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Corporations--Disregard of the Corporate Entity

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STUDENT NOTES

CORPORATIONS — DISREGARD OF THE CORPORATE ENTITY

Two recent West Virginia decisions[1] raise the problem as to when the courts may disregard the concept of the corporation as a separate and distinct legal entity. The rule is well established in this[2] and other jurisdictions[3] that in ordinary, every-day business transactions, such as the acquisition and transfer of property,[4] the making of contracts,[5] and the institution and defense of suits,[6] the distinction between the corporation as a legal entity and separate personality, on the one hand, and its shareholders and officers, upon the other hand, will be strictly maintained.[7] Equally in unison are the authorities which hold that in certain cases it is imperative that the doctrine of separate corporate existence should be ignored. Such exception to the general rule is seemingly predicated upon the theory that the doctrine of separate corporate existence, being a mere fiction,[8] introduced for convenience in the transaction of business, may, like every other legal fiction be disregarded when urged to an intent or purpose subversive to that for which it was created.[9] While such a rule affords little as a yardstick by which to measure the cases, an analysis of the decisions

[1] Southern Co-op. Foundry Co. v. Warlick Furniture Co., 185 S. E. 773 (W. Va. 1936); Tynes v. Shore, 185 S. E. 845 (W. Va. 1936).

[2] Moore v. Schoppert, 22 W. Va. 282 (1883); Transportation Co. v. Standard Oil Co., 50 W. Va. 611, 40 S. E. 591 (1902).

[3] Ulmer v. Lime Rock Ry. Co., 98 Me. 579, 57 Atl. 1001 (1904); Fietsam v. Hay, 122 Ill. 293, 13 N. E. 501 (1887).

[4] Park v. Petroleum Co., 25 W. Va. 108 (1884); Sellers v. Greer, 172 Ill. 549, 50 N. E. 246 (1898).

[5] Hall's Safe Co. v. Herring-Hall-Marvin Safe Co., 146 Fed. 37 (C. C. A. 6th, 1906); Smith v. Parker, 148 Ind. 127, 45 N. E. 770 (1897).

[6] Button v. Hoffman, 61 Wis. 20, 20 N. W. 667 (1884); Smith v. Hurd, 12 Metc. 371, 46 Am. Dec. 690 (Mass. 1847).

[7] See Wormser, *Disregard of Corporate Fiction* (1923) 23 COL. L. REV. 702-715.

[8] That the law is by no means settled whether the corporate personality is to be regarded as a factual reality or a legal fiction see Colson, *Corporate Personality* (1936) 24 GEO. L. J. 638-652. Also see Note (1925) 13 CAL. L. REV. 235. Chief Justice Marshall in Dartmouth College v. Woodward, 4 Wheat. 518 (1819) defined a corporation as "an artificial being, invisible, intangible and existing only in contemplation of law". Note the language in People v. North River Refining Co., 121 N. Y. 599, 622, 24 N. E. 834, 839 (1890) where the court states: "The abstract idea of a corporation, the legal entity, the impalpable and intangible creation of human thought, is itself a fiction, and has been appropriately described as a figure of speech." Also see Farmers' Loan & Trust Co. v. Pierson, 130 Misc. 110, 222 N. Y. Supp. 532 (1927).

[9] State v. Standard Oil Co., 49 Ohio St. 137, 30 N. E. 279 (1892); Southern Electric Securities Co. v. State, 91 Miss. 195, 44 So. 785 (1907).

indicates that courts have tended to disregard the corporate entity in the following situations.

1. Where a corporation is organized to perpetrate a fraud, courts have held that they will look beyond the corporate unit to the persons who are responsible for its existence.[10] Where the corporate device is used to defraud creditors[11] or to evade existing legal obligations[12] courts have had no difficulty in looking to the real parties in interest. Such cases commonly involve attempts of financially embarrassed individuals,[13] partnerships,[14] or corporations[15] to transfer their assets to a "dummy corporation" as a means of evading their obligations. Creditors have under such circumstances been allowed to reach the assets in the hands of the "dummy" provided the rights of innocent shareholders therein will not be adversely affected.[16] While such exception to the general rule is well recognized by the courts, it is believed that in many instances the lifting of the corporate veil is unnecessary to reach the desired result. A transfer in fraud of creditors void when made to a third party is no less subject to rescission by the creditors when made to a "dummy corporation", even though such a corporation be recognized as a separate and distinct legal entity.[17] In *Southern Co-op. Foundry Co. v. Warlick Furniture Co.*,[18] an attempt was made to transfer the assets of an insolvent furniture company to a new corporation composed of the same officers and shareholders, the purpose being to force creditors to accept a reduced settlement of their claims. The West Virginia court held that the two cor-

[10] THOMPSON, CORPORATIONS (3d ed. 1927) § 5445; Brundred v. Rice, 49 Ohio St. 640, 32 N. E. 169 (1892); First Nat. Bank of Chicago v. Trebein Co., 59 Ohio St. 316, 52 N. E. 834 (1898).

[11] Hibernia Ins. Co. v. St. Louis & New Orleans Transp. Co., 13 Fed. 516 (E. D. Mo. 1882); Kellogg v. Douglas County Bank, 58 Kan. 43, 48 Pac. 587 (1897).

[12] Donovan v. Purtell, 216 Ill. 629, 75 N. E. 334 (1905); Higgins v. Cal. Petroleum & Asphalt Co., 147 Cal. 663, 81 Pac. 1070 (1905).

[13] Shumaker v. Davidson, 116 Iowa 569, 87 N. W. 441 (1901); First Nat. Bank of Chicago v. Trebein Co., 59 Ohio St. 316, 52 N. E. 834 (1898).

[14] *In re* Rieger, Kapner & Altmark, 157 Fed. 609 (S. D. Ohio, 1907); Mulford v. Doremus, 60 N. J. Eq. 80, 45 Atl. 688 (1900); Colorado Trading & Transfer Co. v. Acres Comm. Co., 18 Colo. App. 253, 70 Pac. 954 (1902).

[15] Montgomery Web Co. v. Dienelt, 133 Pa. 585, 19 Atl. 428 (1890).

[16] Kellogg v. Douglas County Bank, 58 Kan. 43, 48 Pac. 587 (1897); Shumaker v. Davidson, 116 Iowa 569, 87 N. W. 441 (1901).

[17] Once the intent to defraud, delay or hinder creditors is established, the assets may be reached in the hands of a third party unless he be a *bona fide* purchaser for value. That mere exchange of stock of a dummy corporation for such assets will not suffice, see Note (1933) 85 A. L. R. 133.

[18] Southern Co-op. Foundry Co. v. Warlick Furniture Co., 185 S. E. 773 (W. Va. 1936).

porations were in legal effect one and the same and that creditors of the old company might collect in garnishment proceedings against the new corporation. Such a decision is apparently justified upon ground of fraud, although a similar result might have been achieved, as has been suggested, on the ground of fraudulent conveyance.

2. Where a corporation has been used to evade an existing statute or to modify its effect, courts have refused to be blinded by the doctrine of separate corporate existence and have looked to the true situation.[19] Such cases often arise where a corporation has been organized to perform a function or do an act which the first corporation or individual is forbidden by law to perform. Courts have tended in this situation to hold the act of such corporation as the act of the individual or corporation who controls it and to whose ultimate benefit the act will inure.[20] Thus where the Pabst Brewing Company sought to evade provisions of the Elkins Act against rebates by organizing a transit company to receive such rebates the court held the transit company to be the mere "alter ego" of the brewing company, the real beneficiary.[21] Such decisions are believed to be eminently sound, the corporate device being used in such cases for an illegal purpose.

3. Where a corporation is so organized and controlled as to become the mere agent or instrumentality of another corporation, courts have laid down the rule that the doctrine of corporate separateness may be ignored.[22] Under such a theory a parent company has been held liable for the debts[23] and even the negligence and other torts[24] of the subsidiary. Likewise, the assets of

[19] United States v. Lehigh Valley Railroad, 220 U. S. 257, 31 S. Ct. 387 (1911); Northern Securities Co. v. United States, 193 U. S. 197, 24 S. Ct. 436 (1903); Miller & Lux v. East Side Canal Co., 211 U. S. 293, 29 S. Ct. 111 (1908).

[20] United States v. Milwaukee Refrigerator Transit Co., 142 Fed. 247 (E. D. Wis. 1905); United States v. Lehigh Valley Railroad, 220 U. S. 257, 31 S. Ct. 387 (1911).

[21] United States v. Milwaukee Refrigerator Transit Co., *ibid.*

[22] *In re* Muncie Pulp Co., 139 Fed. 546 (C. C. A. 2d, 1905); Seymour v. Woodstock & Sycamore Traction Co., 281 Ill. 84, 117 N. E. 729 (1917).

[23] Luckenbach S. S. Co. v. W. R. Grace & Co., 267 Fed. 676 (C. C. A. 4th, 1900); Stark Electric R. Co. v. McGinty Cont. Co., 238 Fed. 657 (C. C. A. 6th, 1917). *Contra*: New York Trust Co. v. Carpenter, 250 Fed. 668 (C. C. A. 6th, 1918); City of Holland v. Holland City Gas Co., 257 Fed. 679 (C. C. A. 6th, 1919).

[24] The Willen Van Driel, Sr., 252 Fed. 35 (C. C. A. 4th, 1918); Foard Co. of Baltimore City v. Maryland, 219 Fed. 827 (C. C. A. 4th, 1914). *Contra*: Union Sulphur Co. v. Freeport Texas Co., 251 Fed. 634 (D. C. Del. 1918); Stone v. Railroad Co., 202 N. Y. 352, 95 N. E. 816 (1911).

the subsidiary have been held available to the creditors of the bankrupt parent corporation.[25] Mere ownership of stock by the parent company[26] or ownership of stock in both companies by the same individuals,[27] however, will not justify disregard of their separate entities. Likewise, the mere intermingling of affairs[28] or identity of directors and officers,[29] will not be held sufficient, but it must appear also that the subordinate corporation was the "business conduit" of the parent company.[30] Despite the many generalizations of the courts to the effect that two corporations will be regarded as one and the same where one is the mere "agent", "tool" or "dummy" of the other, a review of the authorities[31] and an analysis of the decisions leads to the conclusion that courts have been influenced in such cases by the further fact that to recognize their separate legal existence would result in a fraud, or injustice to some third party.[32] Indeed the tendency of the latest decisions has been to expressly limit the rule to cases where adherence to the separate entity doctrine would aid in consummation of a wrong,[33] result in a fraud[34] or work injustice to the rights of third parties.[35]

4. In the case of the one man corporation or the corporation in which all stock is owned by a single individual, except a few

[25] *In re* Muncie Pulp Co., 139 Fed. 546 (C. C. A. 2d, 1905); *In re* Rieger, Kapner & Altmark, 157 Fed. 609 (S. D. Ohio 1907).

[26] Berkey v. Third Ave. Ry. Co., 244 N. Y. 84, 155 N. E. 58 (1926); Hall v. Chicago & N. W. Ry. Co., 133 Minn. 413, 158 N. W. 627 (1916).

[27] Pittsburg-Buffalo Co. v. Duncan, 232 Fed. 584 (C. C. A. 6th, 1918); Richmond Const. Co. v. Richmond Ry. Co., 68 Fed. 105 (C. C. A. 6th, 1895).

[28] *In re* Watertown Paper Co., 169 Fed. 252 (C. C. A. 2d, 1909).

[29] In Perry v. Ohio Valley Ry. Co., 70 W. Va. 697, 74 S. E. 993 (1912), "It is not to be inferred that two corporations are in legal effect one and the same, . . . because they have the same men as officers, [and] employ the same men as laborers. . . ." Ft. Smith Traction Co. v. Kelley, 94 Ark. 461, 127 S. W. 975 (1910).

[30] WORMSER, DISREGARD OF CORPORATE FICTION AND ALLIED PROBLEMS (1929) 56.

[31] See Ballantine, *Separate Entity of Parent and Subsidiary Corporation* (1926) 60 AM. L. REV. 19.

[32] New York Trust Co. v. Carpenter, 250 Fed. 668 (C. C. A. 6th, 1918); Erkenbrecher v. Grant, 187 Cal. 7, 200 Pac. 641 (1921).

[33] Erkenbrecher v. Grant, *ibid.*; Ballantine, *supra* n. 31.

[34] See Gledhill v. Fisher & Co., 272 Mich. 353, 262 N. W. 371 (1935) where the court states, "Before the corporate entity may be properly disregarded . . . it must be shown not only that undue domination and control was exercised by the parent corporation over the subsidiary, but also that this control was exercised in such a manner as to defraud and wrong the complainant, and that unjust loss or injury will be suffered by the complainant as the result of such domination unless the parent company be held liable." Also see North v. Higbee Co., 131 Ohio St. 507, 3 N. E. (2d) 391 (1936).

[35] New York Trust Co. v. Carpenter, 250 Fed. 668 (C. C. A. 6th, 1918); Fed. Trade Comm. v. Thatcher Mfg. Co., 5 F. (2d) 615, 621 (C. C. A. 3d, 1925).

shares necessary to qualify directors, courts have shown great liberality in lifting the veil of the corporate entity and holding the sole shareholder and the corporation to be one and the same.[36] The test in such cases, again as in the case of the parent and subsidiary corporation, seems to be one of substantial identity, *i. e.*, is the corporation the "alter ego" of its owner?[37] Under such a theory the corporation has been held liable for debts incurred in its name by the sole shareholder without compliance with corporate formalities.[38] Likewise liability has been imposed on the sole shareholder for the obligations of the corporation.[39] Except for cases in a few jurisdictions which suggest a policy of the law against one man corporations,[40] there is apparently little justification for the disregard of corporate entities on the mere ground that the corporation is owned by a single individual.[41] Such decisions are in many instances justified, however, by the further consideration that the corporation was formed or being used for a fraudulent purpose,[42] or to evade an obligation,[43] or circumvent a restrictive covenant upon the shareholder.[44] The recent decision of *Tynes v. Shore*[45]

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[36] Walter & Co. v. Zuckerman, 214 Cal. 418, 6 P. (2d) 251 (1931); Briggs & Co. v. Harper Clay Prod. Co., 150 Wash. 235, 272 Pac. 962 (1928). See Note (1932) 45 HARV. L. REV. 1084; also see Note (1936) 14 CAN. BAR REV. 663.

[37] Wenban Estate v. Hewlett, 193 Cal. 675, 227 Pac. 723 (1924); State Nat. Bank v. Encinal Mercantile Co., 277 S. W. 398 (Tex. Civ. App. 1925).

[38] Commercial Surety Co. v. Modesto Drug Co., 43 Cal. App. 162, 184 Pac. 964 (1919); Gamer Paper Co. v. Tuscany, 264 S. W. 132 (Tex. Civ. App. 1924).

[39] Minifie v. Rowley, 187 Cal. 481, 202 Pac. 673 (1922).

[40] See Louisville Banking Co. v. Eisenman, 94 Ky. 83, 93, 21 S. W. 531, 532 (1893). ". . . the Legislature never intended to permit one person to conduct his ordinary business in the name of a corporation, so as to exempt him from personal liability, or his property not embraced by or used in his corporate business from the payment of a debt for no other reason than its being a debt of the corporation." See also The Bellona Company Case, 3 Bland 442, 446 (Md. 1831). *Cf.* First Nat. Bank of Gadsden v. Winchester, 119 Ala. 168, 172, 24 So. 351, 352 (1898).

[41] WORMSER, *op. cit. supra* n. 30, at 81. "The writer, although a firm believer in the necessity for a frequent and liberal disregard of the concept of corporate entity, believes that to ignore it simply because the number of shareholders has become few or even one, is to convert an otherwise sane, safe, and sensible policy into a *'reductio ad absurdum'.*" Elenkrieg v. Siebrecht, 238 N. Y. 254, 144 N. E. 519 (1924).

[42] *In re* Berkowitz, 173 Fed. 1013 (D. C. N. J. 1908); Noble v. Burnett Co., 208 Mass. 75, 94 N. E. 289 (1911).

[43] Hagy v. Maguire, 147 Pa. 187, 23 Atl. 806 (1892); Nat. Conduit Mfg. Co. v. Conn. Pipe Mfg. Co., 73 Fed. 491 (D. C. Conn. 1896).

[44] Ferrell v. Prame, 206 Fed. 278 (C. C. A. 6th, 1913); Booth Co. v. Seibold, 37 Misc. 101, 74 N. Y. Supp. 776 (1902).

[45] Tynes v. Shore, 185 S. E. 845 (W. Va. 1936).

apparently places West Virginia in line with other jurisdictions adopting the liberal rule in respect to one-man corporations. In this case an individual was held liable for the debt of a corporation whose stock he had purchased on the ground that when a corporation is merely a simulacrum appropriated to the personal business of an individual, the corporate entity may be disregarded. It is submitted that the court should be extremely cautious in the application of such a rule and that in the ordinary situation all distinctions between the sole shareholder and the corporation should be preserved. Only in the extreme case where necessary to prevent fraud[46] or injustice to a third party[47] should the distinction be ignored.

W. V. R.

[46] *Supra* n. 42.
[47] Briggs & Co. v. Harper Clay Prod. Co.; Walter & Co. v. Zuckerman, both *supra* n. 36.