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Inadequate Capitalization of the Construction Firm: Piercing Corporateness Under the Alter Ego Theory

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Piercing the corporation veil is the most litigated issue in corporate law. Although a corporation is recognized as a legal entity having limited liability to the individual shareholder, officer, and director, there are many instances when the court will ignore corporateness, and hold the shareholder, officer, and director liable. One particular area that is most litigated is the question of proper capitalization of the firm. For the newly formulated construction organization, the issue of adequate capitalization has significant ramifications in terms of personal liability shielding.

Key Words: legal fiction, corporation, piercing the veil, alter ego

Introduction

The term *incorporate* means to create a legal body (Black Law Dictionary, 1979). A corporation is a legal entity that is strictly a creation reserved by the state (Berle, 1947). In essence, unlike the sole proprietorship and the partnership, one has no authority to create a corporation without first having the state of proper jurisdiction sanction its existence (Revised Model Business Corporation Act, Sec. 1.28, 2.01, 2.02, 2.03, 1999). Justice Marshall gave further definition to the construct corporateness and its creation by stating... “a corporation is an artificial being, invisible, intangible, and existing in the contemplation of the law...it possess only those properties which the character of its creation confers upon it” (*Trustees of Dartmouth College v. Woodward*, 17 U.S. 4 Wheat. 636 ,1819).

The character referred to by Justice Marshall is the “articles of incorporation” filed with the appropriate state officials having jurisdiction. Expanding the operational definition of corporateness further, a corporation is a collective association of equity investors (shareholders) having separate legal personality from the equity individuals (shareholders). Thus, the rights, duties, and other legal relations arising out of the enterprise are adjusted as though the corporation were a separate legal entity. As a result, the law perceives, in apparent recognition, that the corporation is a *fictional entity* that is coordinated and directed by equity investors (Klein, 1982). The shareholder, in theory, has only an *indirect interest* in the assets of the corporation. In the event of liquidation, this indirect interest is a function manifested by the right to receive corporate dividends, and distribution of corporate assets (Clark, 1986).

Owing to the notion of *fictional legal entity* and *indirect interest*, regulatory statutes (state statutes of incorporation) create limited liability for the shareholder of the corporate entity. In essence, what limited liability is construed to mean is that the corporation is unlimitedly liable

for all debts and obligations of the business while the shareholder is not, since in theory, the transactional debt is a contractual function of the fictional or artificial entity (*Lyons v. Lyons*, 340 So. 2d 450 ,1976; *City of Keil v. Frank Shoe Mfg. Co.,* 14 N.W. 2d 164, 1944; *Sampay v. Davis,* 342 So. 2d 1186,1977; *Rosenthal v. Leaseway of Texas, Inc.,* 544 S.W. 2d 180, 1976). In short, the equity investor (shareholder) is at risk for only that proportional capital amount contributed to the corporate capital stock formulating the capital base of the corporation (*Charter Air Ctr. Inc. v. Miller,* 348 So. 2d 614, 1977). Nonetheless however, a court may interpret the statutory scheme as superseding corporate limited liability so as to serve the overriding proposal of the statute. In essence, the principal legal issue is whether the court will recognize the limited liability inherent in corporateness and, thus either inculpate or exculpate the shareholder from personal liability. Essentially, the separate existence of fictional corporateness is at question and may be ignored by the court by using the metaphor "piercing the corporate veil" (*Barlle v. Home Owners Coop*., 127 N.E. 2d 832, 1955). The court oftentimes uses other metaphorical descriptors such as "alter ego" or "mere instrumentality" (*Dewitt Truck Brothers v. W. Ray Flemming Fruit Co.,* 540 F. 2d 681. 1976). In essence, each of these legal doctrines raises the same questions: whether or not the reviewing court will recognize legal separation between the corporation and the shareholder. At the core of this question is the thin divide between the fictional legal entity, and the shareholder's indirect interest. Thus, this paper shall explore this question of corporate law so that an owner/manager of the construction organization can further understand the import of their managerial decisions vis-à-vis the creditor, corporate liability, and their own personal liability.

Exception to Limited Liability

As noted herein, the principal advantage of the corporate business form is that each shareholder's potential loss is limited to the amount invested in the construction entity. Unfortunately, this is not always the case (*Thomas v. Southside Contractors, Inc.,* 543 S.W. 2d 917,1976). In fact, the questions whether corporate veil should be pierced and, thus hold the corporate shareholder liable is the most frequently litigated area of corporate law (Thompson, 1991). In theory, the economic norm of corporateness is contractual risk transfer. Under this construct, the limited liability regime creates a risk paradigm, whereby risk of business failure shifts directly to the creditor and not the shareholder. This risk paradigm however, is reversed in certain circumstances. The key question for a construction corporation is, when will the court pierce the veil of limited liability and transfer the risk back to the shareholder. There are several factual constructs that move a court to legally disregard the shield of liability protection offered by corporateness - these are: (1) undercapitalization, (2) fraud, (3) debt structure, and (4) commingling of funds and assets. In conjunction with these factors giving impetus to piercing the corporate veil, the court typically gives great deference to the type of creditor. The court generally defines two principal types of creditors as: (1) voluntary creditor, (2) involuntary creditor - tort victim (Clark, 1986). In short, these factors give issue to shareholder liability by virtue of their ownership interest (indirect interest) in the corporation. The balance of this writing shall write to the voluntary creditor paradigm.

Piercing the Corporate Veil

The court will only pierce the veil of a closely held corporation or corporate group (Thompson, 1991). Thompson's study identifies profiles and characteristics of closely held corporate organizations and found the following: (1) the stockholder professionally manages the business, (2) the stockholder functions as a member of the board of directors, and (3) the stockholder makes asset risk decisions. Thompson's (1991) study points out that there exists a consistent predictable pattern by the court in piercing the corporate veil cases. Most frequently the court typically looks to shareholder's "domination" or "absolute control" (Thompson, 1991). In *DeWitt Truck_Brothers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (1976), the court set forth a list of tests available to pierce the corporate veil by identifying a closely held corporation as ... " a facade for the operation of a dominant stockholder, thus there is not a closely held corporation that does not flunk one of the test." To understand this area of law more fully, the following written discussion shall examine case law where the factual construct undercapitalization in relation to shareholder dominion and control vis-à-vis the voluntary creditor is at issue.

Inadequate Initial Capitalization

The reason most often given for the court to pierce the corporate veil is inadequate capitalization of the corporation (Thompson, 1991). The test is applied at the time of incorporation, and seeks to balance the amount of capital base contribution in relation to the nature of the risk the corporation will encounter (*Minton v. Caveney*, 364 P.2d 476, 1961). This test must be applied on a case-by-case basis (*Platt v. Billingsley*, 281 P.2d 267, 1965). In *Carlesimo v. Schwebel*, 197 P.2d 167 (1948), the court answered the question whether undercapitalization was a matter of deception? The Carlesimo court responded in the affirmative, but however, concluded that a deception was not practiced nor perpetrated by the defendant. In the Carlesimo matter, the court enunciated the test of *alter ego* in undercapitalization cases as whether the shareholder, director, or officer represented oneself as an individual or distinguished themselves as representatives dealing with a corporation. In such instances, under the "alter ego doctrine," the court disregards the corporate entity and thus holds the individual personally liable for acts knowingly and intentionally done with disregard for corporateness (*Ivey v. Pyler*, 246 Cal. App. 2d 678, 1962). Thus, the alter ego doctrine does not create additional assets for the corporation, but instead fastens liability to the individual who uses the corporation as an instrumentality in the alter ego conducting business for personal gain (*Garvin v. Mattews*, 74 P.2d 990, 1938). In a case similarly factual to Carlesimo (*Harris v. Curtis*, 8 Cal. App. 3d 837, 1973), directors and stockholders were personally sued for undercapitalization. The court articulated that undercapitalization was ground for piercing the corporate veil, however, the court declared that undercapitalization was not a per se rule (automatic) and, therefore liability would not automatically accrue to the shareholder, officer, or board director. Here too, similar to the Carlesimo court, the Harris court looked to the business conditions, and circumstances of the parties and declared no deception, or fraud. The court simultaneously examined the question of control and dominion. In this instant case, the court concluded that undoubtedly the corporation was under financed, however, the stockholder, director, and officer at no time took direct control of the corporate entity or held themselves out to the alter ego of the corporation. Thus, the court

did not disregard the corporate entity, thereby exculpating the stockholder, director, and officer of direct personal liability.

The antithesis occurs however, when the court finds purposeful, and or continued undercapitalization (*DeWitt Truck Brokers, Inc., v. W. Ray Flemming Fruit Co.,* 540 F.2d 681, 1976). In DeWitt, the court looked to how the individual defendant conducted operations with creditors and the corporation in applying the "instrumentality", "alter ego" doctrine. The DeWitt court citing to *Automotrig Del Golfo De Cal. V. Resride*, 306 P.2d 1, (1957), states capitalization begins with incorporation and remains a continuous obligation thereafter during business operations. The court further articulates that undercapitalization must be viewed in light with other factors necessary to pierce the corporate veil. In the instant case, defendant Flemming purposefully siphoned down the original risk capital stock, and deliberately operated the company at a financial loss. During this period, in conjunction with operating at zero level capital stock, Flemming took excessive personal compensation as a salary by not paying transportation fees owing and due voluntary corporate creditors. Plaintiff DeWitt (voluntary creditor) subsequently sued Flemming under the alter ego theory. Flemming countered the suit with the defense that the Flemming Co. was insolvent, and that Flemming was only personally liable for the amount of his original capital stock investment. The DeWitt court, similar to the Carlesimo and Harris courts cited herein, spoke to the issue of deception and fraud. The DeWitt court citing to *Anderson v. Abbot*, 64 5. Ct. 531 (1944), explained fraud is a ground for disregarding the corporate veil, however, the DeWitt court concludes absolute proof of fraud is not a necessary element in disregarding the corporate entity. In short, the DeWitt court concludes that something less than fraud, in conjunction with other corporate violation, serves as adequate reason to employ the alter ego doctrine as a remedy for a corporate creditor. The court articulates that a court must... "necessarily vary according to the circumstances of each case...every case is *sui generis*... decided in accordance with it own underlying fact." Here the court exhaustively examined money violations in the management of the corporation, but the court finally concludes that disregard for the corporate entity was appropriate in this case owing to the fact that Flemming personally abused credit extensions made to the Flemming Co. The abuse and causality factor took place when Flemming induced corporate creditors to continue extending credit to the Flemming Co., by making bold and personal statements giving assurance that he personally would pay the debt of the Flemming Co. In the instant case, the court views such assurance was given to the corporate creditor for the obvious purpose of promoting a personal advantage to Flemming himself. On this basis, in addition to the origination and continuation of inadequate capitalization, and the deliberate and purposeful control in reducing the capital stock of the corporation, the court pierced the corporate veil, thereby disregarding the separate corporate entity paradigm and the construct of limited liability and, thus holding and inculpating Flemming personally liable for Flemming Co's, outstanding debt to voluntary creditor DeWitt. (See also *Weisser v. Mursam Shoe Co.*, 127 F.2d 344, 1942; *Bobby Jones Garden Apartments, Inc. V. Suleski,* 391 f. 2d 172, 1968; *Newberry v. Barth Inc.,* 252 N.W. 2d, 1977).

In a similar action, *Sea-Land Services, Inc., v. Pepper Source*, 941 F.2d 519 (1991), the court laid down the Van Dorn test for ascertaining corporate veil piercing as articulated in the *Van Dorn Co. v. Future Chemical and Oil Corp.*, 753 f.2d 565 (1985). The Van Dorn court held:

A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met: First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporations] no longer exist, and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.

The Sea-Land court citing to *Macaluso v. Jenkins*, 420 N.E 2d 255 (1981) for testing whether the corporation is controlled by another to justify disregarding corporate separateness list a four factor test: (1) the failure to maintain adequate corporate records or comply with corporate formalities, (2) commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own. Here one can see the confluencing of the Garvin and DeWitt cases by the Sea-Land court. First, in the Garvin case, piercing the veil for undercapitalization is one factor however, the court made it clear that this was not a per se rule (automatic) in and of itself. In fact, the Garvin court strictly examined and tested whether the stockholders, directors, and officers exceeded their indirect interest as equity holders, thereby separating themselves from the legal fiction of corporateness. Similarly, as with the DeWitt court, the Garvin court stated, there must be a conjoining or unity of interest exhibited by the stockholder, and the undercapitalization issue does not necessarily need to rise to the level of fraud, in fact, under the Van Dorn test, it can be something less than fraud such as precluding an injustice.

The facts in the Sea-Land case are similar to the DeWitt matter except the defendant stockholder (Gerald Marchese) is a single stockholder of five business entities all qualifying as separate corporations, with Pepper Source Corporation maintaining no assets (Corporation's veil being sought to be pierced). Like DeWitt, the Pepper Source Corporation incurred debt to plaintiff, a voluntary creditor (Sea-Land), in the amount of $87,000. Further, defendant Marchese also borrowed large sums of money from Pepper Source interest free, used Pepper Source's bank accounts to pay personal expenses including alimony and child support, during this period. In addition to the above, Pepper Source had no origination capital at the time of incorporation, nor did Marchese ever attempt to grow the capital stock base of Pepper Source once business operation commenced. Sea-Land sued Pepper Source and received a judgment against same for debts outstanding. However, because Pepper Source had no assets, Sea-Land could not recover under the judgment against Pepper Source. Sea-Land then sought suit to pierce the corporate veil of Pepper Source and, thereby render Marchese personally liable on the judgment owed Sea-Land. The court held that all five corporations were not only the alter egos of Marchese, but more importantly of each other.

The Sea-Land court, in applying the first part of the Van Dorn test, concludes that the "shared control/unity of interest and ownership" of the Van Dorn test had been met because Marchese had commingled personal funds and assets with those of the corporation, and deliberately and purposefully undercapitalized the corporation by moving and borrowing funds without regard to their source. In short, the court's analysis concludes that under the first part of the Van Dorn test, the nexus between each corporation and Marchese was so close that corporateness, and separateness, and indirect interest were ultimately indistinguishable. As a result Marchese was found to be operating as the alter ego of Pepper Source.

Under the second part of the Van Dorn test: "would sanction fraud or promote injustice", the court explicitly states, unlike the implicit statement made by the DeWitt court, that the analytics vis-à-vis "promote injustice" is something less than an affirmative showing of fraud. The Sea-Land court held that there must be a showing of unfairness to the creditors, or a wrong that invokes injustice, or a standard of fraud. On remand the district court rendered a verdict in favor of Sea-Land finding Marchese had made personal assurances to Sea-Land representatives that he would pay the corporate debt knowing that he had deliberately and intentionally manipulated Pepper Source's funds so that no such funds were available. The court found Marchese had perpetrated a fraud on Sea-Land and other creditors by receiving the benefits of credit extensions at the expense of creditors including loans and salaries paid to him. Thus, the court concluded both parts of the Van Dorn test were present and, therefore pierced the corporate veil holding Marchese personally liable for all five corporate debts.

Conclusion

Piercing the closely held corporation raises the issue of whether the individual stockholder, officer, and director will be imputed with personal liability. The most often cause cited for justifying a piercing action by the court is that of undercapitalization or deliberate siphoning off of adequate capital to manage the organization. The court in such an instance applies the alter ego metaphor to pierce corporateness, and thereby hold the individual liable. In this instance, the court typically applies the Van Dorn test. Under Van Dorn, the court looks to the unity of the action between corporation and the party or parties managing same, and whether the adherence to the fiction of legal separateness of corporateness would sanction a fraud or promote injustice. It seems, when both prongs of Van Dorn test are met, the court ignores the legal fiction of corporateness and, thus pierces the veil. If, however, the court finds facts whereby one prong is met, yet the other is unsatisfied, then the court is less compelled to pierce the veilness of the corporation.

End Notes

1. Business Corporations are of two types: publicly held and closely held. For further exposition regarding the significant differences see Soderquist, *Reconciling Shareholder's Rights and Corporate Responsibility: Close and Small Public Corporations,* 33 Vand. L. Rev. 1307 (1980).

2. Closely held corporation is a corporation that does not publicly trade stock, and the stock is generally subject to restrictions on transfer.

3. Alter ego means "other self" or "second self." *Ivey v. Pyler,* 246 Cal. App. 2d 678 (1962).

4. Fraud: an intentional perversion of the truth for purposes of inducing another to surrender a legal right. *Delahanty v. First Pennsylvania Bank, N.A.,* 464 A.2d 1243 (1973).

5. The instrumentality rule is applied to parent and subsidiary corporation relationship, and should not be considered in the present context of this discussion. *Taylor v. Standard Gas & Electric,* 96 F.2d 693 (1938).

6. See Thompson, *Piercing the Corporate Veil: An Empirical Study,* 76 Cornell L. Rev. (1991), a study setting forth other matters considered by the court as predictable legal constructs employed when piercing the veil.

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