Piercing the Corporate Veil—The Undercapitalization Factor

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UNDERCAPITALIZATION FACTOR

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Limited liability is regarded commonly as a corporate attribute, indeed an advantage of doing business in the corporate form.1 Its significance to shareholders may be diminished to the extent that creditors obtain personal guarantees from them2 or insurance covers certain liabilities. However, neither guarantees nor insurance are always present or adequate3 and when corporate funds are otherwise insufficient to cover judgments, frustrated plaintiffs may sue shareholder-defendants in defiance of the limited liability principle.

The recognition of a corporation as an entity separate from its shareholders is well established and furnishes a theoretical basis for the idea that the liabilities of the corporation, whether tort or contract, are its liabilities and not those of its shareholders.4 Moreover, limited shareholder liability serves an important public policy—the policy of encouraging investment by limiting risks. A prospective investor, while willing to invest some assets and even considerable time and effort in a new venture, may be unwilling to accept the risk of losing certain other assets not involved in the venture. Therefore, in a society which wishes to stimulate investment it is not surprising that the law should sanction, at least to some degree, a device which protects an investor against unlimited liability.5 Thus, it generally is held that even when a business is incorporated for the sole purpose of limiting the liability of its owner,
this motivation by itself does not stigmatize the entity as fraudulent or render it ineffective to achieve its purpose.\(^6\)

There are situations, however, in which courts decide to disregard the corporate entity or, in other words, pierce the corporate veil. One familiar generalization descriptive of this phenomenon states that "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."\(^7\) Another court explains that "the doctrine of ‘piercing the corporate veil’ is invoked ‘to prevent fraud or to achieve equity.’"\(^8\) While such generalizations give courts considerable latitude, they afford little guidance as to the bases for piercing the veil. Moreover, courts often use a variety of interesting words and phrases, such as, "alter ego," "dummy" and "sham" in announcing their decisions,\(^9\) but such words and phrases of themselves are of little aid in explaining such decisions. To some extent difficulties in formulating generally applicable tests may be attributed to the intensely factual nature of the issues involved in piercing cases.\(^10\) However, courts often do identify a variety of specific factors such as undercapitalization, failure to observe corporate formalities and non-payment of dividends which contribute to the resolution of such cases.\(^11\) While piercing the corporate veil may occur for various reasons,\(^11\) this article focuses on piercing to enable creditors to collect judgments,

\(^6\) See, e.g., Gartner v. Snyder, 607 F.2d 582, 586 (2d Cir. 1979); Arnold v. Phillips, 117 F.2d 497, 502 (5th Cir.), cert. denied, 313 U.S. 583 (1941).


\(^9\) A collection of such words and phrases is found in H. HENN, supra note 1, § 146, at 250-51 n.2.

\(^10\) A two-pronged test commonly used in piercing cases is as follows: "First, there must be 'such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist.' Second, it must be true that, 'if the acts are treated as those of the corporation alone, an inequitable result will follow.' " Note, Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law, 95 HARV. L. REV. 853, 854 (1982). The lack of utility of such an abstract test (and particularly its first prong) as a tool in deciding cases is apparent. In Bucyrus-Erie Co. v. General Products Corp., 643 F.2d 413, 418 (6th Cir. 1981) the court said: "No precise test for disregarding the corporate fiction has been articulated by the courts, each case being regarded as 'sui generis' and decidable on its own facts." In United States v. Standard Beauty Supply Stores, Inc., 561 F.2d 774, 777 (9th Cir. 1977), the court indicated that "[w]hether the corporate veil should be pierced depends upon the innumerable individual equities of each case."

\(^11\) For example, piercing may be used to prevent the evasion of a statute, United States v. Milwaukee Refrigerator Transit Co., 142 F. 247 (C.C.E.D. Wis. 1905), or to achieve service of process, Comprehensive Sports Planning, Inc. v. Pleasant Valley Country Club, 73 Misc. 2d 477, 341 N.Y.S.2d 914 (1973).
and its primary purpose is to consider the use of the undercapitalization factor in such cases. In the pages which follow judicial attitudes regarding the significance and measurement of the undercapitalization factor are explored as well as the relationship between undercapitalization and the other factors which are relevant to "piercing" analyses.

It should be noted that the author subscribes to three positions which underlie the various observations included in this work. First, the limited liability attribute of the corporation is worth preserving and should not be lightly discarded. Second, in certain cases in which a corporation has been undercapitalized considerations of fairness may require that the corporate veil be pierced. This is because it is inherently unfair to certain kinds of claimants for stockholders to operate a corporation without providing it with at least a certain minimal level of assets in light of the business in which the corporation is engaged.

Third, although capital is one factor it is not always the only corporate asset to be considered in determining the adequacy of the level of assets provided to the corporation. Thus, an inquiry as to whether a corporation is "undercapitalized" may prove too narrow, and instead the question should be framed in terms of whether the corporation has been provided with an "inadequate level of assets."

Furthermore, regarding the issue of whether the level of assets provided to a corporation warrants disregard of the corporate entity in

12. Some states have a statutory minimum capital requirement which is quite insignificant. See, e.g., WYO. STAT. § 17-1-205 (1977) which has a $500 requirement and ILL. REV. STAT. ch. 32, § 157.47-14 (1981) which has a $1,000 requirement. This article does not deal with the failure of a corporation to meet such requirements. This article deals with nonstatutory capital inadequacy which, as will be seen, is often considered by courts in deciding whether to pierce the corporate veil.

13. One well known statement discussing the unfairness of undercapitalization is 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 creditors 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.

H. BALLANTINE, BALLANTINE ON CORPORATIONS § 129, at 302-03 (1946). As will be seen this statement is not on its face wholly consistent with positions taken in this article. For example, the statement does not distinguish among piercing cases on the basis of types of claimants involved. See infra notes 43 and accompanying text. Though obvious perhaps, it should be emphasized that this is not to say that the failure to provide adequate assets to pay either all valid claims or only those of certain creditors compels a decision to pierce the corporate veil. To do so would have destructive implications for the limited liability principle.

14. As indicated, capital may only be one element involved in determining the level of assets provided to the corporation. See infra notes 66-68 and accompanying text.
a given case, the following contentions are made and discussed in this article: 1) A finding that a corporation has been provided with an inadequate level of assets in cases brought by certain kinds of creditors may of itself furnish an appropriate basis for piercing the corporate veil;\footnote{15} 2) Not all claimants are entitled to judicial relief on the basis of the argument that a corporation has been provided with an inadequate level of assets; \textit{i.e.}, what may be regarded as an inadequate level of assets to a certain creditor, such as a tort victim, may not be considered inadequate in cases brought by certain contract creditors;\footnote{16} 3) While piercing is sometimes necessary, it is desirable to discourage a proliferation of piercing suits predicated on questionable allegations of undercapitalization or an inadequate level of assets, and a judicial approach which may inhibit such suits should be used;\footnote{17} 4) Courts cannot focus solely on initial corporate capital or assets, as some are prone to do, in deciding whether inadequacy of assets warrants a decision to pierce because subsequent changes, such as increased hazards or reduced assets, may render a determination as to initial inadequacy irrelevant.\footnote{18}

Finally, this article addresses both the factors involved in measuring the adequacy of the capital or assets level of a corporation and the issues involved in determining who among shareholders and others are fitting targets for personal liability in cases in which undercapitalization or an inadequate level of assets contributes to a decision to pierce.

**THE SIGNIFICANCE OF UNDERCAPITALIZATION AND ITS RELATIONSHIP TO OTHER FACTORS**

Examination of three specific cases can illustrate judicial attitudes towards the undercapitalization factor, its significance in case analyses and its relationship to other factors considered by courts when plaintiffs

\footnote{15} It will be seen, however, that current judicial attitudes are largely inconsistent with such an approach in that courts commonly cite a number of factors, some of which are not really relevant, as bearing on the issue of whether to pierce, and indicate that undercapitalization alone will not justify piercing but rather that some combination of factors is needed. \textit{See infra} notes 27, 29-30, 32-40 and accompanying text.

\footnote{16} As will be seen, however, most courts do not differentiate in the weight to be accorded to the undercapitalization factor because of the type of claimant involved. \textit{See note 43 infra}.

\footnote{17} Of course, this does not mean that success in such a case can only be achieved where a determination regarding undercapitalization or inadequacy of the assets level is a simple one to make. The possible complexity of such a determination is discussed in this article under the heading “Measurement of the Adequacy of Capital or Assets.” \textit{See infra} notes 59-71 and accompanying text.

\footnote{18} Cases taking various approaches as to the appropriate time for the determination of the adequacy issue are discussed in this article under the heading “Measurement of the Adequacy of Capital or Assets.” \textit{See infra} notes 61-71 and accompanying text.
seek to pierce corporate veils. *Minton v. Cavaney*¹⁹ and *Walkovszky v. Carlton*²⁰ present straight-forward yet opposing views on whether undercapitalization alone should prompt a court to pierce a corporate veil. However, *DeWitt Truck Brokers v. W. Ray Fleming Fruit Co.*²¹ requires more in-depth analysis before its position can be assessed. Though seemingly unequivocal in its language that more than just undercapitalization must be shown before a court should pierce a corporate veil, the opinion refers to a number of relatively insignificant factors in addition to undercapitalization when making its decision in support of piercing. Therefore, *DeWitt* will be analyzed at length to provide an illustration of the undercapitalization factor’s true significance in relation to other factors.

In *Minton*, the plaintiff, whose daughter drowned in a swimming pool, recovered a wrongful death judgment for $10,000 against the corporation which operated the pool. The judgment being unsatisfied, the plaintiff sued an organizer of the corporation and obtained a judgment for $10,000 against his estate, which was substituted as defendant after his death. On appeal from the judgment, the defendant contended that the evidence did not support a determination of personal liability.²² Citing the principle that “[t]he equitable owners of a corporation...are personally liable...when they provide inadequate capitalization and actively participate in the conduct of corporate affairs,”²³ the California court concluded that the evidence supported findings of such inadequacy and participation and therefore supported the decision to pierce the corporate veil.²⁴

While *Minton* reflects a perspective favorable to piercing the corporate veil because of undercapitalization,²⁵ *Walkovszky* evidences a different point of view. In *Walkovszky*, a person injured by a cab

21. 540 F.2d 681 (4th Cir. 1976).
22. 56 Cal. 2d at 579, 364 P.2d at 475, 15 Cal. Rptr. at 643.
23. *Id.*
24. Actually though, the *Minton* decision did not result in a judgment against the individual defendant because the court concluded that the defendant was entitled to relitigate the issues of the corporation’s negligence and the amount of damages. *Id.* at 581, 364 P.2d at 476, 15 Cal. Rptr. at 644. It should be noted too that the court was influenced in the case by disregard of corporate formalities. Still, a fair reading of the opinion supports the view that undercapitalization by itself was the decisive factor.
25. *Id.* at 580, 364 P.2d at 475, 15 Cal. Rptr. at 643. It should be noted that subsequent California cases retreated from the apparent *Minton* position which relied so much on the undercapitalization factor and indicated that undercapitalization alone does not suffice as a basis for piercing the corporate veil. See, e.g., *Harris v. Curtis*, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (1970); and *Arnold v. Browne*, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972).
owned by a corporation sought to hold an individual shareholder personally liable. The shareholder's motion to dismiss the complaint, on the ground that as to him it failed to state a valid cause of action, was granted despite allegations of undercapitalization. Allegedly, the individual defendant held shares in ten corporations, including the one which owned the cab involved in the accident, and each corporation had two cabs and the minimum automobile liability insurance required by law ($10,000). In dealing with the personal liability of the individual defendant, the court noted that the complaint alleged undercapitalization of the separate corporations but did not contain sufficiently particularized allegations “that the defendant Carlton and his associates are 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.'” Thus, while it is clear that undercapitalization by itself would not persuade the *Walkovszky* court to pierce a corporate veil, it is unclear what weight the New York court would attribute to the undercapitalization factor in the presence of other factors deemed relevant by the court.

Finally, in *DeWitt*, a case involving a claim against a shareholder-president for transportation charges owed by a corporation, the court felt the facts of the case justified piercing the corporate veil, but not because of undercapitalization alone. The *DeWitt* court did, however, indicate that undercapitalization had a role to play and discussed its perception of that role.

After recognizing that all authorities consider gross undercapitalization significant and listing other factors which courts emphasize, the court in *DeWitt* indicated that a decision to pierce the corporate veil

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27. *Id.* at 420, 223 N.E.2d at 10, 276 N.Y.S.2d at 590.
28. In a more recent case, Gartner v. Snyder, 607 F.2d 582 (2d Cir. 1979), the court stated: "We know of no New York authority that disregards corporate form solely because of inadequate capitalization." *Id.* at 588. The court also made the following statement: Because New York courts disregard corporate form reluctantly, they do so only when the form has been used to achieve fraud, or when the corporation has been so dominated by an individual or another corporation (usually a parent corporation), and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own and can be called the other's alter ego. . . . The court will also generally consider whether the corporation was adequately capitalized in determining whether to disregard the corporate form. *Id.* at 586 (citations omitted).
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could not be based on a single factor such as undercapitalization or disregard of formalities, but must involve a number of factors, and must present an element of injustice or fundamental unfairness. However, the court did not persuasively explain why certain other factors which led to the result (such as disregard of formalities, domination of operations, and monopolization of benefits by the principal shareholder) needed to be present in combination with undercapitalization. There are several weak links in the DeWitt court's analysis concerning the importance of factors other than undercapitalization. Therefore, an in-depth examination of the factors relied on in DeWitt can serve to clarify the significance of the undercapitalization factor.

For example, in discussing the factor of disregard of corporate formalities, the court pointed to a lack of shareholder meetings and corporate records of director meetings and the mere figurehead status of another director who attended no meetings and received no salary from the corporation. It was not made clear in the court's opinion why disregard of corporate formalities was significant in its decision to pierce the corporate veil. If such disregard confused a creditor into believing that he was dealing with the individual shareholder rather than the corporation it would certainly have been quite significant. However, there was no evidence presented which showed that disregard of corporate formalities, and particularly the failure to hold shareholder and director meetings, caused creditor confusion or reliance on shareholder liability in this case. Moreover, the court should have

30. In DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d at 686-87, the court said:

Other factors that are emphasized...are failure to observe corporate formalities, non-payment of dividends, the insolvency of the debtor corporation at the time, siphoning of funds of the corporation by the dominant stockholder, non-functioning of other officers or directors, absence of corporate records, and the fact that the corporation is merely a facade for the operations of the dominant stockholder or stockholders.

31. Id. at 687. The court explained:

But undercapitalization, coupled with disregard of corporate formalities, lack of participation on the part of the other stockholders, and the failure to pay dividends while paying substantial sums, whether by way of salary or otherwise, to the dominant stockholder, all fitting into a picture of basic unfairness, has been regarded fairly uniformly to constitute a basis for an imposition of individual liability under the doctrine.

32. Id. at 687-88.

33. However, in such a situation piercing of the corporate veil may be unnecessary to support a claim against the shareholder.

34. Indeed there are contrary implications in that the court states:

Finally, it should not be overlooked that at some point during the period when this indebtedness was being incurred—whether at the beginning or at a short time later is not clear in the record—the plaintiff became concerned about former delays in receipt of payment for its charges and, to allay that concern, Flemming stated to the plaintiff, according to the latter's testimony as credited by the District Court, that "he (i.e., Flem-
recognized that inattention to formalities may be quite common in connection with close corporations and that there is generally no significant state interest involved which would warrant allowing such disregard to contribute to a stripping away of the corporate shield. It is obviously not a justification for treating defendants in piercing cases differently simply because their respective corporations are more or less attentive to formalities.35

Nor does any good reason appear in DeWitt for the significance attached by the court to the point that no shareholder or officer ever received any salary, dividend or fee from the corporation except for the individual defendant.36 Surely there is nothing inherently evil about the fact that no other shareholder or officer received payment and nothing linked that fact to the failure to pay the creditor. Indeed, nothing indicated that additional payments to shareholders and officers would result in more funds being available to pay creditors and it is probable that the contrary would have been true.

Another shortcoming of the DeWitt opinion is that the court felt it was important that the individual shareholder, who owned the bulk of the shares, made the decisions and dominated corporate operations.37 Domination as such is not evidence of any impropriety which should contribute to a decision to pierce the corporate veil; indeed it would be foolish to expect that a controlling shareholder in such circumstances would bring in another person to share in decision making. It gener-

Id. at 689.


37. DeWitt, 540 F.2d at 688. At various points in the opinion the court referred to nonfunctioning of other officers or directors, lack of participation on the part of the other stockholders, that the corporation was a one-man corporation, that the other director was a figurehead, that no other stockholder or officer exercised any voice in corporate operations or decisions, that there was evidence to sustain the finding of the court below that the individual defendant made all the corporate decisions and dominated its operations. Thus while the dominance of the individual defendant obviously figured in some way in the court's decision, just how is unclear. Id. at 687-88.

It should be noted that domination is often referred to by courts in piercing cases. See, e.g., Baker v. Raymond International, Inc., 656 F.2d 173, 180-81 (5th Cir. 1981), cert. denied, 102 S. Ct. 2256 (1982); Martin v. Pilot Indus., 632 F.2d 271, 276-77 (4th Cir. 1980).
ally has been the rule that even the shareholder in a one person corporation is protected by its limited liability attribute, and far from discouraging domination of corporations by one person there are corporation statutes which expressly contemplate such a situation. The idea of encouraging or compelling participation by more than one person in the close corporation's decision making process as a price for achieving limited liability would be a radical one. Indeed, a rule which made domination as such a contributing factor to a decision to pierce would be inconsistent with the principle that "[o]wnership of a controlling interest in a corporation entitles the controlling stockholder to exercise the normal incidents of stock ownership, such as the right to choose directors and set general policies, without forfeiting the protection of limited liability."

One last problem with the DeWitt opinion was the court's analysis in disposing of the defendant's contention that undercapitalization was irrelevant because of the contractual nature of the claim being pursued by the creditor. The DeWitt court avoided the issue as to whether undercapitalization should be irrelevant in determining whether to pierce the corporate veil in contract cases, by pointing to certain special facts which were present in the case, when it said:

The reasoning is that when one extends credit or makes any other contractual arrangement with a corporation, it is to be assumed he acquaints himself with the corporation's capitalization and contracts on such basis, and not on the individual credit of the dominant stockholder. In this case, however, that reasoning would be applicable, since the plaintiff did not rely on the corporation's capitaliza-

39. See, e.g., PA. STAT. ANN. tit. 15, § 1402 (Purdon 1982-83) and WYO. STAT. § 17-1-134 (1977) which contemplate corporate boards of directors consisting of only one director if there is only one shareholder.
40. Baker v. Raymond International, Inc., 656 F.2d 173, 180-81 (5th Cir. 1981), cert. denied, 102 S. Ct. 2256 (1982). However, the circuit court's position in Baker as to what the jury must find appears abstract:

To justify the extraordinary step of holding the dominant party liable, the jury must find that this control "amounts to total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."

Id. at 181.

In Amsted Indus., Inc. v. Pollak Indus. Inc., 65 Ill. App. 3d 545, 382 N.E.2d 393 (1978), the court recognized the basic business reality that in close corporations stock ownership and management control are often found in the same person. As such, merely because one person controlled and dominated the two corporate defendants and was the sole shareholder, principal manager, and sole source of equity financing for both corporations was not enough justification for holding him personally liable. Illinois law or policy is not violated because a corporation is under the domination and control of a principal shareholder who is entitled to all its profits. Id. at 549-50, 382 N.E.2d at 396-97.
ton but received an assurance from [the dominant stockholder] of personal liability.\textsuperscript{41}

While an assurance to the plaintiff may contribute to a decision to hold him personally liable, it really furnishes no basis for according any weight to the undercapitalization factor in deciding whether to pierce the corporate veil. The patent lack of reliance by the plaintiff on the capitalization of the corporation, which the court expressly recognized, should diminish rather than increase any inclination which the court might have to attach significance to the undercapitalization factor. Of course, if failure to pierce would present the court with an unjust result, particularly in light of the defendant's personal assurance, then such assurance may well be an element contributing to a decision to pierce,\textsuperscript{42} in a case involving a contract claim like \textit{DeWitt}.

\textsuperscript{41} \textit{DeWitt}, 540 F.2d at 686 n.13.
\textsuperscript{42} Indeed the court recognized that possibility in \textit{DeWitt}:

\textit{When one, who is the sole beneficiary of a corporation's operations and who dominates it, as did Flemming in this case, induces a creditor to extend credit to the corporation on such an assurance as given here, that fact has been considered by many authorities sufficient basis for piercing the corporate veil. . . . The only argument against this view is bottomed on the statute of frauds. . . . But reliance on such statute is often regarded as without merit in a case where the promise or assurance is given "at the time or before the debt is created," for in that case the promise is original and without the statute. . . . A number of courts, including South Carolina, however, have gone further and have held that, where the promisor owns substantially all the stock of the corporation and seeks by his promise to serve his personal pecuniary advantage, the question whether such promise is "within the statute of frauds" is a fact question to be resolved by the trial court and this is true whether the promise was made before the debt was incurred or during the time it was being incurred. . . . This is that type of case and may well have been resolved on this issue.}

\textit{Id.} at 689-90 (citations omitted). It may be that to some courts piercing the corporate veil on the basis of a personal assurance would be easier than making such an assurance binding in the face of the statute of frauds.

\textsuperscript{43} The argument for not considering or for giving less weight to undercapitalization in contract cases is supported by the idea that the contract creditor is in a position to insist on safeguards before dealing with the debtor. \textit{White v. Winchester Land Development Corp.}, 584 S.W.2d 56 (Ky. App. 1979) (Bank's loss was not unjust because it could have secured its loan). Thus in many contract cases the corporate debtor and its shareholders may be presumed to be saying to the world of potential contract creditors—"our liability is limited unless you bargain for more"—and when courts, relying in whole or in part on undercapitalization as a factor, decide to hold such shareholder liable, they are acting contrary to the expectations of the parties. \textit{But see Campbell, Limited Liability for Shareholders: Myth or Matter of Fact, 63 Ky. L.J. 23, 53 (1975) (hereinafter "Campbell"): "One who signs a contract with a corporation should be entitled to assume that the corporation has a reasonable amount of capitalization from which he could recover in the event of a breach." The suggestion that undercapitalization should be weighted less heavily in a contract case than in a tort case has not been well received in most courts. \textit{Cary & Eisenberg, Cases and Materials on Corporations, 100-01 (5th ed. 1980). Some courts, however, have indicated that contract cases should receive different treatment from tort cases. \textit{J-R Grain Co. v. FAC, Inc.}, 627 F.2d 129, 135 n.13 (8th Cir. 1980) ("In addition, this writer is of the opinion that the courts should be particularly reluctant to disregard the corporate entity in cases involving contract liability as opposed to \textit{tort} liability."). See also \textit{Gentry v. Credit Plan Corp. of Houston}, 528 S.W.2d 571, 573 (Tex. 1975) (plaintiff has "the burden of justifying a recovery against the parent when he willingly contracted with a subsidiary.").}

In another case, \textit{Brunswick Corp. v. Waxman}, 599 F.2d 34 (2d Cir. 1979), the court refused to
However, notwithstanding the disagreement with much of the reasoning used by the *DeWitt* court expressed herein, it is submitted that the court reached the correct result in holding the individual defendant liable. According to the court, the corporation, as commission agent, was selling produce (which it never purported to own) for the account of growers, and "[u]nder the arrangement with the growers, it was to remit to the grower the full sale price, less any transportation costs incurred in transporting the products from the growers' farm or warehouse to the purchaser and its sales commission." The court indicated that the individual defendant was withdrawing at least $15,000 per year from the corporation even though he must have known that the corporation could only afford to make such disbursements by withholding payment of the transportation charges due the plaintiff. A fair reading of the *DeWitt* opinion would indicate that the withdrawal of funds in the particular circumstances of this case was a crucial factor in the court's decision to pierce the corporate veil in favor of the plaintiff-creditor. It is simply contended here, however, that the withdrawals by the shareholder alone, in the circumstances of this case, justified the result reached—without the need for the court to pierce the corporate veil indicating that the seller knowingly entered into a contract with a no-asset corporation formed for the sole purpose of taking title to equipment sold by the seller. *Id.* at 36. *See also* Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 988-89 (1971).

44. *DeWitt*, 540 F.2d at 688.

45. *Id.* at 689.

46. The court stated that: Were the opinion of the District Court herein to be reversed, Flemming would be permitted to retain substantial sums from the operations of the corporation without having any real capital in the undertaking, risking nothing of his own and using as operating capital what he had collected as due the plaintiff. Certainly, equity and fundamental justice support individual liability of Flemming for plaintiff's charges, payment for which he asserted in his accounting with the growers that he had paid and for which he took credit on such accounting. This case patently presents a blending of the very factors which courts have regarded as justifying a disregard of the corporate entity in furtherance of basic and fundamental fairness. *Id.*

47. It may be that the low level of capital contributed to a corporation would seem important to a court in a case like *DeWitt* because the withdrawals could not be justified on the basis of the investment made, or because the lack of investment together with the withdrawals raises an issue as to the good faith with which the business was being operated. Obviously the court in *DeWitt* made some linkage between the undercapitalization and the withdrawals. Of course, it should be remembered in piercing cases that investment is not the only possible justification for withdrawals. For example, bona fide services to the corporation may furnish the basis for withdrawals. In Gonzalez v. Progressive Tool & Die Co., 455 F. Supp. 363, 367 (E.D.N.Y. 1978), an unsuccessful attempt was made to pierce the corporate veil. The court indicated that to show that corporate assets have been siphoned off to the detriment of creditors, more is needed than a recitation of salary paid to officers: "Some showing is required that in light of the corporation's financial status the salaries paid were so excessive as fraudulently to deplete the assets available to creditors." *Id.* at 367. There is no indication in the *DeWitt* opinion that any such argument about bona fide services as a basis for withdrawals was made or could have been made successfully.
cite extraneous factors. It would be useful at this juncture to stress several points in light of the foregoing discussion of the Minton, Walkovszky, and DeWitt cases. First, it should be noted that the Minton court's sole reliance on undercapitalization as a sufficient basis for piercing the corporate veil has not won general acceptance. One need only look at such decisions as DeWitt and Walkovszky as evidence of this judicial unwillingness.

Second, reliance on the term "undercapitalization" as a basis of decision in piercing cases may prove unwise because it may reflect only one element in determining if in a given case the level of assets available for creditors is fair. Also the term "undercapitalization" may un-
duly focus a court's attention on assets provided to a corporation as capital at the time of its organization, to the exclusion of consideration of the adequacy of assets at a later time. A more appropriate and accurate term than "undercapitalization" for courts to use in piercing cases is the term "inadequate level of assets," and the analysis should focus on whether the corporation has been provided with an "inadequate level of assets" to meet the type of claim involved.

Third, the approach of the Minton court in giving decisive importance to the undercapitalization factor is correct in light of the type of claim involved in that case; because considerations of fairness and as a matter of policy the attempted total transfer of the risk of loss from the business to the tort victim is not justified. Furthermore, in Walkovszky, which also involved a tort claim, the court could have based a decision on whether or not to pierce on a determination with regard to the "inadequate level of assets" factor and thus could have avoided reliance on other factors such as nonobservance of formalities.53

Fourth, while DeWitt, like Walkovszky, illustrates the use of factors in a piercing case, which are not relevant to or necessary for the decision, DeWitt presents different considerations as to the significance of the "undercapitalization" (or "inadequate level of assets") factor because the claimant is a contract creditor. Although it must be remembered that courts have not generally adopted a distinction in piercing cases between contract and tort creditors, it is argued here that in the interest of preserving the vitality of the limited liability principle, contract creditors who are able to protect themselves should be precluded from piercing on the basis of the argument that the corporation has been provided with inadequate capital or an inadequate level of assets. On the other hand, contract creditors who are unable to protect themselves when they deal with corporations should arguably be able to win piercing cases solely because of undercapitalization or inadequacy of assets. However, the negative impact of such a position on the limited liability principle and the resultant chilling effect on investment should be carefully studied and weighed against its benefits before reaching such a decision.

53. While it may be contended that the court in Walkovszky was influenced by the presence of a statutory minimum automobile liability insurance requirement to deny judicial relief predicated on the insufficiency of assets, this would not justify the court's willingness to rely on irrelevant factors.

54. For further discussion see supra note 43.
MEASUREMENT OF THE ADEQUACY OF CAPITAL OR ASSETS

Should courts be forums for fine measurements as to whether a corporation has been properly capitalized or provided with an "adequate level of assets" whenever a plaintiff with an uncollectible judgment against a corporation seeks to pierce the corporate veil? Perhaps to avoid the significant impacts which would accompany such tasks, courts have indicated that the extent of undercapitalization (or inadequacy of assets) would have to be considerable.

For example, in DeWitt the court referred to authorities which required that "the corporation [be] grossly undercapitalized for the purposes of the corporate undertaking," and cited a Supreme Court case for the proposition that "[a]n 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." Also, in Minton the court concluded: "In the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. Seminole never had any substantial assets. . . . Its capital was "trifling compared with the business to be done and the risks of loss. . . ." Requiring that undercapitalization must be "obvious" or "gross" or the capital "trifling" compared with the corporation's business needs and risks of loss somewhat lessens the impact of the undercapitalization (or "inadequate level of assets") factor.

However, a requirement that the deficiency in capital or assets be gross or obvious in order to contribute to a decision to pierce a corporate veil does not make the courts' task a simple one. Whatever the courts' requirements in terms of inadequacy of assets, courts must still consider many varying factors relevant to their deliberations. For example, where the inadequacy of capital and other assets is at issue the testimony of expert financial analysts and statisticians as to comparable businesses may be relevant. Perhaps this analysis might include evi-

55. 540 F.2d at 685 (4th Cir. 1976).
58. This is not to say that all cases which refer to undercapitalization require such extremes. See, e.g., Martin v. Pilot Indus., 632 F.2d 271, (4th Cir. 1980); United States v. Healthwin-Midtown Convalescent Hosp. and Rehabilitation Center, Inc., 511 F. Supp. 416 (C.D. Cal. 1981); Amsted Indus., Inc. v. Pollak Indus., Inc., 65 Ill. App. 3d 545, 382 N.E.2d 393 (1978). One might speculate, however, that the omission of such adjectives, at least in some cases, is inadvertent and does not signal any difference in approach.
59. See, e.g., J-R Grain Co. v. FAC, Inc., 627 F.2d 129, 135 (8th Cir. 1980) (witness testified that the fertilizer brokerage business did not require a great deal of capital); and Costello v. Fazio,
dence of the adequacy of insurance coverage, and involve testimony concerning the amounts of insurance carried by comparable businesses. Furthermore, in addition to consideration of the amount of capital provided, other factors such as shareholder loans and the amount of earnings retained by the corporation may be analyzed.

Also, the courts must pay heed to the relevant time periods involved in the cases before them. Whether there was an inadequate level of assets since the inception of the corporation is of significance. However, the analysis cannot stop there. For example, if the corporation was started with an adequate level of assets which thereafter became inadequate the court must then delve into the factors causing the decline. Obviously, a decline in the amount of assets due to purely business reasons could be viewed more sympathetically in a decision whether to pierce than would a situation where the defendant-shareholder bled the corporation of its assets. All of these factors and many more may play parts in a court's difficult task of measuring the adequacy of assets.

Analysis of several court decisions reveals an interesting variety of judicial views on the appropriate time and elements involved in determining undercapitalization. In *DeWitt Truck Brokers v. W. Ray Fleming Fruit Co.*, the court takes the position that the determination as to undercapitalization goes beyond initial capitalization saying, "The obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter . . . during the corporation's operations." One problem with the *DeWitt* formulation is that its tone may seem rather frightening to the person who is willing to invest but only on a limited liability basis. On the other hand, the dissenting opinion in *Walkowszky v. Carlton*, while assuming the relevance of post initial capitalization factors, adopted a posture somewhat less menacing to the investor when it said, "Where corporate income is not sufficient to

256 F.2d 903, 906 (9th Cir. 1958) (three experts, including a C.P.A., a business consultant, and a management consultant testified regarding inadequate capitalization). *See also* In re Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977), where the court said: "Capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized." *Id.* at 703.

Furthermore, where a new corporate entity is organized to continue an already existing business, such as where partners decide to incorporate, the capital and other needs of the new corporation may be discerned to some degree from a study of the preexisting business. *See Costello v. Fazio*, 256 F.2d 903, 905 (9th Cir. 1958).

540 F.2d 681 (4th Cir. 1976). *See* notes 29-48 *supra* and accompanying text.

62. *Id.* at 686.

cover the cost of insurance premiums above the statutory minimum or where initially adequate finances dwindle under the pressure of competition, bad times or extraordinary and unexpected liability, obviously the shareholder will not be held liable."

In *Arnold v. Phillips*, the court displayed an ability for in-depth analysis concerning disputed corporate assets. Arnold formed a corporation with $50,000 in capital stock and loaned the company $75,500 for building and equipping a plant so that it could begin operations. In a bankruptcy liquidation proceeding, the court invalidated a mortgage to the extent that it represented the aforementioned $75,500, concluding that that sum actually represented capital investment. Nevertheless, the court upheld the mortgage insofar as it secured later loans made by Arnold after the business was launched, saying:

> Although the charter provided for no more capital than $50,000, what it took to build the plant and equip it was a permanent investment, in its nature capital. . . . There can be little doubt that what he contributed to the plant was actually intended to be capital, notwithstanding the charter was not amended and demand notes were taken. . . .

After two years of prosperity, with the original capital thus enlarged demonstrated to be sufficient, with a book surplus of nearly $100,000 after payment of large salaries and dividends in the form of interest, there arose a situation very different from that in the beginning. Adversity then occurring raised a problem not different from that which commonly faces a corporation having losses. It may borrow to meet its needs. Had this corporation borrowed of a bank upon the security of the plant, the debt would no doubt be valid. What would render it invalid when Arnold furnished the money?

Moreover, the court indicated why this was not a case in which the corporate veil should be pierced when it said:

> We do not think a case is presented where the corporate entity ought to be disregarded. . . . That it was created to shield the owner from liability beyond the capital set up by the charter does not show an unlawful or fraudulent intent, for that is a main purpose of every incorporation. It becomes an evidence of fraud only when the capital is unsubstantial and the risk of loss great, or the contributions to capital are greatly overvalued, and the like. It would be hard to say in this case that $50,000 was not a substantial capital, and impossible so to say after holding that the real capital was $125,500, though some was irregularly paid in.

64. *Id.* at 427, 223 N.E.2d at 14, 276 N.Y.S.2d at 595-96, citing H. Henn, *supra* note 1, at 208 n.7.
65. 117 F.2d 497 (5th Cir. 1941).
66. *Id.* at 501.
67. *Id.* at 502.
Thus, in *Arnold*, the court considered a loan to be capital to the detriment of a shareholder, in that subordination of his claim resulted, but utilized the capital figure as judicially modified in concluding that the capital was substantial enough to avoid piercing the corporate veil. The reasoning in the *Arnold* case points to the conclusion that certain funds invested by the shareholders of a corporation in the form of loans should be treated as capital contributions (or assets provided for creditors) for purposes of determining if a deficiency in the corporate level of assets exists as a basis for piercing a corporate veil. For example, it might lead a court to count uncollectible shareholder loans as capital contributions in favor of shareholders seeking to avoid personal liability in piercing cases.\(^6\)

Finally, in the case of *In re Mobile Steel Co.*,\(^6\) which involved an effort to subordinate the debt of a shareholder to other creditors, the court rejected the notion that an investor is obligated to pour funds continually into a corporation to enable it to survive and indicated that in subordination cases a capital amount is adequate which is "what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable capitalization in the light of any special circumstances which existed at the time of incorporation of the now defunct enterprise."\(^7\) It continued, "This general definition is helpful because it focuses on the culpability of the organizer-stockholders and pegs the assessment to more specific standards which do not involve open-ended quantitative questions."\(^8\)

It is submitted that a focus on the time of incorporation and organizer-stockholders as called for by *In re Mobile Steel Co.* will on occa-
sion prove unreasonable because of changes in assets and in business. The determination of the adequacy of the level of assets provided for a corporation should not be frozen arbitrarily as suggested by courts which stress only capitalization at the inception of the corporation. Certainly, for example, at some point in time after funds fall below the level deemed appropriate for providing the requisite degree of creditor protection, such deficiency should afford a basis for disregarding the corporate entity. So too it should be recognized that an initially inadequate level of assets can be cured.

WHO IS LIABLE?

Who should be personally liable in cases in which undercapitalization or an inadequate level of assets is a factor leading to a decision to pierce the corporate veil? If courts followed *Minton v. Cavaney*\(^ {72}\) they would impose liability in inadequate capitalization cases on those equitable owners of a corporation who "actively participate in the conduct of corporate affairs."\(^ {73}\) This approach is supported by two sensible policy objectives. First, it provides an incentive to active investors to see to it that the corporation is properly capitalized or provided with an adequate level of assets. Second, it encourages investment by shielding those who are passive investors.\(^ {74}\) Nevertheless, in determining the range of appropriate targets in piercing suits the determination cannot be so simplistic because a number of issues are involved.

First, one difficulty with the *Minton* approach is in determining what activity is of such a nature and degree as to warrant the fastening of personal liability on a shareholder. Should every shareholder who is also a director or employee of a corporation be considered an active participant in corporate affairs and thereby subject to personal risk in inadequate capital or assets cases? The extent to which employee-shareholders or director-shareholders may be actually aware of and understand the capital and assets needs of the business, either at its inception or thereafter, may vary considerably. Quite obviously, certain employees may have nothing to do with and be truly ignorant of such matters. While directors, in theory at least, may be expected to know more, in practice they may also be ignorant of such matters. On the one hand, it certainly seems that the proposition that ignorance or inactivity should be an absolute bar to a successful piercing suit against an

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\(^{73}\) *Id.* at 579, 364 P.2d at 475, 15 Cal. Rptr. at 643.

\(^{74}\) *See* Campbell, *supra* note 43, at 52-53.
employee-shareholder or director-shareholder is untenable. But, on the other hand, such a shareholder, even if assumed to be aware of capital or assets needs, would not be an appropriate target in a piercing suit if lacking the power to do anything about such matters.

Of course, determinations as to the power which a particular shareholder may have in the corporate structure may not be easy to make. Conceivably, even where a shareholder unsuccessfully advocates improved capitalization or higher insurance, a question may be raised as to the sincerity of such efforts and as to whether a genuine effort could have improved the situation. In addition, while the contention may be made that failure of a shareholder to become disengaged from a corporation which lacks an adequate level of assets evidences complicity in such inadequacy, such an inference may be improper in a close corporation setting where a ready market for shares most likely is lacking. Furthermore, the extent of ownership of the employee-shareholder or director-shareholder may be quite significant if it indicates that such shareholder alone or with others has the power to control the corporation and, therefore, may bear a real responsibility for its failure to be provided with a fair level of assets. Indeed, a shareholder may be neither an employee nor a director of a corporation and still by virtue of his holdings actually exercise control over corporate affairs and be an appropriate target in a piercing suit.

There is also the question of whether a person with sufficient shares to exercise control in the corporation should escape liability because such shareholder chooses not to be officially involved in the corporation and refrains from actually exercising any power. This result is clearly suggested by the phraseology of Minion referred to above. Arguably, such a substantial shareholder attempting to reap gains as a passive investor from a corporation which has been provided with an inadequate level of assets should not be able to escape potential responsibility by such voluntary abdication. Still, the policy of encouraging investment by limiting liability may overcome efforts to make a truly passive investor liable. Certainly, there are situations where significant shareholders for various reasons are willing to invest funds but not time

75. See Briggs Transportation Co. v. Starr Sales Co., 262 N.W.2d 805 (Iowa 1978), where an officer-owner who did not actively participate in corporate activities was held personally liable because "[a]s a major corporate officer she could not avoid liability by emulating the three fabled monkeys, hearing, seeing and speaking no evil." Id. at 811. But see Kilpatrick Bros., Inc. v. Poynter, 205 Kan. 787, 798-99, 473 P.2d 33, 43 (1970), where a wife who had official involvement with several corporations and owned all of the stock of two of them was absolved of liability where she left corporate matters to her husband.

76. See note 73 supra and accompanying text.
and effort in a corporation. Should they be discouraged from investing as passive investors by the potential of personal liability resulting from piercing suits? While this question is not without difficulty, it is submitted that if investors are truly passive, it may be contended reasonably that such investors should be immune from personal liability.

Next, because the *Minton* formulation is expressly directed toward the liability in a piercing suit of equitable owners who participate actively in the conduct of corporate affairs, a question which arises is whether persons with interests in the corporation who are not equitable owners, such as corporate creditors, may be appropriate targets in piercing suits. It must be noted that it is possible for creditors not only to be active in corporate affairs but to be quite powerful. Moreover, some creditors may be inactive but potentially powerful. Obviously the position that all corporate creditors, even relatively passive ones who have the latent power to influence the affairs of the debtor, would be appropriate targets in piercing suits would involve radical changes in many creditor-debtor relationships. Many creditors are not inclined, equipped nor expected to become intimately involved in the affairs of their debtors. Still there are situations where creditor involvement in the business of the debtor may become so extensive as to render the creditor liable in piercing suits.

An additional question arising from the *Minton* perspective is whether the persons who hold powerful corporate positions should be held personally liable in inadequate capital or assets cases even if they have no funds invested in the corporation as creditors or otherwise. This question may have special significance with respect to those publicly held corporations where the power of management is great and where shareholders, as such, have little, if any, power to influence corporate affairs. In the face of a strong public policy to protect certain claimants, non-investors involved in management in such corporations, and perhaps even in close corporations where they exercise great power, might be considered appropriate targets in some piercing suits.

A rigid rule precluding the liability of persons who have not invested in

77. See, e.g., Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916).
78. Contrast the approach of the court in Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098 (1973), modified 490 F.2d 916 (5th Cir. 1974), where the court did not impose liability on a creditor but clearly would have been willing to “[i]f a lender becomes so involved with its debtor that it is in fact actively managing the debtor’s affairs, then the quantum of control necessary to support liability under the ‘instrumentality’ theory may be achieved;” *Id.* at 1105; with the approach of the court in *Lane v. Dickinson State Bank*, 605 S.W.2d 650, 652-53 (Tex. 1980), where the court, indicating that it found no authority for applying the alter ego doctrine against individuals not alleged to be shareholders, incorporators, directors or officers of the target corporation, refused to hold a creditor responsible for corporate conduct.
corporations could lead to unreasonable differentiation in treatment among responsible management; i.e., those with even a relatively small number of shares or other investments could be targets and those without any such shares or investments would not be.

Finally, in what situations, if any, should an investor whose investment interest has been transferred before a piercing suit is filed be an appropriate target in such a suit? One can envision various possibilities: an investor's interest may be transferred before the claim which is the basis of the piercing suit arises or after such claim arises; the asset level of the corporation may be deemed adequate at the time of transfer but may become inadequate thereafter; or it may be deemed inadequate at the time of transfer. Clearly, it would be just in some situations to hold the transferor liable. Otherwise a person who owns shares in a corporation at the time that a claim arises, and who would otherwise be liable in a piercing suit, could escape liability by simply transferring the shares prior to the filing of the suit.

Interesting questions may also arise as to the liability of transferees of shares or other interests. Suppose, for example, that a person purchases shares of a corporation which has been provided with inadequate capital or assets. If the policy of the law is to encourage reasonable protection for at least some creditors, the transferee may be obliged to take some action at some point in time to provide such protection or face the possibility of being considered an appropriate target in a piercing suit.79

**Conclusion**

As a general rule in piercing cases, where capitalization is relevant it would be more useful and realistic for courts to try to determine not merely if there is undercapitalization but rather whether the corporation has been provided with an "inadequate level of assets" to meet the type of claim involved in light of the business in which it is engaged, its financial needs, and risks of loss. In order to avoid a flood of litigation involving courts in reviewing business judgments of corporate investors and officials and severely undermining the corporate limited liability attribute, the judicial climate for piercing suits should be made inhospitable, at least to a degree, by courts making it clear that a serious defi-

79. In Northern Ill. Gas Co. v. Total Energy Leasing Corp., 502 F. Supp. 412 (N.D. Ill. 1980), a transferee's contention that it was not responsible for inadequate capitalization was rejected. The court indicated that while the capital was established by the original incorporators the transferee could not rely on the original capitalization.
ciency in the level of assets required must be present before the corporate entity will be disregarded. It is important also that there be judicial recognition that while such a deficiency may be unfair to certain creditors who are unable to protect themselves (such as tort creditors and arguably even some contract creditors unable to protect themselves) it would not be unfair to those contract creditors who are able to protect themselves. In addition, to a degree, there must be a continuing requirement for the maintenance of an "adequate level of assets" and not one based solely on the assets situation at the inception of the business. Persons responsible for the conduct of corporate business must recognize that at some point the level of assets available, for some potential creditors at least, is inadequate and must be increased. By the same token, an initially inadequate level of assets may be made adequate and cease to be a factor in piercing cases.

It is important too for courts to recognize that in those cases in which a deficiency in assets is unfair to the creditor seeking to pierce the corporate veil the introduction of other factors (whether singly or in combination with the level of assets factor), such as disregard of corporate formalities, as contributing to the result is unnecessary, irrelevant and may lead to error.

Finally, even in a case where the court determines that in light of the claim involved a deficiency in the level of assets exists as a basis for piercing the corporate veil, the court may well decide to exclude certain investors from liability. Persons should be free to invest in a corporation without fear of personal liability if they lack the power to do anything about the provision of assets to take care of claims, or arguably even where they possess latent power if they choose to be truly passive investors.