" in this connection may only tend to confuse. It was unfortunate that Judge Cardozo who warned against legal metaphors used one himself.

(2) **Identity theory or alter ego doctrine.**

This theory says that when the corporation and the shareholder are in substance identical, the shareholder will be liable for the corporate obligations as if they were his own.

In Luckenbach S.S. Co., Inc. v. W.R. Grace & Co., Inc.,[53] Luckenbach Company capitalized at $800,000 rented its fleet of steamers to Luckenbach Steamship Company, its subsidiary, which was capitalized at $10,000, for the purpose of operating the vessels. Both corporations had the same officers and 90 per cent of the shares in each corporation were held by Luckenbach who was president and general manager of both units. The parent corporation leased several steamers to its subsidiary upon terms which were obviously beyond their rental value. The subsidiary breached a freight contract and the parent was held liable for this breach. The court held:

"...We think it too plain for serious question that the facts here considered show such identity of the two corporations, or at least give rise to such a strong presump-

49) Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, at 95(1926).
50) Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F. 2d 265, at 267(2nd Cir. 1929).
51) Lowendahl v. Baltimore & O. R. Co., 287 N.Y. Supp. 62, at 74—75(1936).
52) Walkovszky v. Carlton, 18 N.Y. 2d 414, 223 N.E. 2d 6(1966).
53) 267 F. 676 (4th Cir. 1920).

tion of their identity, as warrants the conclusion that the Luckenbach Company is equally responsible with the Steamship Company for the breach by the latter of its contract with the appellee. For all practical purposes the two concerns are one, and it would be unconscionable to allow the owner of this fleet of steamers, worth millions of dollars, to escape liability because it had turned them over a year before to a $10,000 corporation, which is simply itself in another form."

The enterprise entity theory by Professor Berle[54] is in the same category. According to this theory, if a shareholder or a holding company controls two or more corporations which do not represent separate enterprise, but became inseparable parts of a greater enterprise, the court can create a new entity comprising all the assets and liabilities of thes corporations. If the court, for sufficient reason, has determined that though there are two or more personalities, there is but one enterprise, this enterprise should res pond, as a whole, for the debts of any component element of it. In Walkovszky v. Carlton,[55] the plaintiff who was allegedly severely injured by a taxicab brought an action to recover damages against the taxicab corporation and its shareholder. Defendant Carlton is alleged to be a stockholder of 10 corporations, including the defendant corporation, each of which owned two taxicabs. The court, relying on Berle's enterprise entity theory, recognized that if a corporation is a fragment of a larger combine which actually conducts the business, the larger corporate entity would be held financially responsible, but it held that the plaintiff did not show good reason why the defendant Carlton should be personally liable for the corporate torts.

But the identity or enterprise entity theory does not give a valid basis for disregarding the corporate personality because identity of the corporation and the shareholder through the latter's ownership of all or controlling shares, and the identity of the parent and the subsidiary corporations through identical shareholders or directors, are not per se illegal. The legality of a one-man company[56] and the permissibility of incorporation for the sole purpose of obtaining limited liability[57] are generally ap-

54) Adolf Berle, The theory of enterprise entity, 47 Colum. L. Rev. 343, at 348—354 (1947).
55) 18 N.Y. 2d 414, 223 N.E. 2d 6(1966).
56) Salomon v. A. Salomon & Co., Ltd., [1897] A. C. 22, see note 40 supra.
57) Elenkrieg v. Siebrecht, 238 N.Y. 254(1924).
Bartle v. Home Owners' Cooperative, 309 N.Y. 103(1955).

proved. Again the mere fact that a corporation is a part of a bigger concern is not a sufficient ground for ignoring its independence. The real basis of the decision in the Luckenbach Steamship case would be the undercapitalization of the subsidiary.[58]

(3) Instrumentality rule.

Under this theory, the shareholder is personally liable for the debts of the corporation if it has become a mere tool or an instrument of his business.

In Lowendahl v. Baltimore & Ohio Railroad Co.,[59] the plaintiff who recovered a judgment against individual defendants A and B, and corporate defendant C on a promissory note, but did not get satisfaction from the judgment because of insolvency, brought another action against defendant railroad company for the amount of that judgment on the theory that C corporation was a mere instrument and department of the present defendant. Defendant railroad company had participated in the organization of C corporation, and exercised a powerful influence as a majority stockholder over the policy of that corporation. But the directors of the two corporations were different. After rejecting the agency and the identity theories, Judge Dore in his decision said:

> "Except, therefore, in cases of express agency, estoppel, or direct tort committed by a parent corporation, the "instrumentality rule" seems to furnish the most practical and effectively applicable theory for breaking down corporate immunity where equity requires that this be done to circumvent fraud or other legal wrong."

He then formulated three factors necessary for applying this rule. They are: (1) control by the parent corporation over its subsidiary to such an extent that the subsidiary has become a mere instrumentality or department of the parent's business; (2) purpose of the defendant to commit fraud or wrong in violation of plaintiff's rights; and (3) injury or unjust loss to the plaintiff from the above control and breach of duty. He further held that in view of these standards the C corporation was an independent corporate entity and rejected the plaintiff's claim.

The court in Herman v. Mobile Homes Corp.,[60] applied this theory in holding the parent liable.

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58) Ballantine, op. cit. 316.
59) 287 N.Y. Supp. 62(1936).
60) 317 Mich. 233. 26 N.W. 2d 757(1947), see note 35 supra.

The difficulty with this rule is that it does not provide meaningful criteria for deciding when to disregard the corporate entity.[61] It is almost impossible to ascertain from the cases what will be considered an instrumentality and it has sometimes been used as a substitute for reasoned analysis of the real factors behind decisions.[62] To quote Judge Hyde's statement,

"Since all corporations are in one sense instrumentalities of their stockholders, it does not state the true ratio decidendi to say that liability is imposed because a corporation is an instrumentality of its owner(corporate or individual). The question should not be merely "instrumentality", but "instrumentality for what purpose."[63]

B. The courts often regard a case which involves the individual liability as that of the disregard doctrine. However the disregard theory should be applied only when liability is imposed on a defendant in his capacity as a shareholder. If he is liable as an individual, it has nothing to do with the corporation, hence there is no room for disregarding the corporate personality. Since the courts often misunderstand the latter cases as involving the disregard problem, some comments are necessary regarding the ratios given by the courts in these cases.

First, when the shareholder expressly uses his corporation as an agent, he is obviously liable as a principal for the liabilities incurred by the corporation in its course of business as an agent. Equally obvious is the fact that the shareholder or the parent corporation should be liable as a joint tortfeasor if they participate in the torts of the corporation or the subsidiary.[64]

Second, the shareholder will be personally liable for the corporate obligations, if he guarantees or represents himself to be personally responsible. In Weisser v. Mursam Shoe Corporation,[65] a landlord agreed to lease a building to Murray and Samuel Rosenberg who told him that the tenant was to be Mursam Shoe Corporation and explained: "the name Mursam was an abbreviation for Murray and Samuel, and that

61) Comment, Disregarding the corporate entity: Contract claims, 28 Ohio St. L.J. 441, at 447 (1967).
62) Latty, Subsidiaries and affiliated corporations, 157—158(1936).
63) May Department Stores Co. v. Union Electric Light & Power Co. 341 Mo. 299, 107 S.W.2d 41, at 55(1937).
64) For agency, see Lowendahl case, note 59 supra. For joint tort, see Owl Fumigating Corporation v. California Cyanide Co. Inc., 24 F. 2d 718(1928), aff'd 30 F. 2d 812(3rd Cir. 1929).
65) 127 F. 2d 344(2nd Cir. 1942).

he and his brother were the corporation and stood behind the lease." The corporation was a so-called leasehold corporation, without assets or business except through defendants, and it was maintained solely for the purpose of insulating defendants and their occupying corporations under subleases from liability on the lease. Its original capital was only $1, although annual rents were more than $10,000. After performing fourteen years of the fifteen-year lease, Mursam defaulted and the plaintiffs sued the Rosenberg brothers individually. Their allegations and affidavit were held to create triable issues. The real ground for the decision was the representation guaranteeing the obligation or the operating nature of the corporation.[66]

Third, the shareholder may be liable for the obligations of his corporation if there has been a misrepresentation of the corporation's financial condition or the adequacy of its capital. The same is true when he has concealed the fact of incorporation. In Portsmouth Cotton Oil Refining Corporation v. Fourth National Bank,[67] the defendant bank acquired the assets of a corporation on foreclosure, incorporated it through dummies, and financed it through loans, seeking to recoup losses on old loans on the security of the assets. The bank was held liable for breach of warranty on cotton oil sold by its subsidiary corporation. The reason seems to be that the bank had sent an undercapitalized business into the market place, with an appearance of financial soundness, to sell faulty goods. This was thought to be implied misrepresentation of wealth.[68]

In Shafford v. Otto Sales Company,[69] plaintiff brought an action to recover his commission on the sales of cocoanut made on behalf of defendant Otto who was doing business as Otto Sales Company. Otto had incorporated his business with nominal capital secretly, and plaintiff subsequently discovered that his contract had been concluded during the life of and assertedly with Otto Sales Company, Inc. Furthermore, Otto having attempted to conceal the fact that the sales had been consummated, the corporation had run through its capital and was quite unable to pay the commissions. While the court discussed at length the inadequacy of the corporation's capital, it noted that "plaintiff did not know that Otto Sales Company was a corporation, nor

66) Accord, Quaid v. Ratkowsky, 170 N.Y.S. 812 (1918).
67) 280 F. 879(1922), aff'd 284 F. 718 (5th Cir. 1922).
68) Comment, 28 Ohio St. L.J., 441, at 454 (1967).
69) 149 Cal. App. 2d 428 (1957).

did he understand that he was dealing with a corporation." Otto's suppression of the fact of incorporation was a ground for relief.

Fourth, it is more than natural that a shareholder who is doing business as an individual independently of the corporation should be personally liable for his individual activities. Sometimes liability has been imposed on a shareholder even though the transaction was ostensibly executed by the corporation, because the acts of the individual could not be distinguished from the acts of the corporation. Some courts have asserted in such cases that the stockholder was "doing business as an individual." In African Metals Corp. v. Bullowa,[70] the plaintiff purchased from the Meade Steel & Metals Company material which was represented to be pure nickel carthodes but turned out to be junk consisting of parts of old automobiles. Plaintiff sued Bullowa, an incorporator of Meade Steel to recover the price paid. The court focused on the fact that prior to the transaction with the plaintiff, Bullowa had opened a personal bank account. The ordinary operating expenses of the corporate defendant were drawn from this account, and into it went the check from African Metals. Other checks were similarly deposited. Although the original capital was $5,000, the total assets of the corporation at the time of this transaction were only $623. The court held that Bullowa had carried on the business as an individual and that he was personally liable. This was an example of commingling the affairs and assets of the corporation and the shareholder, and a case for the disregard doctrine.

The courts not infrequently have held that a shareholder was doing business as an individual even when the transaction was clearly carried on by the corporation, to promote justice, or to protect public policy. This reveals an unfortunate confusion. In Walkovszky v. Carlton,[71] the court specifically found the complaint "barren of any "sufficiently particular[ized] statements" that the defendant Carlton and his associates were actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations without regard to formality and to suit their immediate convenience". It was held that the stockholder would be personally liable when he was in reality carrying on the business in his personal capacity for purely personal rather than corporate ends.

70) 288 N.Y. 78, 41 N.E. 2d 466 (1942).
71) 18 N.Y. 2d 414 (1966), see note 55 supra.

The theories we have observed in this section have nothing to do with the disregard of the corporate personality. These theories are applicable when there is no corporation on the stage. They are independent grounds for imposing liability on an individual, and it is an unfortunate confusion to invoke them to hold shareholders personally liable for corporate obligations.

C. What is the real basis for disregarding the corporate entity in a given situation? The reason must be found in basic principles of law. The concept of corporate personality is contrived so that corporations may pursue just and useful purposes. As a corollary, the corporation can claim its independent personality insofar as it functions within those purposes. According to the traditional notion, the shareholders' limited liability by way of incorporation is a privilege given by the law. Therefore, the privilege ought not to be perverted for illegal or unjust purposes unwarranted by the law. Thus many decisions hold that the corporate entity concept cannot be employed for fraud.[72] But fraud is only one of the unjust or ineqitable purposes not warranted by the law. Many other cases rightly make it clear that the limited liability privilege will be lost if adherence to the concept of separate corporate entity would promote injustice or result in inequitable results.[73] The corporate personality can be preserved only insofar as it is invoked and employed for lawful purposes and honest ends. If the corporate form is perverted for purposes not permitted by the law, the courts will interpose and deprive the privilege of limited liability, holding the shareholders liable. It may be concluded that the corporate form will be disregarded if it is abused for purposes not sanctioned by the law.[74]

3. FACTORS OR REQUIREMENTS FOR DISREGARD

What factors lead the courts to disregard the separate personality of a corporation? There seems to be no rule of thumb or general formula. But it is not impossible to find common features amongst some decisions.

A. Factors and the Nature of the Claims

As can be expected, factors which make the court pierce the corporate veil are not always identical. Different policy considerations obtain in different legal fields.

72) Grotheer v. Meyer Rosenberg, Inc., 11 Cal. App. 2d 268, at 271 (1936).
73) Boro Park Sanitary Live Poultry Market, Inc. v. Heller, 280 N.Y. 481, 21 N.E. 2d 687, at 690 (1939). Minifie v. Rowley, 187 Cal. 481 (1921).
74) Ballantine, op. cit. 292—293.

and different policy requires different factors. But the courts in many cases fail to recognize this difference and their opinions are still enveloped in the mists of metaphor,[75] which often obscure the real issues. Analysis of the cases reveals that the doctrine of disregarding the corporate entity embraces a number of separate policies.

While contract cases require consensus, this is not a factor in tort cases. The conflict between limited liability and other policies is sharpest in the contract cases. Before making a contract, a creditor is normally expected to ascertain with whom he is doing business, and their ability to satisfy his claim. If he is contracting with a corporation which is not financially sound, he can ask for some kind of guarantee. But where the debt arose from a tort, the creditor will have had no opportunity to choose not to do business with the corporation. In contract cases it is important whether the shareholder breaks the reasonable expectation of a creditor, whereas in tort cases the emphasis is on the public policy limitation on the amount of risk that a shareholder may effectively transfer to the public by the operation of a corporation.[76] This difference becomes vivid with the requirement of the subjective factor to be discussed later. But this strict dichotomy can be dangerous. Take a farmer who contracts with a sophisticated salesman of a shell corporation. He is in little better position than the tort creditor in terms of choosing, and ascertaining the financial standing of, the corporation.

In other kinds of cases, where the corporate entity barrier is not challenged by a contract or tort creditor, the factors for ignoring the corporate entity are far different and the policy behind limited liability has no application.[77] In taxation cases, for example, the issue is how much tax is due rather than the limited liability of the shareholder. The guiding principle is protection of the government against evasion. Where the question is whether an injunction previously issued against an individual should be applied to a corporation formed by him, the issue is the extent of activity covered by the injunction, and financial liability is not involved. Again, whether service of process on a subsidiary is effective to join a parent corporation

75) Cardozo, J., in Berkey v. Third Ave. Ry. Co., 244 N.Y. 84 at 95 (1926), Professor Henn collected 37 metaphors. Henn, Corporations, 250—251 (2nd. ed. 1970).
76) Latty, op. cit. 201—205.
77) Comment, 28 Ohio St. L.J. 441, at 444 (1967).

in a law suit involves the question of due process and meeting the jurisdictional requirements rather than the principle of limited liability.

It is, therefore, very important to look for the special policy considerations before drawing a conclusion about the separate entity concept. Factors which the courts have taken into account can be divided into the objective and the subjective category.

B. Objective Factors

The following factors are often required by the courts.

(1) Control or Dominion.

Many decisions require "a complete dominion" by a sole shareholder (or a parent corporation) over his corporation (or its subsidiary) in order to disregard the separate personality of the latter and hold the shareholder or the parent liable. But mere control through ownership of all, or the controlling shares, and the right to elect directors and officers, is not of itself a ground for disregarding the corporate personality. The control should be exercised in a manner which is not usual and normal and to such extent and in such manner, in disregard of the corporation's paraphernalia, directors and officers, that the corporation could be said to have no separate mind, will or existence of its own.

In Berkey v. Third Ave. Ry. Co.,[78] the plaintiff was hurt getting out of a streetcar through the negligence of the motorman in charge. The car belonged to the Forty-Second Street Company. All the stock of the company was owned by defendant. Members of the two boards of directors were nearly the same. Both companies had the same executive officers. All the cars were marked "Third Avenue System". The cars were bought by the defendant and then leased to the subsidiary for a daily rental which was paid. The parent had made loans to the subsidiary from time to time, but they were charged to the account of the subsidiary and usually repaid. But the Forty-Second deposited in its own bank account the fares collected, and paid out of that account the wages of the motormen and conductors. The salaries of the executive officers were first paid by the parent, and then charged to the account of the subsidiary. Its franchise went back to 1884, and through all the intervening years it had preserved its corporate identity, and owned adequate property. Many

78) 244 N.Y. 84, 159 N.E. 58(1926).

other expenses for maintenance and repair, as well as many judgments for personal injuries were paid by the subsidiary. The cars leased to one road did not continue along the routes of others. The motormen and conductors did not travel beyond their respective lines. The plaintiff tried to hold the parent liable for the torts of its subsidiary. But Judge Cardozo rejected this claim, saying that the parent had never been adjudged liable when the subsidiary has maintained so consistently and in so many ways as here the separate organization. He further held:

"Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice."[79]

Judge Dore, in Lowendahl v. Baltimore & O.R.Co.,[80]
developed this thought as follows :

"Control through mere ownership of a majority or even all the capital stock and the use of power incident thereto to elect officers and directors will not in and of itself predicate liability. Liability must depend upon a domination and control so complete that the corporation may be said to have no will, mind, or existence of its own, and to be operated as a mere department of the business of the shareholder."

and held that defendant Baltimore & Ohio Railroad Company did not exercise such a complete control over its subsidiary.

What, then, is a "complete control"? In Steven v. Roscoe Turner Aeronautical Corporation,[81] the plaintiff's decedent was killed as the result of an airplane crash. The airplane was chartered by the deceased and others from the subsidiary of the defendant corporation. The directors and officers of both corporations were almost the same and the controlling shares of both were owned by the Turners. Chief Judge Hastings in his decision held:

"In determining whether the requisite degree of control is maintained by the parent corporation, many factors are relevant. It is the presence of these factors in the proper combination which is controlling."

And he explained, according to Powell's famous formula,[82] the factors generally

79) For comment on this, see agency theory, supra.
80) See p. 115 supra.
81) 324 F. 2d 157 (7th Cir. 1963).
82) Powell, Parent and Subsidiary Corporations, 9 (1931).

considered by courts as follows:

(a) The parent corporation owns all or most of the capital stock of the subsidiary.

(b) The parent and subsidiary corporations have common directors or officers.

(c) The parent corporation finances the subsidiary.

(d) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.

(e) The subsidiary has grossly inadequate capital.

(f) The parent corporation pays the salaries and other expenses or losses of the subsidiary.

(g) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.

(h) In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.

(i) The parent corporation uses the property of the subsidiary as it own.

(j) The directors or executives of the subsidiary do not act independently in the interests of the subsidiary but take their orders from the parent corporation in the latter's interest.

(k) The formal legal requirements of the subsidiary are not observed.

The Costan case[83] indicates that the result in a given situation may turn on formal aspects of control. The parent corporation's control, exercised as a normal incident of share ownership and through the usual rituals of careful corporate procedures, is one thing. Dominion exercised by the parent over its subsidiary in a direct or obtrusive manner is quite another. The former is judicially sanctioned, with the consequence that the separate corporate personality of each unit will be sustained. The latter is judicially condemned, with the result that the corporate entity will be disregarded and the two units will be assimilated. Judge Learned Hand put this tersely in the following words:

"Control through the ownership of shares does not fuse the corporations, even when the directors are common to each, ·····and liability normally must depend

83) See p. 108 supra.

upon the parent's direct intervention in the transaction, ignoring the subsidiary's paraphernalia of incorporation, directors, and officers. The test is, therefore, rather in the form than in the substance of the control, in whether it is exercised immediately, or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises. Some such line must obviously be drawn, if shareholding alone does not fuse the corporations in every case."[84]

But if the concept of control is to be developed from the original one incident to the share ownership to the formal tests examined above, it already represents a heterogenous substance. This is because the direct and obtrusive control which ignores the corporation's separate paraphernalia means the commingling of the affairs and assets of the corporation and the shareholder. In this sense, then, control is not an independent factor, but an indication of the commingling.

(2) Unity of interest and ownership, or commingling.

Commingling the assets of the corporation with those of the shareholders has a direct influence on the creditors of the corporation. For they will be paid out of the corporate assets. Intermingling the affairs of the corporation with those of the shareholder has the same effect, because it gives to the other party the impression that the shareholder carries on the business as an individual. Either fact can be a ground for assimilating the corporation and the shareholder. The same is true between the parent and subsidiary corporations.

Professor Douglas (now a Justice of the U.S. Supreme Court), in a famous article suggested four standards, the observance of which will keep the parent and subsidiary corporations from being treated as assimilated.[85] Two of them are related to the commingling. First, the day to day business of the two units should be kept separate. In addition, the financial and business records of the two units should be kept separately. Second, the formal barriers between the two management structures should be maintained. The ritual of separate meetings should be religiously observed. The activities of the individuals serving on the two boards should be tagged so that the individuals qua directors of the subsidiary can always be distinguished from the same individuals qua

84) Kingston Dry Dock Co. v. Lake Champlain Transp. Co. 31 F.2d 265, at 267(2nd Cir.1929).
85) Douglas and Shanks, op. cit. 197.

directors of the parent. The same problem arises in connection with the officers. These two standards can be equally applicable to the sole or controlling shareholder who carries on a personal business.

"Unity of interest and ownership" has become a grab-bag for facts showing less than scrupulous adherence to the formalities of corporate operation.[86] Originally this meant ownership of all, or controlling shares, of a corporation. But unity of interest and ownership through mere stockholding is not a ground for shareholder's personal liability. Thus courts came to emphasize that there should be such unity of interest and ownership that "the separate personalities of the corporation and the individual no longer exist."

In Minifie v. Rowley,[87] defendant Rowley was indebted to the partnership of Jones & Givens in the sum of $10,000. Later he delivered to the partnership a promissory note in the amount of $10,000 executed by Rowley Investment Company. The corporation paid the interest on the note for several years. Jones and Givens both died. Present action for the amount of said note and interest accrued was commenced by the executors of the partners. Rowley had been the owner and holder of almost all of the stock of the Rowley Investment Company. He controlled the board of directors and was the representative of, and the only person interested in, that corporation. Plaintiffs brought this action against Rowley on the ground that Rowley Investment Company was no more than the alter ego of defendant. The court held:

> "Before the acts and obligations of a corporation can be legally recognized as those of a particular person, and vice versa, the following combination of circumstances must be made to appear: first, that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality or separateness of the said person and corporation has ceased; second, that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice."

The complaint was held to comply with the above two tests.

The California Supreme Court applied the same tests in Autometriz del Golfo de

86) Lattin, Jennings, Buxbaum, op. cit. 154.
87) 187 Cal. 481 (1921).

California v. Resnick.[88] Here the plaintiff brought an action for the balance due on the price of eight automobiles which were alleged to have been sold to defendants. Defendant Resnick formed Irbel, Inc., a car corporation, with defendants W.D. Cowan and R.W. Cowan. It was agreed that Resnick, who was to manage the business, was to receive 50% of the profits and that each of the Cowans was to receive 25%. The three of them became officers and directors of the corporation. The corporation never issued stock. A checking account was opened with a bank under the curious name…… "Irbel, Inc. dba Bi-rite Auto Sales". Funds required to purchase cars were supplied by the Cowans, and the title of the purchased cars was held by them until a purchaser for a car was found. The proceeds of resale were deposited in the above bank account, and checks were drawn on that account by Resnick to reimburse the Cowans for the money they advanced. The volume of sales from the automobile business ran between $100,000 and $150,000 a month but the company capital was only $5,000. Prior to entering into any transactions with defendants, plaintiff was assured that W.D. Cowan would be giving the business financial backing. The action was based on two checks which were drawn by Resnick on that bank account. The court confirmed the two tests enunciated in the Minifie case and gave judgment for the plaintiff holding (1) that the failure to issue stock was an indication that defendants had been doing business as individuals, (There was such unity of interest and ownership that the separate personalities of the corporation and the individual no longer existed), and (2) that the corporation was so undercapitalized that if the above transactions were treated as those of the corporation alone, an inequitable result would follow.

The facts which make up the unity of interest and ownership in the above two cases represent the commingling of the affairs and assets of the corporation and the shareholder. Thus "the unity of interest and ownership where the separate personalities of the corporation and the shareholder no longer exist", like the "complete or direct control", boils down to commingling of assets and affairs, though the commingling notion did not, in fact, take root until later.[89]

In Banks v. Jones,[90] plaintiff's 16-year-old son sustained an injury while using

88) 47 Cal. 2d 792, 306 P. 2d 1 (1957).
89) Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, at 838—840 (1962).
90) 239 Ark. 396, 390 S.W.2d 108 (1965).

a gymnastic equipment commonly referred to as a trampoline. The trampoline was operated by Jumping Hills, Inc. Suit was sustained against the corporation, but later appellant (plaintiff) filed an amendment to her complaint making Jones a party individually. By the amendment the plaintiff alleged that the corporation was a fiction organized to avoid Jones' personal liability. Jones was the owner of 80% of the stock of the corporation. The trampoline enterprise was adjacent to his theatre business on land owned by him. The two enterprises had separate entrances. A fence separated the two businesses and there were separate tickets and admission prices. Separate books were kept on the two businesses and advertising was handled separately. Income tax returns were properly filed by the corporation. The court, warning that the rule of piercing the fiction of a corporate entity should be applied with great caution, held that in the case at bar, there was no interchange of employees, facilities, funds and management and that there was no abuse of the corporate form.

The Wittman case[91] illustrates that commingling of funds and assets may justify a charge to a shareholder personally. Another example is given by Louisville & N. R. Co. v. Nield.[92] Here plaintiff, Louisville & Nashville Railroad Company, advanced money to a corporation. Defendant was an officer and director of the corporation, and acted for the corporation as its agent in contracting the debt sued on. Thereafter, he acquired all of the capital stock of the corporation and sold all of its assets. After paying all corporate debts(except this one), he, with knowledge of the existence of plaintiff's claim, fradulently converted to his own use the balance of the proceeds of the sale of all the corporate assets. The corporation being insolvent, though not legally dissolved, plaintiff brought an action in debt against the defendant as an individual. The court held that as a general rule legal remedies against the corporation should be exhausted in a prior action before suing the stockholder upon the secondary liability. However, where there is only one creditor and only one stockholder, and the latter has by his fraudulent act made any independent action against the corporation an impracticable and vain undertaking, the general rule is inapplicable and the creditor can sue the shareholder directly.

In Consolidated Rock Products Co. v. DuBois,[93] the fairness of a reorganization

91) See p. 105 supra.
92) 186 Ky. 17, 216 S.W. 62 (1919).
93) 312 U.S. 510 (1940).

plan of a parent corporation and its two wholly owned subsidiaries was involved. One issue was whether the secured bondholders of the subsidiaries could pursue the assets of the parent. There had been a unified operation of the properties of three corporations by the parent pursuant to an operating agreement, That operation resulted in extensive commingling of assets, and all management functions of the several companies were assumed by the parent. The subsidiaries abdicated. The parent operated the subsidiaries as mere departments of its own business. Not even the formalities of separate corporate organization were observed. In view of these facts, the Supreme Court, through Justice Douglas, held that the parent, Consolidated, was in no position to claim that its assets were insulated from the claims of creditors of the subsidiaries. The three corporations were assimilated as a unit.

Riddle v. Leuschner[94] serves as one further example. Here the plaintiff was a creditor of Yosemite Creek Company. He commenced this action for declaratory and other relief against Yosemite, Kadota Creek Company, and most of the shareholders, officers and directors of the two companies, alleging that each of the corporations was the alter ego of the individual defendants. Yosemite and Kadota were at all times completely controlled, dominated, managed and operated by Richard D. Leuschner, Sr., Elizabeth F. Leuschner, his wife and Richard D. Leuschner, Jr., his son. The assets of Yosemite were intermingled with the assets of Kadota to suit the convenience of the Leuschners and to assist them in evading payment of their obligations. The three Leuschners entered into a large number of personal transactions with the corporations without specific, formal approval by directors or stockholders. Leuschner, Jr. and Mrs. Leuschner were stockholders. The court found that the corporations were such in name only and were mere fictions employed by the Leuschners, that after such intermingling the two corporations were not separate entities but were a single entity, and that there was no individuality or separateness insofar as the corporations and the Leuschners (except Leuschner, Sr., who was not a stockholder) were concerned. The court held two Leuschners liable for the obligation of their corporation.

Professor Latty has argued that the reason why commingling can bring personal liabilty to the shareholder is often his failure to keep accurate records. Since the

94) 51 Cal. 2d 574, 335 P. 2d 107 (1959).

corporate creditors cannot ascertain the assets of the corporation which they are to look to for payment, and both assets are indistinguishable, they cannot but pursue all the assets.[95] A further reason is that if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors.[96] One who fails to draw a line between his individual and corporate affairs is in no position to ask that the court effect what he failed to do.

Not all the shareholders will be personally liable for the corporate obligations if one shareholder commingles his affairs and assets with those of the corporation. It is unreasonable to impose liability on bona fide shareholders who are not responsible for the commingling and expect limited liability.[97]

(3) Undercapitalization

(i) As a general rule, the shareholders are not liable for the corporate obligations if they paid the subscription price of their shares. But the courts, willing to protect the corporate creditors, developed a ground for imposing personal liability on the shareholders even when they had paid the subscription price for the shares, if the corporation had insufficient capital for its ordinary needs.

In a well-known statement, Professor Ballantine summed up this principle as follows:

> "If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditor is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege."[98]

95) Latty, op. cit. 183—187.
96) Ballantine, op. cit. 294.
97) Cf. Baker v. Bates-Street Shirt Co., 6 F. 2d 854 (1st Cir. 1925). See p. 83 infra.
98) Ballantine, op. cit. 302—303.

Arnold v. Phillips[99] illustrates the principle that adequate capitalization is a prerequisite for limited liability. The same principle prevails when the shareholder is a corporation, that is in the parent-subsidiary relationship. It may be reasonable to expect that the requirement of adequate capital is more exacting when the parent-subsidiary relationship is involved, because the subsidiary corporation is really seeking a double insulation.[100] In the Luckenbach Steamship Company case,[101] the parent corporation was held liable for the breach of contract by its subsidiary which was undercapitalized.

The California courts traditionally demanded two requirements for disregard of corporate entity. They were unity of interest and ownership, and inequitable results.[102] The former means commingling of the affairs and funds between the shareholder and the corporation, whereas the latter comprises undercapitalization. Therefore, failure to keep the corporate formalities was generally required in addition to the undercapitalization of the corporation in order to hold the sharehoder personally liable. Chief Justice Traynor, however, suggested a new formulation in Minton v. Cavaney.[103] Here the plaintiff's daughter drowned in a swimming pool controlled by the Seminole Hot Springs Corporation. Plaintiffs recovered a judgment for $10,000 against Seminole for her wrongful death, but the judgment remained unsatisfied because Seminole was insolvent. Cavaney was an attorney at law and helped form Seminole. He was a director and secretary and treasurer of Seminole. After the drowning, Cavaney applied for permission to issue three shares of Seminole stock, one share to be issued to him, the other two to others, but the permission was refused. For a time Seminole used Cavaney's office to keep records and to receive mail. Seminole never had any substantial assets. Plaintiffs brought the present action to hold defendant Cavaney personally liable for the judgment on the ground that Seminole was the alter ego of Cavaney. Justice Traynor illustrated three cases where the shareholders are personally liable:

"The equitable owners of a corporation, for example, are personally liable when

99) See p. 110 supra.
100) Latty, op. cit. 193—201; Warner Fuller, op. cit. 1382.
101) Luckenbach S.S. Co. Inc. v. W.R. Grace & Co., see p. 113 supra.
102) Minifie v. Rowley, see p. 125 supra; Autometriz del Golfo de California v. Resnick, see p. 126 supra; Riddle v. Leuschner, see p. 128 supra.
103) 56 Cal. 2d 576, 364 P. 2d 473 (1961).

they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will; when they hold themselves out as being personally liable for the debts of the corporation; or when they provide inadequate capitalization and actively participate in the conduct of corporate affairs."

The court found that Seminole was inadequately capitalized and Cavaney actively participated in the conduct of the business and implied he was personally liable. This case has dispensed with the formal aspect which was generally required in addition to the undercapitalization and substituted active partcipation for it.

Where adequate risk capital is lacking, the courts will deny the privilege of separate incorporation, as justice requires. The separate corporate form is not a privilege to function under the practices of the jungle. Contribution of adequate risk capital to respond to the corporation's ordinary needs is the required consideration for the stockholder's personal immunity and this is not unreasonable.[104]

(ii) In order to obtain the privilege of limited liability, shareholders must contribute capital reasonably adequate for the needs of the particular business. What capital is "reasonably adequate"? Justice Douglas in Anderson v. Abbott[105] stated that:

"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."

But this test is hard to apply. No hard and fast rules have yet been laid down. There are no absolute tests or definite formulae. As Professor Lattin illustrated, if the popcorn man on the corner and the owner of a fleet of taxis were to incorporate their respective businesses, the amount of adequate capital for each business would be quite different.[106] The scope and magnitude of the contemplated operations, the risk generally accompanying the operations, and necessary facilities[107] are all relevant. The test is what a reasonably prudent man with a general knowledge of the business and its hazards would determine was reasonable capitalization. If the business had

104) Dix, Adequate Risk Capital: The Consideration for the Benefit of Separate Incorporation, 53 Nw. U.L. Rev. 478, at 483 (1958).
105) 321 U.S. 349, at 362(1944).
106) Lattin, op. cit. 76—77.
107) Cf. Arnold v. Phillips, p. 110 supra.

previously been carried on in some other form, experience can indicate fairly clearly what amount of capital may be reasonably adequate.

To make matters worse, capitalization is a vague term. The "capital" itself has different meanings for different purposes. Suffice it to say that "capital", in this context, means "net worth" or "net wealth".[108]

(iii) Undercapitalization can have different nuances and forms.

First, there are cases in which the corporation is formed with a nominal or trifling capital. Here it is common to find that the corporation, at the very start of its existence, has few or no assets and requires financial support for its operations. In these cases, it is natural to impose personal liability on the shareholders. Weisser v. Mursam Shoe Corporation,[109] Herman v. Mobile Homes Corp.[110] are such examples.

Second are cases in which the corporation is formed with capital which is more than nominal, but which is insufficient to meet the expectable strains of a business of its size and nature. These cases are difficult to decide. All relevant factors must be carefully evaluated. Luckenbach S.S. Co. Inc. v. W. R. Grace & Co.[111] falls within this category.

Third are those cases which fall under either of the first two categories and, in addition, reveal a plan to "milk" the corporation for the shareholders' benefit. The presence of this additional factor removes any doubt that may remain as to the right of the creditor of the corporation not to be limited to the corporate assets for the satisfaction of his debt.[112] A good example is Henderson v. Rounds & Porter Lumber Co.[113] Here a subsidiary was created to manufacture lumber products. It started operations with capital of $30,000 and some machinery. There was great demand for lumber products and the prices were high at the time. The capital was sufficient for normal operations. But the subsidiary sold the lumber products below market price to the parent, and the constant operating loss which resulted led to bankruptcy. The court concluded that under the circumstances the subsidiary should be regarded as

108) Latty, op. cit 133—135; generally 133—138, 119—128.
109) See p. 116 supra.
110) See p. 107 supra.
111) See p. 113 supra.
112) Latty, op. cit. 138—141; Cataldo, op. cit. 495.
113) 99 F. Supp. 376 (W.D. Ark. 1951).

"undercapitalized from the start". Accordingly, the parent was held liable to the subsidiary's creditors.

Undercapitalization can be classified in the following three patterns in terms of time. To the first pattern belong cases in which a corporation formed with inadequate capital has remained financially fragile up to the time of the transaction or the accident. These cases are easy to decide. The second pattern concerns cases in which a corporation started with insufficient capital but at the time of transaction was adequately equipped with capital through issue of shares. In the absence of other factors, the shareholders should not be held liable in such a case. The third pattern represents those cases in which the corporation started with reasonably adequate capital, but at the time of the transactions or accidents became unable to meet the ordinary needs of the business because of business adversity or other circumstances. Presence of adequate risk capital should be a continuing obligation. Where risk capital is inadequate, either because initial capitalization was insufficient or the risk capital subsequently became impaired from any cause, including business adversity, that deficiency must be cured or the business wound up. If the business continues operation with uncured impairment, its obligations devolve on the managing and controlling shareholders personally.[114] In Empire Steel Corporation of Texas v. Superior Court,[115] Empire, the parent corporation, kept Gachman Steel Corporation of California, its subsidiary, in business through advances beyond a period safe for persons dealing with it. In an ensuing action, plaintiff sought to recover $25,000 alleged damages for breach of a contract by Gachman. He also sought to recover damages from Empire, on the ground that Gachman was the alter ego of Empire. The court noted that Empire's activities in keeping Gachman in business beyond a safe period were manifestly related to plaintiff's cause of action.

If money is advanced by shareholders to a corporation in financial distress, no matter in what form or manner it is provided, it cannot be treated as a claim or debt equivalent to debts with outside creditors. When the corporation is failing, the managing and controlling shareholders, by virtue of their power to wind up the business, have a duty to creditors and public shareholders. If they are unwilling to

114) Dix, op. cit. 491, 494.

115) 56 Cal. 2d 823, 366 P. 2d 502 (1961). Accord, Kent-Reese Enterprises, Inc. v. Hempy, 378 F. 2d 910(1967).

liquidate the corporation, whatever they subsequently put in or put up is risk capital. The managing or controlling shareholders cannot shut their eyes to the facts when the business is so precarious or hopeless that it should be wound up.[116] Judge Learned Hand has had this to say:

"Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditor's interest, if the venture is successful, on the other hand, the creditors have only their interest, but they must come first in distribution of the assets. To compel him [a public creditor] to divide the assets in insolvency with those who at their option have all along had power to take all the earnings, is to add to the risk which he accepted."[117]

Thus the shareholder loses his creditor status.

(4) Insolvency or Dissolution of the Corporation.

Some courts have held that the corporate remedy should be exhausted before the shareholder can be held personally liable.

In Eskimo Pie Corporation v. Whitelawn Dairies, Inc.,[118] the plaintiff brought a suit against the subsidiary and against the parent corporation and persons who allegedly controlled the parent for goods sold and delivered and for breach of contract. The parent corporation and individual defendants moved to dismiss the action against them. The court held that creditors of a corporation as a general rule may not recover from a parent corporation or its stockholders until they have exhausted their legal remedy against the corporation by judgment against it, and return of an execution wholly or partly unsatisfied, unless they can show that this would be impossible or useless. Likewise the court, in Louisville & N.R. Co. v. Nield,[119] held that a creditor of a corporation cannot have equitable relief against its shareholders until he has prosecuted his demand to a judgment at law against the corporation, unless circumstances exist execusing him from doing so. Further as a general rule, legal remedies against the corporation should be exhausted in a prior action before suing the stockholders upon the secondary liability.

116) Dix, op. cit. 485, 491.
117) In re V. Loewers' Gambrinus Brewery Co., 167 F. 2d 318, at 320 (2nd Cir. 1948).
118) 266 F. Supp. 79 (1967).
119) See p.127 supra.

In almost all of the cases in which the corporate entity was disregarded and the shareholder was held personally liable, the corporation was either insolvent,[120] dissolved,[121] or sleeping,[122] and the legal remedy against the corporation was impossible or useless. But different views are not lacking.[123] Limited liability is one of the most characteristic attributes of the corporate system, and generally serves useful ends. It should not be lightly ignored. The creditors should not be permitted to sue the shareholders directly for corporate debts, unless circumstances render corporate remedies impossible or useless. This requirement applies equally when courts deprive the shareholder of his creditor status.[124]

The next question is whether the creditors of a corporation can invoke the disregard doctrine even when they can effectively impose liability on the shareholders with traditional legal remedies. No case has been found which deals directly with this point. But in view of the factual settings of those cases applying the disregard doctrine, the courts do not seem to think the existence of other legal remedies bars applying the doctrine. Many cases where a remedy has been granted by the disregard device appear to be independently actionable under other theories of liability, for example, an action in deceit, an action in the nature of breach of contract or warranty, and so on.[125] But there seems to be no good reason why the disregard doctrine should be available when the traditional theories give proper remedies. It is an unwarranted expansion of the doctrine.

C. Subjectiv Factors

(1) Intent of the defendant.

Many decisions have held that the corporate personality can be disregarded only when it has been used by the shareholder or the parent corporation to commit fraud, or violate other legal duty, or has been used to perpetrate a dishonesc or unjust act.[126] Thus defendant's purpose to use the corporate device for illegal ends has often

120) Weisser v. Mursam Shoe Corp., p. 116 supra.
121) Gordon v. Aztec Brewing Co., 33 Cal. 2d 514 (1949).
122) Louisville & N.R. Co. v. Nield. p. 127 supra.
123) Lattin, Jennings, Buxbaum, op. cit. 152.
124) See pp. 108—111 supra.
125) Comment, 28 Ohio St. L.J. 441, at 442 (1967).
126) Lowendahl v. Baltimore & O.R. Co. 287 N.Y. Supp. 62, at 75—76(1936). May Department Stores Co. v. Union Electric Light & Power Co. 341 Mo. 299, 107 S.W. 2d 41, at 55(1937). Bell Oil Gas Co. v. Allied Chemical Corp. 431 S.W. 2d 336 (1968).

been an important factor. But it is not easy to prove such illegal or unjust purpose. Some courts, therefore, do not require actual proof of fraud or illegal intent, but think it sufficient to prove that the scheme would be fraudulent or unjust if accomplished. Accordingly, bad faith in one form or another is thought to be an underlying consideration.[127] There are, however, cases in which justice damands disregard of the corporate entity, although the bad faith of the defendant shareholder is lacking. Suppose a shareholder forms a corporation with capital which he thinks to be reasonably adequate, but which is in fact far from sufficient This and additional factors may justify to disregard the separate personality of the financially fragile corporation.

Many California courts have held that the objective factors are all that is necessary. In Minifie v. Rowley,[128] the court held that if there is such unity of interest and ownership that the individuality of the shareholder and the corporation has ceased, and if adherence to the fiction of the separate existence of the corporation would bring about inequitable results, the corporate entity can be set aside. Again in Autometriz del Golfo de California v. Resnick,[129] the court confirmed that the above two factors were necessary and that undercapitalization represented the second requirement. Minton v. Cavaney[130] went one step further and held that undercapitalization and active participation by the shareholder in the conduct of the corporate business would justify disregard of the corporate personality, dispensing with the non-compliance of corporate formalities implied in the unity of the interest and ownership concept. This trend approaches the ideal that Professor Ballantine suggested.[131]

(2) Reliance or knowledge of the plaintiff.

Does the plaintiff need to be confused by the commingling of activity and should he be misled to believe that the corporation was adequately capitalized? These factors often are elements influencing the decision, either directly or indirectly.

This is greatly emphasized in contract cases. Professor Latty draws a line between voluntary and involuntay creditors. A bank which had made loans to the subsidiary.

127) Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. 2d 825, at 838(1962).
128) 187 Cal. 481 (1921).
129) 47 Cal. 2d 792 (1957).
130) 56 Cal. 2d 576 (1961).
131) Ballantine, op. cit. 302—303.

a voluntary creditor, could have refrained from making the loan. It could have investigated the credit standing of the borrower or demanded collateral. If it chose to make the loan, it should look to the borrower for repayment. There was nothing inequitable in refusing to let the bank recover against the parent in the absence of other factors imposing liability, such as "milking" or "commingling". On the other hand, the plaintiff who is run over by the subsidiary's truck is an involuntary creditor, and if it is fair to make the entrepreneur bear the consequence of an act done by another person, the corporate entity can be disregarded.[132] Thus contract claimants particularly close to the entity have been "estopped" from claiming disregard.[133]

But if reliance can be a factor in contract claims, the same rule cannot be applied to tort creditors, because they are involuntary. Some courts do not recognize this difference, however, and require reliance even in tort cases.[134] But in most tort cases reliance is not an element in imposing liability on the shareholders.[135] The distinction between contract(voluntary) and tort (involuntary) creditors does not have absolute validity. Suppose a farmer makes a contract to sell his crops to a corporation which is the only one in his area, yet of which he does not know much. He is in some respects in no better position to choose the corporation than a tort claimant. As far as the commingling aspect is concerned, a tort creditor has as much difficulty in ascertaining the true party in interest as a contract creditor. This difficulty certainly deserves consideration. Failure to comply with formalities and adequately capitalize leads to disregard of the corporate entity because, on the average, this leads to abuses that may eventually harm those dealing with the corporation, either voluntarily or involuntarily.[136] Thus in both contract and tort cases reliance should not be a prerequisite for the disregard remedy. Only when the contract creditor knows that the corporation with which he is dealing has little capital and does not take measures to protect himself, can this remedy be denied. In this case, he must sustain the loss himself.

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132) Latty, op. cit. 201—205.
133) Cf. Wynn v. Treasure Co., 146 Cal. App. 2d 69, 303 P. 2d 1067 (1957).
134) Zubik, v. Zubik, 384 F. 2d 267 (3rd Cir. 1967).
135) See notes 78, 81, 103, supra
136) Lattin, Jennings, Buxbaum, op. cit. 157.

4. LEGAL EFFECTS OF DISREGARDING

(1) When the separate personality of a corporation is disregarded, the independent existence of the corporation is ignored and the corporation is regarded as a mere association or collection of individual shareholders. Consequently the corporation and the shareholders are treated as one unit. But this simple generalization has many ramifications. For example, if a person incorporates and conveys to the corporation all his property to evade payment of a judgment, the conveyed property will not be respected as that of the corporation, but will be regarded as the individual property of the shareholder. His creditor can then execute against that property. If a person who has assigned his business and agreed not to compete with the person who bought it, forms a corporation of which he is a sole or a controlling shareholder and conducts the same business through the corporation, the new business will not be dealt with as that of the corporation, but looked upon as that of the shareholder and the corporation will be enjoined from conducting the business. When a parent corporation forms a subsidiary in order to evade a statutory restriction, the subsidiary will be regarded as the same unit as the parent. In ordinary cases where corporate personality will be disregarded because of "commingling" or undercapitalization, the corporate obligation becomes the individual obligation of the shareholder and limited liability is denied. If a shareholder (or parent corporation) claims a loan as a creditor of his corporation (or its subsidiary), the two units will be assimilated, and the advance is treated not as a loan but as a capital investment. Therefore the shareholder (or parent corporation) can be paid only after the other creditors have been satisfied.

(2) It is settled that, if the corporate personality is disregarded, only the shareholders will be liable, not the directors or officers of the company. Attempts to hold the directors or officers liable have been unsuccessful.[137] This contrasts with the French approach which does impose liability on the directors.[138]

If there is more than one shareholder, there may be some question about exactly, which stockholders will be liable. In a one-man company there is clearly no problem.

137) Riddle v. Leuschner, 51 Cal. 2d 574 (1959).
138) See pp. 155—157 infra.

In the case of a "straw man" corporation which is a type of one-man campany, the controlling shareholder only will be responsible. The other "straw" shareholders are not liable, because they did not actively participate in the misuse of the corporate form. Likewise the minority shareholders of a subsidiary corporation generally will not be liable, unless they actively participated in the conduct of the corporate business. A family corporation or incorporated partnership is not so simple. It can have more than one shareholder who actively conducts the corporate business. When the corporate personality of such a corporation is ignored, those shareholders will all be liable.[139]

If more than two shareholders are liable, what is the relation between them? The disregard of the corporateness is the converse of the recognition of corporateness in some instances of defective incorporation. If the incorporation is so defective that it cannot be regarded as a de facto corporation, only the incorporators who actively participated in the conduct of the business will be liable for the obligations incurred. They will be held liable as partners.[140] On this analogy, some scholars suggest that active shareholders will be liable as partners when the corporate personality is disregarded. According to partnership law, the liability of patrners is different in contract and tort claims.[141] But the decisions do not seem to distinguish the cases clearly.[142]

(3) How much is the shareholder liable?

In ordinary cases where the corporate creditors try to hold the shareholder liable for the corporate debts, the shareholder is liable to the full amount that the creditors were not satisfied by the corporate assets. In this sense, his liability is unlimited. In contrast, the shareholder loses only his claim and his liability is restricted to its amount, when he competes as a creditor with the outside creditors of the corporation.

5. CRITICISM

One feature of the American disregard doctrine is its propensity for enlarging the field of influence. Courts apply this doctrine in various areas and situations. Are these properly disregard cases? As Professor Mueller-Freienfels has pointed out, it is wrong to assume that the case involves the disregard doctrine merely because a

139) Autometriz del Golfo de California v. Resnick, 47 Cal. 2d 792 (1957).
140) Baker v. Bates-Street Shirt Co., 6 F. 2d 854 (1st Cir. 1925).
141) Joint liability in contract cases, but joint and several liability in tort claims.
142) Riddle v. Leuschner, 51 Cal. 2d 574 (1959).

corporation is involved.[143] Many cases in which courts used this doctrine could have been settled by other theories of liability. Fraudulent transfers, unfair preferences, and personal promises by the shareholder to stand behind his company are a few examples. Many of the so-called disregard problems can be handled more appropriately as straightforward questions of private contract or statutory interpretation.[144] Suppose an association which has capacity to contract in its name but no legal personality is involved in each of the above cases. The members of the association will be held personally liable for the association's debts, and the result is reached without using the disregard approach.

So long as the traditional theories of liability can properly hold the shareholders liable for corporate debts, there seems to be no room for the disregard doctrine. The corporate personality concept and the shareholders' limited liability incident thereto are the most basic attributes of the corporate system and should not be disturbed too easily. Consequently, if there is a way to correct the abuse of the corporate form without challenging the validity of the basic corporate attributes and the policy behind them, this course should be followed. The disregard doctrine therefore should in principle be restricted to those cases which the traditional remedies cannot appropriately solve, that is, to the commingling and undercapitalization cases.

Another characteristic of this doctrine is the lack of theoretical precision and the confusion of concepts. There are too many metaphors and epithets obscuring the real issues. As Judge Cordozo put it, "this problem is still enveloped in the mists of metaphor."[145] This does not mean that the solutions in particular cases were not right.

The result in each case is generally acceptable. Our concern is to the theoretical refinement.

The most vivid example is furnished by the various theories given by the courts in applying this doctrine. We have seen those theories already, and need not repeat them. Suffice it to say that many theories advanced by the courts cannot successfully explain the reason why the corporate entity should be ignored in particular circumstances. More effort is needed to refine the theoretical basis.

Although this doctrine provides a useful tool for regulating abuse or misuse of the

143) Mueller-Freienfels, Acp 156 (1957) 522, at 539–541.
144) Lattin, Jennings, Buxbaum, op. cit. 153, 169–170.
145) Berkey v. Third Ave. Ry. Co., 244 N.Y. 84, at 94 (1926).

corporate form, attitudes of the courts approaching this theory vary much from one jurisdiction to another. The most conservative trend is represented by the New York courts. They seem to cling to the separate personality of a corporation as far as possible. On the other hand, the California courts stand for the most liberal jurisdiction. The disregard theory in the last decades has been predominantly developed by the California courts. It is interesting that this doctrine has been applied most often by a developing industrial state. Here it is established that objective factors are sufficient to ignore the corporate entity. It is difficult to decide which trend is the best. Too strict an adherence to the separate personality concept can hinder a just and equitable result in a given situation, and can fall into the pit of conceptualistic jurisprudence. On the other hand, if the court is too quick to apply the disregard doctrine, this leads to a threat to the corporate system.

The corporate system and limited liability presuppose a reasonably adequate capital for the magnitude and nature of the corporate business and require that those privileges are employed for legitimate and just ends. In evaluating these factors, courts are advised to look solely to the objective facts, not requiring an intent to abuse the corporate form on the part of the shareholders. The California courts are right in not requiring the subjective element.

6. "LIFTING THE VEL" IN ENGLAND

The English courts have never overcome the case of Salomon.[146] It has choked any attempt to disregard the corporate entity even when justice reqires it. Professor Gower, after reviewing the English cases, concludes that the courts will not challenge the corporate personality except when compelled to do so by the clear words of a statute[147] and that judicial inroads into the corporate entity principle are few. But in connection with the proposed reform of English company law, the British Institute of Comparative and International Law has collected material on this subject. One lawyer who assisted this project summed up by saying "the doctrine of lifting the veil has come to stay and it is not necessarily a more difficult operation here than in other countries".[148]

146) Salomon v. A. Salomon & Co., see p. 109 supra.
147) Gower, The Principles of Modern Company Law, 193, 207 (2nd ed. 1957).
148) Cohn & Simitis, "Lifting the veil" in the Company Laws of the European Continent, 12 Intl. & Comp. L.Q. 189-225 (1963).

III. THE SO-CALLED "DURCHGRIFFSLEHRE" IN GERMANY

In Germany it is generally recognized that the corporate personality can be disregarded in particular circumstances, and the shareholders can be held personally liable for corporate obligations. This legal process is called "Haftungsdurchgriff" and the theory is usually referred to as "Durchgriffslehre."[149] The theory has a history of more than half a century, and was given much attention in connection with the German Reich corporations (Reichgsellschaft) after the Second World War. Many attempts have been made to find a principle behind the various lines of cases. The pioneer work is Professor Serick's book[150]. So far none of them has been fully successful.

Many divergent views prevail as to the scope, factors and effects of this doctrine. There is not even any agreement as to the relevance of the corporate personality concept to this doctrine.

However, all scholars agree that this theory circumscribes the concept of corporate personality and amounts to a non-application of the separation principle between the corporation and its members. A brief summary will be presented.

1. SCOPE OF APPLICATION (TYPICAL CASES)

(1) Acts to defraud creditors[151].

Attempts to defraud third parties by the corporate device have not been successful in Germany. In the so-called Tivoli Theatre case[152], a limited company operated a theatre. The building had been lent to it by its sole shareholder who was also its managing director. The plaintiff had a performance claim against the corporation and obtained a judgment thereon. When he tried to enforce it, the sole shareholder

149) For convenience, I will call it the disregard theory. There are scholars who call this "Schleierlüftung" (lifting the veil).

150) Serick, Rechtsform und Realität juristischer Personen (1955). Müller-Freienfels, Zur Lehre vom sogenannten "Durchgriff" bei juristische Personen im Privatrecht, Acp 156 (1957) 522–543. Drobnig, Haftungsdurchgriff bei Kapitalgesellschaften (1959). Rehbinder, Konzernaußenrecht und allgemeine Privatrecht (1969) 85-125.

151) Serick, op. cit. 42–53.

152) RG 22. 10. 1934.

terminated the contract with the corporation, took over the management of the theatre and thereby deprived the company of its chief asset. In these circumstances the court permitted the judgment to be enforced against the shareholder's personal property. The court found that he had abused the forms of law to prevent creditors from getting satisfaction. Similarly, an attempt by a defendant to evade an execution by lessening the property of the corporation of which he was the sole shareholder failed when the German Reich Court held that the personal creditor of the shareholder could execute on the assets of the corporation[153].

These cases could, however, be properly solved as mere fraudulent transfer of properties[154].

(2) Acts to evade contractual obligations[155].

The corporate personality has often been employed to evade a contractual obligation. Where a contract in restraint of trade is permissible, its effect cannot be circumvented by the formation of a separate corporate entity. If A has promised not to compete with B, a corporation of which he is sole or controlling shareholder is bound by his promise[156]. The shareholders of a corporation which has concluded a noncompetition agreement cannot escape the obligations that have been created by dissolving the corporation and forming a new one which competes with the party with which the agreement was made[157]. In these cases, the corporate personality appears to be disregarded. They are, however, questions of contract interpretation.

(3) Acts to circumvent statutes[158].

Statutes cannot be evaded by forming a corporation. Germany had a law designed to protect hire-purchasers (Abzahlungsgesetz vom 16. 5. 1894). This statute was inapplicable to loans. It consequently failed to benefit a person who acquired a motor car from a corporation for cash which he had borrowed from another corporation, whose shares were owned by the same people who owned the selling corporation. The court held that the two corporations were in reality one: the seller was in fact a party to the loan contract. Therefore this latter contract was subject to the provisions

153) RG 28. 1. 1905.
154) Drobnig, op. cit. 64-66; Rehbinder, op. cit. 111-112.
155) Serick, op. cit. 32-41.
156) BGH 13. 2. 1952, BGHZ 5. 126, 133. 136.
157) RG 10. 6. 1926, RGZ 114, 68.
158) Serick, op. cit. 17-31.

intended to protect the purchaser[159].

If the sole shareholder of a corporation sets fire to the corporate building on purpose, his activity is looked upon as that of the corporation and the corporation cannot claim the fire insurance money[160].

An agent under German law may not retain bribe money received by him. He must disclose and deliver it to the principal. In order to circumvent this liability, an agent arranged that bribe money should be paid to a corporation controlled by him and not to him personally. The German Reich Court held that he was bound to pay over the money to his principal, although he personally had not received it.[161]

These cases are, however, questions of norm collisions between the separation principle and other provisions of the law, and the separation principle is simply subordinated to a superior norm[162]. In other words, we can reach the same result by properly interpreting the statutes without invoking the disregard doctrine.

(4) Acts against bona fides.

Bona fides is sometimes a requirement for the acquisition of rights. Thus A may be registered as owner of Blackacre in the register of immovable property while X is the real owner. B, who acquires Blackacre from A, acquires full title, if he relies in good faith upon the fact that A is the registered owner in ignorance of X's title. The courts have restricted the application of this rule in cases where a sole shareholder acquires from his corporation or vice versa. His knowledge excludes good faith even though he may not be a director or officer of the corporation.[163] This doctrine, however, applies only when there is complete identity between the natural person or persons on and the one hand and the shareholder or shareholders of the corporation on the other hand.

The Civil Code provides certain statutory rights in favor of the purchaser to whom defective goods have been delivered or who received possession of goods with defective title. These rules might have been thought not to be applicable where a vendor sold the shares of a corporation which on its part owned a house affected by dry rot,

159) RG 30. 1. 1931.
160) Serick, op. cit.18-21.
161) RG 9. 7. 1926, RGZ 114, 276.
162) Müller-Freienfels, op. cit. 537-538.
163) RG 19. 10. 1929; Serick, op. cit.193-202.

for, strictly speaking, the purchaser had been promised title to shares and he got what he bargained for. But the court resisted the temptation to look at the shell instead of at its kernel and held that the sale of the shares was equal to the sale of the corporation's assets. Thus where a business is sold by way of a sale of shares in the corporation conducting it, the court can inquire whether the business is as good as has been promised[164]. In such cases the independent personality of the corporation is disregarded by interpreting the contracts.

(5) One-man company

The disregard cases in Germany often arise in one-man companies[165]. A sole or controlling shareholder who has failed to distinguish between the assets and affairs of the corporation on the one hand and his own private assets and affairs on the other hand and who has derived advantage from doing so, may be personally liable for the debts of the corporation. An owner of a textile business, A, was also the sole shareholder of a limited liability company. The company was engaged in the same line of business. It occupied the same premises. A, however, was not a director of the corporation and had no authority to act for it. He drew two bills of exchange, stamping them with a stamp reproducing the company's name, though with some alteration. The bills were accepted by a private debtor of A. They were, on his instructions, credited to the account of the company. A creditor of the company obtained an order for attachment against the company, which he enforced by attaching the bills. A brought an action to set aside the attachment. He was unsuccessful on the ground that he had obliterated the dividing line between the corporation's and his own private business.[166] The principle, however, has its limits, and is applicable only where the operations of the sole shareholder have resulted in rendering it impossible for the creditors to get satisfaction from the corporation's assets.

Another field where the sole controlling shareholder is responsible for corporate obligations ruled by him is in the sphere of undercapitalization. It is a well-known habit of less scrupulous businessmen to employ a corporation with a small amount of capital for the purpose of carrying on a large enterprise. Such capital as the

164) RG 9.3. 1928, RGZ 120, 283; RG 5.7. 1928, RGZ 122, 378. Compare Keokuk Electric Railway Co. v. Weisman, supra. p.103.

165) Gadow & Heinichen, Aktiengesetz (1961) I. §15, Anm. 8, N.8.

166) OLG Nürnberg, 26.5. 1955, cf. OLG Karlsruhe 10. 12. 1942.

corporation needs is provided by loans from the sole or controlling shareholder. Thus, in one case, A had formed a corporation with the assistance of B and C, whose shares he purchased shortly after the formation of the corporation. The capital of the corporation amounted to DM 20,000 only. It was utterly insufficient for the corporation's needs, but A provided further capital by way of way of loans which he gave to the corporation. When things began to look bad, the corporation repaid the loans to A. As a result its other creditors were unable to obtain repayment of their debts. They asked the court for an order that A should repay to the corporation the loans which he had given. They were successful. The loans, it was held, were to be treated as if they were the corporation's capital. The sole or controlling shareholder who has started a corporation in this manner should be treated as if the loan capital was share-capital.[167]

(6) The parent and subsidiary corporations[168].

It goes without saying that the subsidiary cannot be employed as a cover for illegal purposes of the parent corporation. In the absence of such illegal intent, the separate personality of the subsidiary can be disregarded in order to carry out the legislative policy of corporation law.

In the so-called Neustaßfurt case[169], a corporation issued new shares to two labor unions at less than par in disregard of the shareholder's preemptive rights. Almost all of the shares of the labor unions were in the hands of the corporation. The German Reich Court held the capital increase to be null and void. It was emphasized that most of the mining shares of the labor unions were owned by the corporation. There was an indirect violation of Sec. 226 II 2 of the German Commerical Code(HGB), which prohibits the purchase by a corporation of its own shares. Although the two labor unions were separate legal personalities, their assets were in fact those of the corporation, and so the price of the new shares was in reality paid from the corporate assets. The same result follows when the subsidiary purchases the shares of the parent corporation. The Statute on Joint Stock Corporation prohibits this[170].

167) BGH 14.12. 1959, NJW 1960.286; RG 16.10. 1937, JW. 1938. 862. Cf. Arnold v. Philips, supra, p. 110.
168) Serick, op. cit. 104-117,
169) RGZ 108, 41.
170) Article 71.

(7) Set-off cases.

The courts have been more reluctant to charge the corporation for the debts of its sole or controlling shareholder. But there is a whole series of cases which have pierced the corporate veil for this end. A number of corporations were formed by the German Reich before or during the Second World War for the purpose of carrying out tasks connected with military operations. They were wound up after the end of the war. Their liquidators claimed payment of the debts owed to them. Many of the debtors of one corporation, however, were creditors of other corporations of the same type. They tried to set off these claims. This should in strictness not have been permitted because claims might be set off only where debtor and creditor on both sides were identical. The courts, however, permitted the setoff. The corporations were not treated as independent legal entities but as mere departments of the State working with the full knowledge of the latter and under its instructions[171]. In a later decision, the Federal Supreme Court declared the principle of these decisions to be inapplicable elsewhere[172]. In this case a sole shareholder of a corporation owed large amounts to debtors of the corporation. The latter tried to effect a set-off, relying on the decisions just referred to. The Court of Appeal, relying on the much invoked equitable principle of "good faith", permitted the set-off. The Supreme Court reversed this judgment. It stressed that only the extraordinary circumstances prevailing at the end of the Second World War had led to the results laid down in those decisions. But it can be difficult to know where the borderline runs between the ordinary and the extraordinary.

(8) Sole shareholder as a creditor of his corporation[173]

When a sole shareholder presents his claim for payment of loans to his corporation, and the corporation is undercapitalized, his claim may not be allowed. The German Reich Court recognized this ground of liability in two decisions in 1937 and 1938. In the first case, a limited liability corporation was formed with capital of RM 30,000 to operate a chemical plant. Within one year the corporation had obtained loans amounting to RM 60,000, partly from its sole shareholder. One year later the corporation went bankrupt, and the sole shareholder presented his claim in the amount

171) BGH 30. 10. 1951; 3. 7. 1953; 17. 3. 1955: Serick, op. cit. 6-10; Drobnig, op. cit. 61-63.
172) BGH 7. 11. 1957.
173) Drobnig, op. cit. 74. 78-82; Serick, op. cit. 45-46.

of RM 85,000 for loan, salary, rents and supplies. Without evaluating the individual items, the court rejected all claims on the unspoken assumption that they were capital investments[174]. A decision of the following year rests on the same ground.[175]

(9) Criticism.

Professor Serick and his followers look upon the cases involving acts to defraud creditors, to evade contractual obligations and to circumvent statutes by corporate device as those of the disregard doctrine.[176] On the other hand, Professor Müller-Freienfels urges a start from the general law to solve such problems, warning that it is erroneous to regard a problem as that of the corporate personality if a corporation is involved in that problem. Where a corporation is involved, he says, we have only to determine how and in what degree the general law can be adjusted to that situation. It is nothing more than a question of norm-collisions.[177] There are a number of differing views lying between the two cited above.[178] Professor Drobnig maintains that cases where the shareholder can be charged personally on grounds having nothing to do with corporation law should be excluded from the field of the disregard doctrine. Thus attempts to defraud creditors by the corporate device can be solved by actio pauliana or fraudulent conveyance. Holding out to be personally liable for the corporate debts or joint torts are also independent grounds of liability, rendering it unnecessray to invoke the disregard doctrine.

Disregard of corporate entity sets a limit on the separation principle, which is one of the basic attributes of the corporation system. It is an exception and should be applied with care.[179] Therefore, this doctrine need not be applied to cases where the traditional theories of the private law can properly solve the problems. Professor Drobnig's theory, which applies this doctrine only to those cases where the special provisions or policies of the corporation law require it, is right.

2. THEORETICAL GROUNDS FOR THE DISREGARD DOCTRINE

(1) Correlation, if any, with the nature of the corporate personality.

174) RG 16.11. 1937, JW. 1938, 862.
175) RG 3.12.1938, JW 1939, 355.
176) Serick, op. cit. 203-219.
177) Müller-Freienfels, op. cit. 539-543.
178) Rehbinder, op. cit. 98-100.
179) ibid. 107-110.

Is the disregard doctrine inseparably related with the controversy over the nature of the corporate entity? Unlike the United States, scholars in Germany usually indulge themselves in the conceptual dispute on the character and value of the corporate personality. The reason they give is that corporation is the starting point of this doctrine.[180] According to Professor Rehbinder, there are three different views as to the nature of the corporate personality. The first view is represented by Professor Serick and presupposes a uniform corporation. It gives the legal person an original value of its own like a natural person, without taking into account the differences in legal facts and sociological types of various corporations. Consequently the strictest requirements should be met before disregarding the corporate personality. According to Professor Serick's second formula, the corporate form generally cannot be disregarded merely because the objective purpose of a norm cannot be attained. It can be ignored only when it is intentionally abused by the shareholders [181]. The second is a view cherished by the modern interest jurists, Professor Müller-Frieienfels being its proponent. This view understands the corporate personality as "a convenient symbol" or "a constructive abbreviation" for complex legal relations, and emphasizes the difference between the natural and legal persons, and the sociological reality and diversity of the legal person. Whether or not to disregard the corporate personality should be decided from the viewpoint of the meaning and importance of the individual norm. The so-called "Durchgriffslehre" is not an independent theory, but an application of the norm by way of evaluating it in a given situation. The requirements vary from case to case.[182] The third view is an eclectic one advocated by the so-called institutionalists, of which Professor Raiser is the leader. This view recognizes that the legal person has an institutional value of its own on the one hand, but that it can be limited by superior regulating principles on the other. This school recommends neither a radical indifference to the separation principle nor a blind adherence to it.[183] The German courts generally take the third position.[184]

The disregard doctrine may be conceptually connected with the nature or value of the legal person. But as Professor Serick has stated, one's position on the nature of

180) Rehbinder, op. cit. 93.
181) Serick, op. cit. 208-212.
182) Müller-Freienfels, op. cit. 525-535. Wiethölter, ZHR 125 (1963) 324-326.
183) Rehbiner, op. cit. 96.
184) ibid. 97.

the corporate personality serves little for the solution in a given case.[185] At any rate, it should not have more than the role of an "extra."

(2) **Legal grounds.**

The Federal Supreme Court, following the precedent of the former German Reich Court, has repeatedly justified the disregard doctrine using the following formula :

"The legal differentiation between a corporation and its sole participant cannot be taken into account without exceptions. The corporate entity and its sole participant must be treated as if they were one and the same entity, if the realities of life, the economic requirements and the power of facts render it imperative for the judge to disregard any differentiation between the personality and the assets of the corporation on the one hand and those of its sole shareholder on the other hand."[186]

This formula is obviously so broad and so vague as to be practically meaningless. The scholars, therefore, tried to find out more certain criteria. They range from public policy, norm-application, immorality, good faith in the form of the abuse of rights or venire contra factum proprium, to implicit waiver of limited liability, voluntary imposition of liability, liability through representation, and the abuse of institution.[187] The corporate personality is disregarded because it is employed for ends not allowed by law. It seems difficult to explain the doctrine exhaustively by invoking or analogizing only one of the traditional theories.

3. FACTORS

(A) Is subjective intent necessary?

Different views obtain as to the requirement of the subjective element in applying the disregard doctrine. Professor Serick thinks it is necessary. All enacted norms have certain purposes or ends. These purposes cannot be realized at the expense of the corporate form which has in turn a valuable function. The mere fact that the purpose of a norm or the objective end of an act-in-law is not realized, therefore, does not justify disregard of the corporate personality. It can be ignored only when the shareholder has an intent to abuse it for illegitimate purposes. The only exception to this rule is the corporation law norms which are of such fundamental significance that

185) Serick, op. cit. 2-3.
186) BGH 29.11. 1956, BGHZ 22, 226; RG 22.6. 1920, RGZ 99, 232.
187) Rehbinder, op. cit. 100-101.

their purpose cannot be even indirectly prejudiced. The objective violation of such norms by corporate form, therefore, requires disregard of the corporate personality. An example of these norms is the provision of the Statute on Joint Stock Corporations which prohibits the purchase by a corporation of its own shares.[188]

But this view has dubious validity. As Professor Müller-Freienfels keenly analyzed it, this requirement of "intentional" abuse finds a parallel in the so-called subjective theory on the circumvention of statutes. But the so-called objective theory gets more support in Germany. The latter theory does not require the difficult proof of the intent to circumvent. Objective infringement of a statute suffices.[189] The corporate form should not be employed for purposes or ends which were not contemplated by the legislators who created it. It is very difficult to prove the abusive intent of the shareholder to employ the corporate device for unjust or dishonest purposes. To require this proof would leave uncorrected many abuses of the corporate personality. Moreover there are cases in which justice requires the corporate entity to be ignored although the shareholders have no intent to abuse it. The objective factors alone are sufficient for disregarding the corporateness.

(B) Objective factors

(1) Control

Control through mere ownership by a sole or controlling shareholder of all or the majority of the shares of his corporation does not of itself make him personally liable for the obligations of the corporation. Nor does control by a parent corporation of its subsidiary through mere stockholding of the latter make the parent liable for the subsidiary's debts. The identity of directors and officers, as where the sole or controlling shareholder is a director or officer or the parent and the subsidiary corporations have the same directors and officers, does not fuse the two units into one. Even the existence of the above two factors is not sufficient for applying the disregard doctrine.[190] The same rules obtain in the United States of America.

But control in peculiar form can hold one unit liable for the obligations of the other unit. In the German Reich corporation cases mentioned above[191], the Federal Supreme

188) Serick, op. cit. 208-212.
189) Müller-Freienfels, op.cit. 536-537.
190) Drobnig, op. cit. 26-27.
191) See p. 147 supra.

Court permitted the set-off when the corporation had conducted public functions under the continuing guide and supervision of the State and when its formal position as an owner of property did not conform to its actual relation to the State. Thus the German Reich corporations which conducted the public functions of the State were controlled by it to such extent that they became mere departments of the State, were deprived of separate legal personality. German tax law recognizes various forms of contracts which treat the legally independent corporations of an economically unified enterprise as if they were one unit for tax purposes. For example, a holding company can take over all the profits and losses of subsidiary corporations at the end of a fiscal year in order to avoid double taxation on the income of a subsidiary[192].

However, except for such particular forms of control, mere control through stock ownership does not justify the "Haftungsdurchgriff."

(2) Commingling of the assets and affairs.

Disregard of the corporate formalities is not in itself a ground for ignoring the separate personality of a corporation.[193] But commingling of the assets and affairs between the corporation and the shareholder can be a ground for imposing personal liability on the shareholder for the corporate debts.[194] Some decision, however, hold differently[195]. Scholars generally think that it is very important to distinguish between the assets and affairs of the corporation and those of the shareholder, and recognize that if the shareholder fails to keep this differentiation, he may be personally liable for the obligations of the corporation[196].

(3) Undercapitalization

Capitalization is a central concern of the business corporations. The courts have supplemented the provisions for the protection of corporate creditors through a rule which restricts the limited liability privilege of the shareholders, where the original capitalization is inadequate or the capital is drained in the course of business activities. In one case a firm had formed two similar corporations, X and Y, out of tax law considerations, and it had conveyed to X corporation all its assets. X corporation leased a business plant to Y corporation which had only small capital. X corporation

192) Drobnig. op. cit. 42-43.
193) ibid. 27-28.
194) See p.145 supra.
195) BGH 26.11. 1957; Drobnig, op. cit. 33-34.
196) Drobing, op. cit. 32; Serick, op. cit. 46, note 2.

guaranteed bank credit to Y corporation. A member of X corporation who was absent at the time of the above transaction claimed damages for the guarantee. The German Reich Court rejected the plaintiff's allegation that the guarantee was ultra vires X corporation and held that if Y corporation had been formed to limit liability to its apparently insufficient capital, it thereby gave the creditors a claim for damages. The Court looked to the undercapitalization of Y corporation to reach an equitable result.[197]

Also noteworthy in this context are statutes regulating the banking system which permit banking business only when the bank is equipped with sufficient capital.[198] Inadequate capital measured by the scope and type of the business is always a ground for disregarding the corporate entity.

(4) Supplementary remedy

First, the disregard doctrine should come into play only when the traditional theories of liability cannot give effective remedies. Invoking this doctrine where the general private law theories can solve the problem properly is not only unnecessary, but also contrary to the exceptional nature of the doctrine.

Second, this doctrine can be applied only after all remedies against the corporation are exhausted, or have become useless.[199] The latter situations arise when the corporation is insolvent or dissolved or has ceased to conduct business. In the Tivoli Theatre case illustrated above,[200] the court held that the corporate creditors could obtain satisfaction from the personal assets of the shareholder only to the amount he could not realize from the corporate assets.

When is a corporation insolvent? Professor Drobnig suggests that the insolvency of a corporation arises only when the bankruptcy proceeding is started,[201] but this goes too far. If the evidence shows that the execution on the assets of the corporation is useless and meaningless, the corporation can be regarded as insolvent.

Is the insolvency of a corporation to be decided only by the easily realizable assets? Professor Drobnig answers this question in the affirmative.[202] But the disregard

197) RG 22.10. 1938, RGZ 152, 302 at 310.
198) Sec. 4 I of Statute on the Credit System (25.9. 1939) and Sec. 2 II of Statute on Capital Investment Corporation (16.4. 1957).
199) Drobnig, op. cit. 56, 87, 92.
200) See p· 142 supra.
201) Drobnig, op. cit. 56.
202) Ibid. 57.

doctrine should be applied with care and so long as the corporation has any assets, although they cannot be realized easily, the creditors of a corporation should not be permitted to hold the shareholders personally liable.

5. EFFECT OF APPLICATION

Scholars are not in total agreement as to the effect of the disregard doctrine. According to Professor Rehbinder, the direct effect of disregarding the corporate entity and thus limiting the separation principle between the corporation and the shareholders is to create a norm-free space. This space can be filled by interpretation, analogy, or development of other norms. This process is the effect of the disregard doctrine.[203] A group of scholars have asserted that the disregard of the corporate personality results in the shareholder's unlimited liability, wheras another group explain that only the compensation of the drained assets is at issue.[204] Neither view is complete. The former fails to indicate the difference of the shareholder liability in various situations and the latter cannot explain the commingling cases. Application of the disregard doctrine results in disregarding the separate personality of the corporation and in regarding the corporation and the shareholder as one and the same. To what extent the shareholder is liable varies in accordance with the facts of the case.[205]

6. CRITICISM

The "Durchgriffslehre" is still in its formative stage, although more than half a century has passed since it first came into play. Many attempts have been made to find a prinicple equally applicable to all situations, but none has been fully successful as yet. As is usual with the German tradition, controversies on this doctrine are focused more on theoretical questions than practical issues. Thus many efforts have been made to draw a demarcation line between the traditional theories of liability and the disregard doctrine, but study on the factors which led the courts to the disregard of corporate entity has been neglected with the exception of Professor Drobnig. Indulgence in the conceptual controversy over the nature of legal persons has no great value in solving problems in given situations.

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203) Rehbinder, op. cit. 101-102.
204) Ibid. 102.
205) See p. 108 supra; Drobnig, op. cit. 24, 71, 78.

IV. DISREGARD PROBLEMS IN FRANCE AND JAPAN

1. FRANCE

In France a statutory provision is provided for what may well be considered the most important aspect of the problem of the disregard doctrine: the responsibility of those who control the corporation's debts. This responsibility, however, comes into operation only if and when the corporation goes bankrupt. It was developed by a number of provisions which codified a long-standing decisional law of the Cour de Cassation. Noteworthy is a decision of the Cour de Cassation rendered in 1908. After a bankruptcy proceeding had been opened on a banking corporation, it was expanded to the private assets of a managing director who had continuously commingled his personal affairs with those of the corporation and distributed warrants of recapitalization to his personal creditor.[206] Art. 437 of the Code du Commerce was amended in 1935 to codify this and later decisions of the Cour de Cassation. This provision, which later became Article 446 of the Commercial Code was expanded with the codification of the French bankruptcy decree in 1955. Article 10 of the decree read:

"En cas de faillite d'une société, la faillite peut être déclarée commune a toute personne qui, sous le couvert de cette société masquant ses agissements, a fait dans son intérêt personnel des actes de commerce et disposé en fait des biens sociaux comme de siens propres."

This provision had long been a favorite of the lower courts in their efforts to hold the proprietors liable for the debts of their corporations. The Cour de Cassation, on the other hand, warned against its too liberal use.[207]

This bankruptcy decree was amended and expanded in 1967.[208] The Article 101 of the new code reads as follows:

"En cas de règlement judiciaire ou de liquidation des biens d'une personne morale, peut être déclaré personnellement en règlement judiciaire ou liquidation des biens tout dirigeant de droit ou de fait, apparent ou occulte, rémunére ou non, qui a:

206) Cass. req. 29.6. 1908; S. 1909. 1.87.
207) See Houin, Faillites et règlements judiciaires, Rev. trim. dr.com. 20(1967), 564, at 567-71.
208) Loi no. 67-763, 13.7. 1967.

-sous le couvert de la personne morale masquant ses agissements, fait des actes de commerce dans un intérêt personnel;

-ou disposé des biens sociaux comme des siens propres;

-ou poursuivi abusivement, dans son intérêt personnel, une exploitation déficitaire qui ne pouvait conduire qu'à la cessation des paiements de la personne morale."

and Article 99 of the same code reads:

"Lorsque le règlement judiciaire ou la liquidation des biens d'une personne morale fait apparâitre une insuffisance d'actif, le tribunal peut décider, à la requête du syndic, ou meme d'office, que les dettes sociales seront supportées, en tout ou en partie, avec ou sans solidarité, par tous les dirigeants sociaux, de droit ou de fait, apparents ou occultes, remunéres ou non, ou par certains d'entre eux.

Pour dégager leur responsabilité, les dirigeants impliquées doivent faire la preuve qu'ils ont apporté à la gestion des affaires sociales toute l'activité et la diligence nécessaires."

With these two provisions, all directors——whether de jure or de facto, apparent or occult, and with, or without remuneration——who have conducted the corporate business in their personal interest, or disposed the corporate assets as though they were their own, or in their own interest abusively pursued a course of business which necessarily led to the corporate inability to pay claims against it, will be personally liable toward corporate creditors in the bankruptcy proceeding of the corporation, unless they carry the burden of proving that they carried out their duties completely and with due care. Professor Wiedemann, after studying the far-reaching effect of these provisions, called them Draconic provisions.[209] They give a powerful weapon to the corporate creditors. The bankruptcy code of 1967 holds liable not only a person who is a director of the corporation, but also a man who has a strong influence on the conduct of the business, although he is not a member of the board of directors or an officer.[210]

Since 1967, the courts seem to have expanded the application of Article 101 of the

209) Wiedemann, Haftungsbeschränkung und Kapitaleinsatz in der GmbH. 51, in Wiedemann, Bär, Dabin. Die Haftung des Gesellschafters in der GmbH (1968). Art. 54 of the Commercial Code, along with Art. 248, were amended in 1966 and 1967, thus parts of them are retained in Art. 99 of Loi no. 67-763, 13. 7. 1967. See Juglart & Ippolito, Cour de Droit Commercial, 2e éd. (1967), at 468.

210) Wiedemann, op. cit. 51.

bankruptcy code. But this provision comes into operation only if and when the corporation goes bankrupt. It remains open whether the courts will extend this provision to cases which do not involve bankruptcy. French law seems to allow no recourse to a general disregard doctrine other than that derived from the aforesaid statutory provision.[211]

A feature of the French approach is that it imposes liability not on the owners of a corporation but on the managers or directors of it. This wide-ranging personal liability of directors goes much farther than the American law.

2. JAPAN

After the Second World War, a few scholars discussed the possibility of introducing the American doctrine of disregard of corporate entity to Japan.[212] As a result of their efforts, several trial court decisions were rendered which applied this doctrine either directly or indirectly. In the first case which directly applied this doctrine,[213] a man engaged in the building business formed a building corporation. The corporation had its principal office at the sole shareholder's premises and its employees were those previously employed by the shareholder. The business was carried on in the same manner as before. The sole shareholder did not distinguish between the businesses of the corporation and his own. He made a building contract with the city where he lived. He purchased building materials from a merchant in the corporation's name and assigned to him his claim against the city arising from the building contract. The vendor brought an action against the city for a declaratiory judgment that he had validly obtained the claim against the city by assignment. The city contended that the party to the building contract was not the corporation but the sole shareholder as an individual, and that the merchant who sold the building materials to the corporation could not get the claim of its shareholder by assignment. The court rejected this contention and held that the vendor had validly taken over the claim, saying that the corporate personality could be disregarded if it was abused for ends unwar-

211) Ripert and Roblot, Traité élémentaire de droit commercial,I. no. 1317–21.

212) Osumi-genichiro, The disregard of the corporate entity, Bupjoshibo, Vol, 2, No. 8, Matsudajiro, Independence of a corporation in concern relationship, Bupjoshibo, Vol. 2, No. 2.

212) Decision of Chiba District Court, 30. 1. 1960, Inferior Court Decisions in Civil Matters, Vol. II, No. 1, p. 194.

ranted by the law. In another case a family corporation which operated hotel, cabaret and cafe businesses had wound up its business and fired employees in order to hinder the formation of a labor union and to exclude those who were active in the labor dispute. The court held that this was an unfair labor practice.[214] This case is considered to involve a disregard problem.[215]

Professor Osumi, who first introduced the disregard doctrine to Japan and was apparently influenced by Professors Wormer and Serick, thinks that attempts to defraud creditors, to evade contractual obligations and to circumvent statutes by the corporate device are all questions of the disregard doctrine.[216] But such unwarranted expansion of the area of the disregard doctrine goes the opposite way from the general trend in the United States of America and Germany.

Such trial court decisions[217] and scholarly works culminated in the Supreme Court decision of February 27, 1969.[218] Here plaintiff A leased a building to B corporation which was formed by C to reduce his tax burden. C was the president and director of B corporation and the corporate business of B was in fact the personal business of C. Plaintiff A asked C to quit the building and C gave to A a written note promising to vacate the building within a certain period of time. C failed to vacate the building within that period. A brought an action for eviction against C. In this proceeding A and C made a judicial agreement in which C promised to vacate the building within a fixed period. Again C failed to quit the building. Now A brought an action for eviction against B corporation. B contended that it had a valid lease agreement with A. The trial court found that the lease had ended when C agreed to vacate the building in the previous proceeding. B corporation appealed against this decision. The Supreme Court, after confirming the separation principle between the corporation and its members, held that corporate personality is a privilege given by legislative policy, and that where it is a mere form or a simulacrum, or is abused to evade statutory provisions, it is against the policy of the law and may be disregard-

214) Decision of Fukuoka District Court, 2.5. 1952.
215) Osumi-genichiro, The abuse of the legal form of the corporation(in Problems of Corporation Law, p. 28).
216) Osumi-genichiro, op. cit.
217) For other decisions, see Osumi-genichiro. The disregard of the corporate entity and recent decisions(in Problems of Corporation Law).
218) Supreme Court Reports in Civil Matters, Vol. 23, No. 2, p. 511, at 512-513 (1970).

ed. It further held that if the corporation is in fact a personal business of its shareholder as here, the third party can regard the transaction of the corporation as that of the shareholder and vice versa. The commingling of the affairs amounted to assimilation of the corporation by its shareholder, and the promise by the shareholder was regarded as that of the corporation. It is interesting that Justices Osumi and Matsuda, who introduced this doctrine to Japan, were among the five justices, who heard this case. Active application of this doctrine is expected in the future.

V. HOW SHALL WE REGULATE THE ABUSE OF THE CORPORATE FORM IN KOREA?

1. THE PROBLEM

The abuse of the corporate form is not unknown to Korea. The corporate system is widely employed by unscrupulous businessmen to limit liability without providing adequate capital. To take an extreme example, corporations, the total assets of which are a rented office, a desk and a telephone, are not few. Even corner grocery stores are being incorporated. A satirical saying suggests that if one throws a stone in Namsan Park[219], it more likely than not will hit the president of a corporation. Such prevalence of undercapitalized corporations brings about many evils. A bona fide creditor who that a corporation is an entity combining the resources and knowledge of many persons believes and that as such it is superior in assets and credit to an individual often finds himself helpless in collecting his money. What of a tort creditor who did not have any chance to choose not to transact with the corporation? The controlling shareholder of such a corporation is frequently wealthy, and has formed the corporation solely to protect his personal fortune. This is but one example of the abuse of the corporate form.

The corporation system is recognized by the law in order to serve the public convenience and justice in legal and business life, and the separation between the corporation and its shareholders, an attribute of the corporation, is preserved only so long as the corporation is employed for legal and equitable purposes and functions within the limits set by the law. If the corporate form is employed for purposes not

219) A park in Seoul City

within these limits and unwarranted by the law. the courts should set aside the corporate form and hold the shareholders who are behind the corporate veil.

What ways of regulation are available? The Korean Commerical Code has a few provisions to prevent or correct the abuse of the corporate personality. For example, more than a half of the authorized capital stock should be issued and paid in full when a corporation is formed (Art. 289. II, 295, 305). If shares are issued for property, it must be carefullly examined by an auditor(Art. 310). Moreover, care is taken to preserve the paid-in capital (Art. 462). But unless the minimum limit of the capital is set, these provisions are meaningless. In addition to such preventive measures, the Code has a weapon to eliminate a corporation when it is abused. Article 176 of the Commercial Code provides that:

"The court may order dissolution of a corporation in the following circumstances on the application of the person interested, or of the public prosecutor, or ex officio:

(1) Where the purpose of incorporation of the corporation is illegal;

(2) Where a corporation, without reasonable cause, has failed to commence its business within one year after it came into existence, or has discontinued its business for a period of one year or more;

(3) Where a director or a member administering the affairs of a corporation has, in violation of law, decrees or the articles of incorporation, committed an act which does not make it permissible to continue the existence of the corporation."

Although this dissolution order can be an effective measure, it is rarely applied. This is partly due to the fact that this order is too harsh when the abuse is limited only to a small portion of the corporation's activities.

The provisions of the Korean Commerical Code, therefore, are not sufficient to regulate the abuse of the corporate personality. It is necessary to examine the applicability of the disregard doctrine. De lege ferenda suggestions will follow.

2. THE APPLICABILITY OF THE DISREGARD DOCTRINE

The doctrine of disregard of corporate entity is nothing more than an attempt to circumscribe the corporate personality concept.[220] The basic idea underlying this doctrine is no less valid in Korea than in other countries. The corporate personality is a fiction

220) Rehbinder, op. cit. 97.

created as a legal method to obtain the proper purposes recognized by the law. If this fiction is employed for purposes contrary to the policies and ideals of the law which created it, it is more than natural that courts, which apply the law, interpose to correct the abuse and disregard this fiction. The disregard doctrine, which ignores the separate personality of a corporation in a given situation, is not restricted to the United States.[221] Nor is it limited to Germany. Attitudes of the courts toward this doctrine in the United States, Germany, France and Japan show an astonishing conformity. As Professor Drobnig properly analyzed it, this conformity is due to the following factors. First, this doctrine is widely applied to fact situations which emerge when capitalism develops to a certain stage, that is, the spreading out of the business corporations in the direction of small manufacturing and selling enterprises on the one hand, and the decentralization and division of the great enterprises on the other. Second, these new problems were not solved by strict statutory schemes, but by the courts (France codified the court decisions)[222]. As Messrs. Cohn and Simitis concluded after reviewing the disregard cases of the Continental Europe, there is no valid reason for the Continental legal system to differ in dealing with this problem from the common law.[223] And Japanese courts actively apply this doctrine. As far as this doctrine is concerned, the decisions of foreign courts not only give theoretical contrast, but also they can be direct models for the decisions of concrete cases in Korea[224].

The legal system of a country is a product of its history and economic structure. We should expect that the disregard doctrine might be modified to some extent when applied to Korean situations.

3. THE APPLICATION OF THE DISREGARD DOCTRINE

(1) Factors or requirements.

As with American and German decisional law, control through mere ownership of all or the majority of the shares of a corporation and the use of power incident thereto to elect directors or officers is not in and of itself a ground for disregarding the separate personality of the corporation. If control by a shareholder or a parent

221) Serick, op. cit. 54.
222) Drobnig, op. cit. 89-90.
223) Cohn and Simitis, op. cit, 219, 225; Osumi, The disregard of corporate entity, note 212 supra
224) Drobnig, op. cit. 90; Serick, op. cit, 60.

corporation is not in a manner normal and usual with stockholding, but to such extent and in such manner that the assets and affairs of his corporation or its subsidiary cannot be distinguished from those of the shareholder or the parent corporation, the two units can be fused and the corporate entity of the corporation may be disregarded. When the shareholder himself disregards the independence of his corporation, the court need not differentiate the two units. The level of commingling giving rise to exercise of the disregard doctrine is to be decided in each individual case. Mere failure to observe corporate formalities is not in itself sufficient.

If a corporation is not adequately capitalized for the ordinary needs measured by the magnitude and type of the business, it can be a ground for imposing liability on its shareholder or parent corporation who actively participated in the conduct of the corporate business. The ideal may be that shareholders of an inadequately capitalized corporation should be held personally liable for the debts of the corporation, whether they actively participated or not. But those who did not actively participate in the business and did not directly cause the loss or injury of the plaintiff, should be immunized. Where no shareholders directly participated in the conduct of the corporation, the shareholders who influenced the course of business should be liable. Where a corporation which originally had adequate capital later became insolvent due to business adversity, those shareholders who did not raise the capital or wind up the business, but continued the business as if the corporation were financially sound by way of advances may by personally liable for the corporate obligations incurred during the period.

The disregard doctrine should be invoked as a last resort. The corporate creditor should first exhaust his remedies against the corporation. If a corporation is dormant, insolvent or bankrupt, or has dissolved, a remedy against the corporation will be meaningless, and he may proceed directly against the relevant shareholders.

The above requirements are sufficient to disregard the corporate personality and hold the shareholder liable for the debts of the corporation. The intent to use the corporate device for illegal purposes is not a necessary element. For the objective factors already show that the corporation is employed for purposes not sanctioned by the policy of the law.

(2) Scope of application

First, the disregard doctrine should be applied only if and when the traditional theories cannot effectively regulate the problems involved. Consequently problems which can be solved by properly interpreting the contracts or statutes, such as attempts to evade contractual obligations and statutory provisions by the corporate device should be excluded. Likewise, attempts to defraud creditors can be corrected by actio pauliana. Furthermore when a shareholder is liable as a principal, joint tortfeasor or guarantor for the acts of the corporation, this is not a problem for the disregard doctrine. The typical cases where this doctrine should be applied boil down to the following two situations. First, where a shareholder or a parent corporation intermingles the assets and affairs of his corporation or its subsidiary with his or its own and, second, where the corporation is not equipped with reasonably adequate capital measured by the nature and magnitude of the corporate undertaking. In the first case, the shareholder himself has failed to respect the separate personality of the corporation and in the second case, the shareholder tried to shift the risk of the business on to others while reaping the benefits from the under taking. Either situation justifies disregard of the corporate entity and deprivation of the limited liability privilege. This position should not be misconceived as approving attempts to defraud creditors, evade contractual obligations or circumvent statutes. They cannot be excused but can be regulated by theories other than the disregard doctrine.

Next, attention should be paid to a provision of the Korean Commercial Code. Where a shareholder of a corporation receives dividend in violation of the laws, for example, if dividend is paid out of capital, the creditors of the corporation can compel the shareholder to pay the money received back to the corporation (Art. 462 II). Such unlawful dividend is a kind of capital drainage. To the extent of the above provision, shareholder's personal liability on the ground of commingling of the assets and the capital drainage is not applicable. The amount of liability of the shareholder who received the unlawful dividend will be limited to the dividend illegally paid.

The question is open whether the shareholder in the above situation should be personally liable for the debts of the corporation after he has paid back the dividend received to the corporation. In the absence of other factors, his liability should be limited to the amount of dividend which he got. The damage to the corporate creditors

due to the unlawful dividend can be restored by this amount alone.[225]

But if the shareholder has failed to provide the corporation with adequate capital or commingled the assets and affairs of the corporation with his own, he will be personally liable for the corporate debts without limit. The same is true when he has drained off the capital after incorporation.

(3) The effects of application

To disregard the corporate personality means to break the separateness between the corporations and the shareholders. Therefore the independence of the corporation is denied, and the corporation and the shareholders are assimilated into one unit. Consequently, transactions with the corporation are regarded as those of the shareholders and vice versa. Likewise the obligations of the corporation are treated as those of individual shareholders, and the creditors of the corporation can execute on the individual properties of the shareholder. When the corporation goes bankrupt, advances by the shareholder to corporation are not looked upon as loans, but treated as capital investment, and so their claims are disallowed or subordinated to those of the outside creditors.

4. DE LEGE FERENDA SOLUTION

Many of the evils of the corporation system stem from lack of adequate capital situations. Therefore every possible measure should be taken to prevent the formation and emergence of corporations which are not adequately financed.

One possible means is to set the minimum limit of paid-in capital. Several states of the United States of America adopt this approach. But generally the amount set is so nominal that the requirement has little practical effect.[226] The problem is to evaluate the proper amount of capital. Tort creditors generally need much more protection than contract creditors because they do not have any chance to transact with the corporation. Contract creditors can ask personal guarantee of the shareholder, but tort creditors lack in this opportunity. Thus where the business of a corporation involves a risk, as in the case of the taxicab corporation, the government can require the corporation to carry compulsory liability insurance.[227] But again the amount of liability is important.

225) Accord. Drobnig, op. cit. 92-93.
226) Henn, op. cit. 214-215.
227) Comment, Should shareholders be personally liable for the torts of their corporation? 16 Yale L.J. 1190 (1967).

One more alternative is to have an administrative agency which supervises the formation, activity and the assets of corporations. The Securities and Exchange Commission, although its jurisdiction is limited mainly to securities, has had a far -reaching effect on controlling this is sue. This is an effective method, but requires further study.

Finally, Korea might adopt the French approach. But this could prevent corporations from getting able management.

5. CONCLUSION

The business corporations have been a main factor in the industrial and commercial development of modern times. However, the defects and evils accompanying them, especially the abuse of the corporate form, should be effectively regulated. As a matter of legislation, it is desirable to set a reasonable minimum paid-in capital for a corporation. As a matter of executing the Commercial Code, more efficient administration of the dissolution order is expected. As a technique of interpreting and circumscribing the corporate personality, the adoption of the disregard doctrine in Korea is imperative.

〔國 文 要 約〕

株式會社의 法形態의 濫用과 그 規制

— 法人格否認理論을 中心으로 —

鄭 東 潤

1. 序 論

株式會社制度는 近代資本主義經濟發展에 있어서 가장 중요한 要素로서 作用하여 왔다. 그러나 그것은 그와 함께 많은 弊害를 招來하였는데, 株式會社의 法人格 내지 法形態의 濫用은 그 현저한 예의 하나이다.

일반적으로 株式會社는 그 構成員과는 分離된 별개 獨立의 實體로 인정되고 있는 바, 이러한 株式會社의 獨立된 法人格은 정당하지 못한 目的을 위하여 株式會社를 이용하려는 企業人에게 좋은 구실 또는 방편을 제공하여 준다. 따라서 모든 나라의 法制度는 이와 같은 法人格 또는 法形態의 濫用을 規制하기 위한 法的 手段을 가지고 있는 것이다.

이와 같은 規制手段에는 豫防的인 것과 矯正的인 것의 두 가지가 있을 수 있다. 株式會社의 設立時에 充分한 資本이 納入되도록 强制하고 設立 후 그 資本을 維持하려는 여러가지 考慮는 前者의 예라고 할 수 있다. 後者에 속하는 規制方法에는 그 濫用된 株式會社의 法人格을 全面的으로 박탈하여 會社의 解散을 命하는 극단적인 方法과 그 法人格이 남용된 특정한 法律關係에 있어서만 그 會社의 獨立性을 否定함으로써 그 구체적인 경우의 濫用의 弊害만을 匡正하는 것으로 만족하고 그 會社의 一般的인 存在自體는 그대로 인정하는 方法이 있다. 우리 商法은 前者의 方法을 취하고 있다(176條). 여기에서 소개하려는 法人格否認理論은 後者의 方法에 속한다.

法人格否認理論은 주로 美國의 法院에 의하여 발전되어온 理論이지만 그것은 美國에만 限定되어 있는 현상은 아니다. 獨逸에 있어서도 이와 같은 理論의 실마리는 이미 半世紀 以前의 判例에서 찾아 볼 수 있고, 二次世界大戰후 帝國會社의 사건과 관련하여 크게 부각되었으며, 현재에 있어서는 學說과 判例에 의하여 美國과 거의 같은 解決에 到達하고 있다. 이탈리아를 제외한 유럽의 모든 나라와 이웃 일본에서도 이미 이 理論은 確立되어가는 과정에 있다.

本稿에서는 이 理論의 본고장인 美國의 法院에 의하여 이 理論이 어떠한 경우에 어떠한 理論的 根據로 어떠한 要件이 충족되는 경우에 적용되고 있으며 어떠한 效果를 가져오는가를 살펴보고, 이어 大陸法系인 獨·佛·日에 있어서의 이 理論의 發展過程을 고찰한 후에 우리나라에서도 이 理論이 적용될 수 있는가에 관하여 음미하여 보려고 한다. 다만 고찰의 범위는 이 理論이 적용되는 法域中 私法 특히 會社法에 국한하였다.

2. 美國의 法人格否認理論

法人格否認理論이라 함은 株式會社의 法人格이 法에 의하여 허용되지 않는 目的을 위하여 이용된 특정한 경우에 그 會社의 獨立된 實體 내지 法人格을 否認하고 그것을 構成員인 自然人의 단순한 結合體로 간주하려는 理論이다.

美國의 判例法上 株式會社의 法人格이 否認된 事例는 無數하나, 이를 일정한 基準에 의하여 區別하는 것은 불가능하지 않다. 이 理論은 株式會社의 法形態가 債權者를 詐害하거나 契約上의 義務를 回避하거나 制定法의 規定을 潛脫하기 위하여 이용될 때, 또는 특정한 경우에 會社의 獨立된 人格을 인정하는 것이 正義와 衡平에 반할 때에 적용되었다. 會社의 類型을 기준으로 하여 보면 이 理論은 주로 一人會社와 親子會社關係에서 많이 적용되고 있다.

이 理論의 理論的 根據로서는 여러 가지가 提示되고 있다. 會社가 株主의 代理人 또는 道具이기 때문이라고 하기도 하고, 會社와 株主가 同一體이기 때문이라고도 하며, 혹은 株主가 會社債務에 대하여 責任이 있는 듯이 행동하였기 때문이라고도 설명된다. 그러나 그 참된 理由는 會社의 法人格이 法에 의하여 허용되지 않는 용도에 이용되는데 있다고 생각한다.

이 理論이 적용되기 위한 要件으로서 株主에 의한 會社의 完全한 支配를 드는 사람도 있지만, 會社와 株主間에 事務와 財產이 混融되어 있는 경우와 會社가 그 事業의 規模와 性質에 비추어 충분한 資本을 가지지 못한 경우에는 일반적으로 株主에게 會社의 債務에 대한 個人的 責任이 인정된다. 그리고 株主에게 責任이 부과되기 위한 前提로서 일반적으로 會社에 대한 法的 救濟手段의 消盡을 요구하고 있다. 이러한 客觀的 要件 외에 株主에게 主觀的 濫用의 意圖가 있어야 하느냐에 관하여는 견해가 일치하지 않고 있다.

株式會社의 法人格이 否認되면 그 效果로서 株式會社는 獨立된 人格體로 인정되지 않고 그 構成員인 株主의 組合體로 간주된다. 따라서 株主의 債權者는 會社의 財產에 대하여 强制執行을 할 수 있고, 反對로 會社의 債權者는 株主의 個人的 財產에도 追及할 수 있게 된다. 만일 營業을 양도한 個人이 會社를 設立하여 同種의 영업을 경영하는 경우에는 讓受人은 會社에 대하여 競業禁止를 請求할 수 있고, 株主가 會社에 不實한 資本을 提供한 채 會社에 필요한 經費를 貸與金의 形式으로 供給하고 나서, 會社가 破產하거나 困境에 빠진 경우에 위 貸

與金의 回收를 꾀한다면, 株主의 위 貸與金은 貸與金으로 취급되지 않고 會社의 資本金으로 간주되어, 一般債權者가 만족을 받은 후가 아니면 이를 回收할 수 없게 된다.

美國에 있어서도 이 理論은 아직 精巧化의 과정에 있으며, 法域에 따라 이에 대한 法院의 태도가 반드시 일정하지 않다. 그리고 法院이 具體的 妥當性을 추구하는데 중점을 두고 있는 까닭에 그 理論的 體系化는 아직 완전하지 못하다고 할 수 있다.

3. 大陸法系 여러 나라의 現況

大陸法系에 속하는 여러 나라에서도 法人格否認理論과 軌를 같이하는 努力이 그치지 아니하였다.

獨逸에서는 1900년 초부터 斷片的인 判例가 쌓여오다가 第二次世界大戰 후 소위 帝國會社의 事件과 관련하여 法院과 學界의 關心을 集中시켰고, 그 결과로 많은 學者에 의한 硏究가 뒤따랐다. 獨逸에서는 이러한 理論이 責任實體把握理論이라고 불리는데, 그 適用範圍를 둘러싸고 많은 論議가 거듭되고 있다. 일반적인 추세는 在來의 私法理論으로 規律할 수 있는 部分, 예컨대 債權者 詐害行爲, 契約上의 義務違反行爲, 脫法行爲 등은 구태여 法人格否認理論에 의하여 해결할 필요가 없다는 것이다. 이 나라에서는 思辨的 理論을 좋아하는 一般的 傾向에 따라, 위 理論이 적용되기 위한 要件에 관한 論議는 비교적 적고, 法人의 本質論과의 관계, 理論的 根據 등 理論的 興味를 끄는 部門에 보다 집착하는 듯하다. 여기에서도 一人會社의 경우에 이 문제가 많이 발생하고 있으며, 具體的 事件의 해결 결과는 美國에 있어서와 거의 같다고 할 수 있다.

프랑스는 일찌기 1908년에 내려진 罷棄院의 判例를 立法化하였는데, 이것이 그 후 수차 개정 확장되어, 오늘날에 이르러서는 法人格否認에 관한 한 가장 强力한 立法을 가지고 있다고 할 수 있다. 즉 會社가 破產할 때에는, 만일 그 理事가 法人의 허울아래 個人的 利益을 위하여 商業活動을 하였거나, 法人의 財產을 마치 個人財產처럼 處分하였거나, 個人的 利益을 위하여 會社를 赤字的으로 경영한 경우에는, 理事의 個人財產 위에도 會社에 대한 破產宣告의 效力이 확장되는 결과를 가져온다. 더우기 이 경우 理事는 필요한 모든 精力과 注意力을 가지고 會社의 業務를 수행하였음을 立證하지 못하면 위 責任을 면하지 못한다. 다만 理事의 이러한 責任은 會社가 破產한 경우에만 문제됨을 주의하여야 한다.

日本에서는 第二次世界大戰 후 一部學者에 의하여 이 理論의 導入可能性이 論議되었고, 이어 이 理論을 直接 또는 間接으로 적용하는 下級審判例가 쌓여 오다가 1969. 2. 27 드디어 最高裁判所에 의하여 이 理論이 正面으로 인정되기에 이르렀으며, 앞으로 이 理論이 활발히 적용될 것이 기대된다.

4. 우리 나라의 現實과 法人格否認理論

企業人에 의한 株式會社의 法形態의 濫用은 우리 나라에 있어서도 현저한 사실이며, 그 規制의 必要性은 어느 때 보다도 크다고 할 수 있다. 물론 우리 商法도 이에 대한 몇가지 對策을 가지고 있으나 완전하지 못하다. 예컨대 會社의 解散命令은 會社의 存在를 全面的으로 박탈하는 것으로 너무 가혹하다.

뿐만 아니라 法人格否認理論은 制定法의 明文規定에 의하여 비롯된 것이 아니고 法院의 解釋에 의하여 발전되어온 것으로서, 우리 나라에서만 이 理論의 적용이 배제되어야 할 아무런 理由도 없다.

생각컨대 法人格否認理論은 法人에 있어서의 構成員과 法人自體 간의 分離原則에 대한 例外로서 法人의 法人格의 범위를 획정하는 문제에 지나지 아니한다. 法人格이라는 制度는 法이 시인하는 有用한 目的을 달성하기 위하여 法에 의하여 그 獨立性을 인정받고 있는 이상, 그것이 法이 許容하지 아니하는 부당한 目的을 위하여 濫用될 때에는 그 獨立된 人格의 特權을 박탈당하는 것은 당연하다.

다만 이 理論을 우리나라에 導入함에 있어서는 그것이 株主와 會社間의 分離·獨立의 大原則에 대한 例外인 만큼, 그 적용을 신중히 하지 아니하면 안된다. 따라서 종래의 私法理論에 의하여 解決이 가능한 問題가 제외되어야 함은 물론이고, 먼저 會社에 대한 救濟手段을 다하거나 그것이 無用할 때에만 株主에 대한 個人的 責任이 追及되어야 할 것이다. 그리고 이 理論이 적용되기 위한 要件은 원칙적으로 株主와 會社間에 事務와 財産이 무분별하게 混融되어 있는 경우 및 會社의 資本이 그 事業의 規模와 性質에 비추어 현저하게 부족한 경우 등에 한하여 충족된다고 할 것이다.