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Piercing the Corporate Veil in West Virginia: The Extension of *Laya* to All Sophisticated Commercial Entities

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PIERCING THE CORPORATE VEIL IN WEST VIRGINIA: THE EXTENSION OF LAYA TO ALL SOPHISTICATED COMMERCIAL ENTITIES

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I. INTRODUCTION

Corporations are entities separate and distinct from their shareholders, and the shareholders’ liability for corporate debt is limited to the amount they have invested into the corporation.1 This limitation of liability that corporations provide is one of the most attractive facets of the corporate form.2 There are, however, instances in which courts will disregard the corporate form and hold the corporation’s shareholders personally liable for the corporation’s debts.3 This is known as “piercing the corporate veil.”4 The piercing doctrine is widely recognized, but there is variety across the various jurisdictions as to under what circumstances the corporate veil may be pierced.5 Some jurisdictions also have

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2 Id. (stating that one main advantage of the corporate form is that it eliminates the problem of unlimited liability that partnerships and sole proprietorships inherently involve).
4 Id.
different criteria for tort and contract creditors attempting to hold the corporate shareholders personally liable.\(^6\)

West Virginia, like all states,\(^7\) allows the corporate veil to be pierced under certain circumstances and piercing cases under both tort and contract claims have come before the West Virginia Supreme Court of Appeals.\(^8\) This Note, however, focuses primarily on corporate veil piercing in West Virginia under a contract claim. The seminal case for corporate veil piercing under a contract claim in West Virginia is *Laya v. Erin Homes, Inc.*\(^9\)

In *Laya*, the West Virginia Supreme Court of Appeals held that in order for a contract creditor to pierce the corporate veil, and hold the shareholders personally liable for the corporation’s debts, two specific elements must be met:\(^10\) (1) there must be such unity of interest and ownership that the separate personalities of the corporation and of the individual shareholder(s) no longer exist (a disregard of formalities requirement); and (2) an inequitable result would occur if the acts are treated as those of the corporation alone (i.e. a fairness requirement).\(^11\) The Court also laid out a third prong for certain “sophisticated commercial entities,” such as commercial lenders:\(^12\) certain commercial entities that have the ability to conduct a pre-contractual investigation of the corporation’s capitalization level will be deemed to have assumed the risk of the corporation’s undercapitalization and will not be permitted to pierce the corporate veil on that basis.\(^13\)

A few years later, the Fourth Circuit Court of Appeals, professing adhering to West Virginia law, held that *Laya’s* third prong dealing with sophisticated commercial entities was merely permissive and allowed an entity, just as sophisticated as the commercial lender example in *Laya*, to pierce the corporate veil.\(^14\) The Court also explicitly declined to rule on whether *Laya’s* third prong was applicable to any sophisticated commercial entity other than the corporate lender example cited in *Laya*.\(^15\) A later case decided by the West Virginia Su-

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\(^6\) See David C. Cummins, *Disregarding the Corporate Entity: Contract Claims*, 28 Ohio St. L.J. 441, 443 (1967) (stating that the policy concerns of courts behind “disregarding the corporate entity in cases not involving consensual transactions, principally tort cases, are different than in contract cases”).


\(^9\) 352 S.E.2d 93 (W. Va. 1986).

\(^10\) *Id.* at 99.

\(^11\) *Id.*

\(^12\) *Id.* at 100.

\(^13\) *Id.* This dicta is generally known as *Laya’s* third “sophisticated commercial entity prong.”


\(^15\) *Id.* at 213.
preme Court,\textsuperscript{16} while denying an \textit{individual} contract creditor of the corporation the ability to pierce the corporate veil, left an opening for even sophisticated contract creditors to pierce the veil if they could prove tortious activity such as fraud or equivalent misfeasance on the part of the corporate shareholders.\textsuperscript{17}

All sophisticated commercial entities have the ability to conduct a precontractual investigation of the capitalization level of the corporation with which they are contracting, and can bargain for terms consistent with the risk associated with the level of the corporation’s capitalization. Accordingly, \textit{Laya}’s third prong should be extended to all sophisticated commercial entities. Under West Virginia law, any contract creditor deemed by the court to be a “sophisticated commercial entity” should not be permitted to pierce the corporate veil under a purely contractual claim.\textsuperscript{18}

Section II of this Note addresses the historical origins of the limited liability corporation as well as economic and public policy justifications for its existence. Section III discusses the concept of “piercing the corporate veil” generally and comments on the historical origin of piercing, the various tests courts use, and the impact that undercapitalization has on the piercing analysis. Section IV explores corporate veil piercing by contract creditors under West Virginia law, with particular emphasis on contract claim cases decided by the West Virginia Supreme Court of Appeals and the Fourth Circuit Court of Appeals. Section V suggests an extension of \textit{Laya}’s third prong to all sophisticated commercial entities, sets out to define “sophisticated commercial entities,” and comments upon the limits of the extension of \textit{Laya}. Several economic and public policy justifications for the extension of \textit{Laya}’s third prong are proffered in Section VI. Finally, Section VII concludes the Note by summarizing a few key

\begin{footnotes}
\item[17] \textit{Id.} at 5 (citing Gray v. Edgewater Landing, Inc., 541 So.2d 1044, 1047 (Miss. 1989)).
\item[18] The phrase “purely contractual claim” is used to denote a claim by the contract creditor dealing with a loss associated with the contract itself (i.e. the failure of the defendant corporation to pay for goods or services), as opposed to a contract creditor that attempts to pierce for “fraud or equivalent misfeasance” on the part of the corporate shareholders under Mills. \textit{See generally Mills,} 438 S.E.2d 1. An action to pierce the veil for fraud by the contract creditor would actually fall under a tort, as opposed to a contract, theory of piercing. \textit{See Stephen B. Presser, Piercing the Corporate Veil} § 1:10 (2005). The purely contractual claim is most easily distinguished from the pure tort claim of piercing, which would be a tort claim by an individual or entity that had no previous dealing with the defendant corporation. \textit{See e.g.}, Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966) (plaintiff attempted to pierce on a pure tort claim after he was hit by a cab owned by the defendant’s corporation with which the plaintiff had no previous dealings). If the claim for piercing is a tort claim by a contract creditor that had previous knowledge of the capitalization level of the defendant corporation, the distinction becomes blurred. \textit{See Mills,} 438 S.E.2d 1 (contract creditor that had previous dealings with the defendant corporation attempted to pierce the corporate veil on a tort theory), discussed \textit{infra}. Because this Note deals primarily with contract claims for piercing, much of the implications of the holding of \textit{Mills} dealing with the ability of contract creditors to pierce under a tort claim are outside the scope of the Note. However, see Section V.C., \textit{infra}, summarizing a few key points regarding the contract creditor’s ability to pierce on a tort theory for fraud or equivalent misfeasance.
\end{footnotes}
points concerning the extension of *Laya's* third prong to all sophisticated commercial entities.

II. THE LIMITED LIABILITY CORPORATION: ECONOMIC AND PUBLIC POLICY JUSTIFICATIONS

Corporations are solely a creature of state legislation. They would not exist without the various state legislative mandates giving them life. These statutes normally contain the same basic elements; they state that the corporation has most of the rights of natural persons, including the ability to enter into contracts, to sue, and to be sued. Additionally, all states have statutory provisions that limit the liability of a corporation's shareholders to their respective capital investments in the corporation. This was not always the case. Early in America's history many states did not afford corporate investors the limitation of liability that shareholders in modern corporations now enjoy. However, the attitudes of state legislatures began to change as ideas emerged concerning the impact that corporations had on political and economic opportunities in the United States.

A. The Origin of the Limited Liability Corporation

There is some authority for the premise that the limited liability corporation had its roots in England as early as the seventeenth century. However, just how far the idea of limited liability spread into America after the Revolution is not clear. Early in America's history many states imposed unlimited liability on shareholders. This was because state legislatures were concerned that limited liability would negatively affect economic development by making creditors less willing to lend corporations money to expand. By the mid-1800s many states, led by New York (the leading industrial state in the first half of the

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20 1 *William Meade Fletcher*, *Fletcher Cyclopaedia of the Law of Private Corporations* 411 (Callaghan 1931).

21 *See id.* at 412-13.

22 *Presser*, *supra* note 18, § 1:3.


24 *Presser*, *supra* note 18, § 1:3.

25 *Id.*

26 *See Seavoy*, *supra* note 23, at 44. For example, the state of New York allowed many types of businesses to incorporate, but only offered the shareholders of certain types of corporations limited liability. *Id.*

27 *Presser*, *supra* note 18, § 1:3.
nineteenth century), began to arrive at the conclusion that the best means to further the policy objective of increased capital formation was to encourage shareholders to invest into corporations by limiting their liability for corporate debt. Many states around the country quickly followed suit as the limited liability corporation came into prominence.

For these nineteenth century legislators in New York, "who mandated the limited liability for corporations' shareholders, the imposition of limited liability was perceived as a means of encouraging the small scale entrepreneur, and of keeping the entry into business markets competitive and democratic." These legislators thought that under a system of unlimited liability, less wealthy investors would be hesitant to invest in corporations for fear of being "wiped out" by the imposition of the corporations' liabilities upon them. The basic premise behind the limitation of liability, at least in New York, was to allow men of any financial means to take part in the great economic expansion occurring during the period. New York's incorporation statutes, in essence, "lev- eled the playing field" for all investors by allowing men of even modest means to participate in "businesses that could most advantageously be organized as corporations." This was an opportunity that, up until the limitation of liability, was afforded only to men with capital reserves significant enough to insulate them from the risk of the corporate default, and being held personally liable for the corporation's debts. This democratic view of limited liability, at the time, existed in conjunction with what is traditionally known as the modern or "economic" justification of the limited liability corporation; higher overall levels of capital investment and greater investment in "riskier" business ventures.

B. The Modern Economic Justification for the Limited Liability Corporation

While the original democratic justifications for the modern limited liability corporation may have been lost over time, the economic justification for the corporate form still carries weight. A corporation is not actually a person, "but the law treats it as though it were a person by process of fiction. It has a

28 See Seavoy, supra note 23, at 59. During this period "[t]he New York City business community . . . was foremost in the country in energy, originality, and aggressiveness." Id.
29 Presser, supra note 18, § 1:3.
30 Id.
31 Id.
32 Id.
33 Seavoy, supra note 23, at 185.
34 Id.
35 Presser, supra note 18, § 1:3.
36 Id.
37 Id.
real existence with rights and liabilities as a separate legal entity." It is precisely this existence, separate and distinct from its shareholders, which continues to make the corporate form so attractive. The public’s potential gain from the policy of limited liability, which encourages greater investment and risk-taking by corporate investors, has remained the leading justification behind the modern corporate form.

By limiting the liability of shareholders, diversification and investment in numerous companies are encouraged. If a shareholder was potentially liable for the debts of any company in which he or she invested, the rational investor, if he or she invested in any corporation at all, would only invest in the one corporation that had the least risk associated with it. To illustrate, if an investor bought stock in one hundred different companies (as in the modern day mutual fund), there would be a great risk that at least one of those companies would be unable to meet its contractual obligations and the shareholder would be held personally liable. With limited liability, the investor is encouraged to buy shares in more corporations; far more than under a system of unlimited liability.

Moreover, the limited liability corporation encourages investment in riskier ventures than does a system of unlimited liability. Under unlimited liability, the rational investor would be hesitant to invest in companies that were not “sure things” for fear of being held personally liable for the corporation’s debts if it was to fail to meet its obligations. The lessened risk associated with limited liability reduces the costs associated with obtaining the needed investors and allows small, unproven companies to raise the capital they need; thus, fostering greater economic growth in the economy.

One commentator quite aptly summed up the great impact the corporate form has had on the American economy when he stated: “I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times. . . . Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it.” By limiting their liability, shareholders

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38 FLETCHER, supra note 20, at 414.
42 See id.
43 See Booth, supra note 40.
44 Huss, supra note 41.
are much more likely to invest in many more companies, as well as riskier companies, than they otherwise would under a system of unlimited liability. The persistence of this view from the very beginning of the rise of the limited liability corporation in the United States to the present day, as well as the vast number of corporations created every year in the United States, evidences the validity of this view.

III. PIERCING THE CORPORATE VEIL

A. What is “Piercing the Corporate Veil?”

The modern concept of stockholder immunity from liability for the debts of the corporation is not absolute. There are instances in which the corporate form will be disregarded. This disregard is known as “piercing the corporate veil.” Generally, piercing the corporate veil is the concept of disregarding the formal and distinct existence of the corporate legal fiction and holding its shareholders personally liable for corporate debts. The corporate veil generally will be pierced when “a court determines that the debt in question is not really a debt of the corporation, but ought, in fairness, to be viewed as a debt of the individual or corporate shareholder or shareholders.” Piercing the corporate veil is not an action separate and independent of that against the corporation; rather, it is an assertion of facts and circumstances that persuades the court to impose corporate liability on its shareholders. Piercing is not a cause of action in and of itself, but merely a “procedural means of allowing liability on a substantive claim.” Because courts recognize the importance of the corporate system and its impact on the American economy, piercing the corporate veil is a rare circumstance.

47 See Huss, supra note 41.
48 See UNITED STATES BUREAU OF ECONOMIC ANALYSIS, STATISTICAL ABSTRACT OF THE UNITED STATES, 1993 TABLE 531. A 1989 census by the United States Bureau of Census showed that there had been 3.6 million public and private corporations created in the United States since its inception. Id.
49 See 18 AM. JUR. 2D., supra note 3.
50 Id.
51 Id.
52 PRESSER, supra note 18, § 1:1.
53 18 AM. JUR. 2D., supra note 3. While piercing is not an action separate from the action against the corporation, veil piercing is also commonly used in conjunction with other separate and distinct causes of action against the corporate shareholders by plaintiffs wishing to hold the shareholders personally liable for the corporation’s debts. These other causes of action, depending upon the circumstances of the individual case, often include fraud, commercial misrepresentation, and enterprise liability. See generally Bainbridge, supra note 46, at 517-27.
54 Id.
55 See generally Thompson, supra note 7.
In theory, the piercing doctrine applies to all corporations whether they are large, publicly-held corporations or small, closely-held family corporations. However, there has never been a situation in which a court has held the individual shareholders of a public corporation or private corporation with widely-dispersed shares liable for the corporation’s debts. Because of this, the piercing doctrine applies primarily to closely-held corporations. Accordingly, many of the factors used by courts to determine if the veil should be pierced appear much more frequently in close corporations than in large, publicly-traded corporations.

B. Historical Origins of Corporate Veil Piercing

After the rise of the limited liability corporation in the United States during the latter half of the nineteenth century, the view that shareholders should be held liable for the corporation’s debts subsided. The period in which the limited liability corporation gained its most prominence (late nineteenth century through the early twentieth century) was a time of relative prosperity in America’s history, and there may have been less of a temptation to hold shareholders personally liable for corporate debts.

After the Great Stock Market Crash of 1929, many scholars began to envision ways to hold corporate shareholders liable for the injustices perpetrated

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56 Barber, supra note 5, at 372.
57 Thompson, supra note 7, at 1055.
58 Id. The study conducted by Thompson found that the vast majority of piercing claims were brought against close corporations. Id. The study also found that in close corporations, as the number of shareholders increased the percentage of successful piercing cases decreased. Id.
59 L. S. Tellier, Inadequate Capitalization as Factor in Disregard of Corporate Entity, 63 A.L.R.2d 1051 (2006). Many of the factors used by courts deal with the failure of the corporate shareholders or directors to maintain the formalities of the corporate form (i.e. the failure to issue stock and the failure to keep adequate corporate records) apply almost exclusively to closely-held corporations because larger corporations have boards in place to see that the corporate formalities are followed. See RALPH D. WARD, IMPROVING CORPORATE BOARDS: THE BOARDROOM INSIDER GUIDEBOOK 3 (John Wiley & Sons, Inc., 2000) (stating that setting and following board operational rules is a “must” for any corporate entity).

The emphasis that many courts place on the disregard of corporate formalities as a ground to pierce close corporations also has important implications for other legal entities, such as limited liability companies. Many states, including West Virginia, have statutes in place stating that the very “corporate formalities” found lacking in cases in which the corporate veil has been pierced, do not apply to limited liability companies. See W. VA. CODE § 31B-3-303(b) (2005) (stating that “[t]he failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not ground for imposing personal liability on the members or managers for liabilities of the company”). Accordingly, what activity on the part of the members of a limited liability company would be required to “pierce” these entities is very much in doubt. See generally Stephen M. Bainbridge, Abolishing LLC Veil Piercing, 2005 U. Ill. L. Rev. 77 (2005).
60 PRESSER, supra note 18, § 1:3.
61 Id.
by their corporations. This was particularly true in the fraudulent issuance of stock, which was a significant problem during the years surrounding the Great Crash. Scholars proffered various theories to deal with this and other problems faced by individuals wronged by the improper use of the corporate form.

More cases of veil piercing began to occur in the decades following the Great Crash as the general decline in the national economy led to different views on the role of the corporate form in America.

C. Policy Behind Piercing the Corporate Veil

Piercing began as an equitable remedy, and it has grown into a complex and vital common law doctrine. Traditionally, corporate veil piercing has been allowed only when recognizing the corporate form would create an unfair result to the corporation's creditors. One of the most famous (and most commonly quoted) comments upon the theory behind veil piercing was stated by Judge Sanborn in United States v. Milwaukee Refrigerator Transit Co.:

[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of a 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.

Because the basic factor under the piercing doctrine is fairness to the corporation's creditors, courts often make a distinction between veil piercing under tort and contract claims. Many courts recognize that because contract creditors are voluntary creditors, they have a heavier burden of proof than tort creditors. These courts often cite the opportunity for the contract creditor to investigate the assets of the corporation before contracting as weighing heavily against the contract creditor in the "fairness analysis." Because tort creditors normally have no such opportunity to investigate the corporation, the general

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62 Id.
63 Id.
64 See id.
65 See id.
66 Cummins, supra note 6, at 442.
67 PRESSER, supra note 18, at § 1:1.
68 See FLETCHER, supra note 20, at 563, 605.
70 See, e.g., J-R Grain Co. v. FAC, Inc., 627 F.2d 129, 135 (8th Cir. 1980).
71 Barber, supra note 5, at 384.
72 Id.
consensus is that piercing is permitted more often for tort than for contract creditors.\textsuperscript{73}

\textbf{D. The Various Tests for Piercing}

The circumstances under which courts allow the corporate veil to be pierced are anything but consistent from jurisdiction to jurisdiction.\textsuperscript{74} One commentator has stated that the law of piercing the corporate veil is “like lightning . . . rare, severe, and unprincipled. There is consensus that the whole area of limited liability, and inversely of piercing the corporate veil, is among the most confusing in corporate law.”\textsuperscript{75} There seems to be as many different views on what is needed in order to pierce the veil as there are theories of, or individual attitudes concerning, the corporate form.\textsuperscript{76}

That being said, courts generally look to the “totality of the circumstances” when dealing with corporate veil piercing.\textsuperscript{77} This test, though, is “applied by judges in an extremely discretionary manner, in accordance with the individual consciences of judges.”\textsuperscript{78} Some courts follow a two-prong test to determine if piercing is appropriate in light of the facts.\textsuperscript{79} This two-prong test is more of a summary of the overall factors used in the “totality of the circumstances” approach.\textsuperscript{80} Courts that use this approach will generally allow piercing when (1) there is such a unity of interest and ownership that the separate existences of the corporation and the individual shareholders do not exist; and (2) if the acts of the corporation are treated as those of the corporation alone, an equitable result will follow.\textsuperscript{81} Another famous piercing test has been deemed the “instrumentality” test.\textsuperscript{82} This test asks whether the corporation is an instrumen-

\textsuperscript{73} Id. at 381. The opposite is actually true; an empirical study on veil piercing cases conducted in 1985 found that up to that point, there had been more piercing permitted for contract than tort creditors. See Thompson, supra note 7, at 1058.

\textsuperscript{74} See Barber, supra note 5, at 376-77.

\textsuperscript{75} PRESSER, supra note 18, § 1:1.

\textsuperscript{76} Id.

\textsuperscript{77} See infra note 122 for a list of factors many courts deem pertinent to the piercing analysis.

\textsuperscript{78} PRESSER, supra note 18, at § 1:3.


\textsuperscript{80} See, e.g., Fontana, 840 N.E.2d at 776; Barton, 558 N.W.2d at 749; Peschel, 75 P.3d at 796-97; Osloond, 609 N.W.2d at 122.


\textsuperscript{82} See PRESSER, supra note 18, at § 1:8. The “instrumentality” rule has been stated by Robert Clark, once Dean of the Harvard Law School, as “the corporate veil will be pierced, and the shareholders and/or the controlling parties will be subjected to personal liability for the debts of the corporation, when the corporation has served as the instrumentality or alter ego of shareholders or controlling parties.” Id.
tality or mere "alter ego" of the corporate shareholders or the corporation's parent company. If a court finds that the corporation is in fact an alter ego or instrumentality of the corporate shareholders, then the corporate veil will be pierced. These are merely a few examples of ways courts analyze cases under the piercing doctrine. There are many other variations on the "totality of the circumstances," "two-prong," and "instrumentality" tests discussed above that courts in various jurisdictions across the United States often use.

E. Undercapitalization as a Reason to Pierce

1. Undercapitalization and its Impact on Veil Piercing

Undercapitalization is generally defined as operating 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." The basic premise behind the "undercapitalization" or "inadequate capitalization" theory is that if the "shareholder or shareholders deliberately incorporate with initial capital that they know to be inadequate to meet the expected liabilities of the business they intended to be doing, they are engaging in an abuse of the corporate form, and ought to be individually liable when those liabilities actually occur." Author Henry Winthrop Ballantine provided further comment upon the duty of shareholders to adequately capitalize the corporation for its undertaking when he stated that:

83 Presser, supra note 18, § 1:8. The instrumentality rule, according to Clark, demands a showing of:

(1) control and complete domination, not only in finances but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and (2) such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of a plaintiff's legal rights; and (3) the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.

Id. (citing Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967)).

The "instrumentality" rule has also been used to hold parent corporations liable for the actions of their subsidiary corporations. See, e.g., Glenn v. Wagner, 329 S.E.2d 326, 330 (N.C. 1985) (stating that "a corporation which exercises actual control over another, operating the latter as a mere instrumentality or tool, is liable for the torts of the corporation thus controlled. In such instances, the separate identities of parent and subsidiary or affiliated corporations may be disregarded.").

84 See Presser, supra note 18, § 1:8.
85 See generally Fletcher, supra note 20, at 617-635.
86 Harvey Gelb, Piercing the Corporate Veil - The Undercapitalization Factor, 59 CHI.-KENT L. REV. 1, 3 (1982).
87 Presser, supra note 18, § 1:9.
[it] is coming to be recognized as the policy of the law that shareholders should in good faith put at risk of the business unincumbered [sic] capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risk of loss, this is a ground for denying the separate entity privilege. 88

Even with this strong language from various commentators concerning capitalization and veil piercing, there have been no recent cases in which a court has deemed undercapitalization as per se triggering the piercing of the corporate veil. 89 Courts generally recognize that undercapitalization alone will not allow the veil to be pierced. 90 Most jurisdictions demand that something more, such as the disregard of corporate formalities, be present to lead to the subjection of the shareholders of liability for the debts of the corporation, and merely list undercapitalization as one factor in the piercing analysis. 91

2. When and How Courts Measure Capitalization Levels

Capitalization is normally measured at the time of the formation of the corporation. 92 A corporation is not considered undercapitalized if it has adequate capitalization when formed, but later suffers financial reverses that result in undercapitalization. 93 However, if a company is adequately capitalized at its inception for its forecasted purpose, but later greatly expands the nature of its undertaking without acquiring additional “risk capital” from its shareholders, it may be deemed by the court to be “undercapitalized.” 94 Because of this, depending upon the circumstances, courts will often look at the level of capitalization between the corporation’s inception and the date of the alleged wrong or injustice. 95

There are several methods that courts use to measure undercapitalization. 96 Normally courts compare the capitalization level of the defendant corporation with the standard level of capitalization in the corporation’s respective industry based upon debt/equity ratios or other standard industry-wide measures

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88 Henry Winthrop Ballantine, Ballantine on Corporations 303 (Callaghan & Co. 1946).
89 See Presser, supra note 18, § 1:9.
90 See Carlesmo v. Schwebel, 197 P.2d 167, 174 (Cal. App. 1948) (stating that both undercapitalization and injustice to the creditor must be shown in order to pierce).
92 Fletcher, supra note 20, at 652.
93 Id.
94 Id. at 653. See also J-R Grain Co. v. FAC, Inc., 627 F.2d 129 (8th Cir. 1980).
95 Fletcher, supra note 20, at 652-53.
of capitalization. Undercapitalization is usually grouped under the “fairness” category of factors in the analysis because if a corporation is knowingly capitalized at a level that is insufficient to meet the liabilities of the corporation, it is inequitable to allow the shareholders to escape personal liability for the corporate debts. Capitalization levels are particularly pertinent in cases dealing with close corporations because undercapitalization is more likely to occur in close corporations than publicly-traded corporations that have raised capital through selling shares to the general public.

IV. PIERCING THE CORPORATE VEIL UNDER A CONTRACT CLAIM IN WEST VIRGINIA

West Virginia, like all other states, has a provision limiting the liability of shareholders for the debts of the corporation in which they have invested. This statute reads in pertinent part: “unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he or she may become personally liable by reason of his or her own acts or conduct.”

Under West Virginia law, there is a presumption that corporations, even those that are closely held, “are separate from their shareholders” and that “a corporate shareholder’s liability is usually limited to his or her capital investment in the corporation, and the shareholder is normally not individually liable to a creditor of the corporation.” However, West Virginia courts do recognize the concept of corporate veil piercing when the corporate form is “urged with an intent not within [the corporate form’s] reason and purpose, and in such a way that its retention would promote injustices or inequitable consequences.”

While piercing is recognized in West Virginia, there have been relatively few cases in the state under the piercing doctrine.

West Virginia does make a distinction, like many states, between corporate veil piercing in contract and tort contexts. However, the West Virginia Supreme Court has changed its view over the years on what circumstances must

97 See Barber, supra note 5, at 392-94.
98 FLETCHER, supra note 20, at 648.
99 Id. at 651-52.
100 See generally id. at 12-13.
104 PRESSER, supra note 18, at § 2:23. See also Thompson, supra note 7, at 1049. The Thompson study, conducted in 1985, found that there had been only seven piercing cases to come before the West Virginia Supreme Court of Appeals up to that point. Id. A Westlaw search similar to the search conducted by Thompson was conducted by the Author in late 2006. This search identified sixteen piercing cases as having come before the West Virginia Supreme Court of Appeals.
be present in order for the corporate veil to be pierced under a contract claim.\textsuperscript{106} Earlier cases under the piercing doctrine in West Virginia placed the state in line with jurisdictions that were more hesitant to pierce the corporate veil.\textsuperscript{107} As late as 1984, the West Virginia Supreme Court seemed to suggest a more cautious approach to piercing.\textsuperscript{108}

Later cases decided by the West Virginia Supreme Court and the Fourth Circuit Court of Appeals have placed West Virginia in line with jurisdictions that take a more “freewheeling approach” to veil piercing by “unsophisticated” contract creditors, particularly when “gross undercapitalization” of the corporation is involved.\textsuperscript{109} At the same time, these cases mandated a much higher burden for sophisticated contract creditors wishing to pierce.\textsuperscript{110} One of the latest piercing cases in West Virginia under a contract claim has moved the state once again to a more restrictive view of piercing for all contract creditors, while providing these creditors the ability to pierce in narrow circumstances; if the creditor could prove some sort of tortious activity by the corporate shareholders.\textsuperscript{111}

There are several key cases that lay out the basics of the piercing doctrine in West Virginia under claims by contract creditors. These cases show how the piercing doctrine under West Virginia law has changed over the past several decades. The most significant cases under the piercing doctrine in West Virginia in terms of defining the general test that contract creditors of the corporation must meet to pierce the corporate veil are \textit{Laya v. Erin Homes, Inc.,}\textsuperscript{112} \textit{Kinney Shoe Corp. v. Polan,}\textsuperscript{113} and \textit{Mills v. USA Mobile Communications, Inc.}.\textsuperscript{114}

\textbf{A. Laya v. Erin Homes, Inc.}

1. Factual History and the West Virginia Supreme Court’s Reasoning

The seminal case in West Virginia for the corporate veil piercing concept in a contract context is \textit{Laya v. Erin Homes, Inc.}.\textsuperscript{115} In Laya, a couple con-
tracted with Erin Homes, a company incorporated in West Virginia for the purpose of manufacturing mobile homes, to purchase a mobile home.\textsuperscript{116} When Erin Homes allegedly breached the contract between the parties, the Layas sued the corporation, as well as Michael Ferns, the owner of the corporation, individually under a piercing theory.\textsuperscript{117} The trial court dismissed Michael Ferns individually due to an absence of evidence of fraud and an absence of a complete disregard of the corporate formalities.\textsuperscript{118}

On appeal, the West Virginia Supreme Court of Appeals began its piercing analysis by quoting the definition of corporate veil piercing laid out previously in \textit{Sanders v. Roselawn Memorial Gardens, Inc.}:\textsuperscript{119}

\begin{quote}
[w]hile legally speaking, a corporation constitutes an entity separate and apart from the persons who own it, such is a fiction of the law introduced for purpose of convenience and to subserve the ends of justice; and it is now well settled, as a general principle, that the fiction should be disregarded when it is urged with an intent not within its reason and purpose, and in such a way that its retention would produce injustices or inequitable consequences.\textsuperscript{120}
\end{quote}

Like many courts, the West Virginia Supreme Court of Appeals stated that veil piercing cases are \textit{sui generis} and that each case must be examined on an ad hoc basis, with a case-by-case analysis based upon specific factual details.\textsuperscript{121} The \textit{Laya} court then listed nineteen factors that various other jurisdictions have used in their piercing analyses under the “totality of the circumstances” test.\textsuperscript{122} The court then, without analyzing any of the factors it previ-

\begin{enumerate}
\item \textit{Id.} at 96.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{159 S.E.2d 784 (W. Va. 1968)}. \textit{Sanders} was one of the first piercing cases to come before the West Virginia Supreme Court of Appeals.
\item \textit{Laya}, 352 S.E.2d at 97-98 (quoting \textit{Sanders}, 159 S.E.2d 784 at Syl. Pt. 10).
\item \textit{Id.} at 98 (citing \textit{S. Elec. Supply Co. v. Raleigh County Nat'l Bank}, 320 S.E.2d 515 (1984)).
\item \textit{Id.} at 98-99. The nineteen factors the West Virginia Supreme Court deemed important were:

(1) commingling of funds and other assets of the corporation with those of the individual shareholders; (2) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholders); (3) failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors; (4) an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation; (5) failure to maintain corporate minutes or adequate corporate records; (6) identical equitable ownership in two entities; (7) identity of the directors and officers of two entities who are responsible for supervision and management (a partnership or sole proprietor-
ously listed, "switched judicial gears" and laid out the usual two-prong test that many courts use in their piercing analysis under a contract claim:123

(1) there must be such unity of interest and ownership that the separate personalities of the corporation and of the individual shareholder(s) no longer exist (a disregard of formalities requirement) and (2) an inequitable result would occur if the acts are treated as those of the corporation alone (a fairness requirement).124

The court, in dicta,125 also recognized the outer limits of the piercing doctrine under a contract claim, at least when some types of sophisticated commercial entities are involved. This third prong was laid out by the court as follows:

[T]here may also be a third prong to the test for piercing the corporate veil which must be hurdled by certain types, and only

ship and a corporation owned and managed by the same parties); (8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking; (9) absence of separately held corporate assets; (10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation; (11) sole ownership of all the stock by one individual or members of a single family; (12) use of the same office or business location by the corporation and its individual shareholder(s); (13) employment of the same employees or attorney by the corporation and its shareholder(s); (14) concealment or misrepresentation of the identity of the ownership, management or financial interests in the corporation, and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security); (15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities; (16) use of a corporate entity as a conduit to procure labor, services or merchandise for another person or entity; (17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another; (18) contracting by the corporation with another person with the intent to avoid the risk of nonperformance by use of the corporate entity; or the use of a corporation as a subterfuge for illegal transactions; (19) the formation and use of the corporation to assume the existing liabilities of another person or entity.

Id.123 PRESSER, supra note 18, § 2:53.

Laya, 352 S.E.2d at 99.124

This language in Laya is dicta because the Layas were not deemed by the Court to be "sophisticated commercial entities." This is presumably because they were individual consumers and did not have the financial means to conduct a credit check, nor the bargaining power to demand contractual terms consistent with the risk associated with the corporation's level of capitalization before contracting to purchase a mobile home.
certain types, of contract creditors of the corporation, specifically, those capable of protecting themselves. When, under the circumstances, it would be reasonable for that particular type of a party entering into the contract with the corporation, for example, a bank or other lending institution, to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged with the knowledge that a reasonable credit investigation would disclose. If such an investigation would disclose that the corporation is grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil.\footnote{Id. at 100 (emphasis added).}

After citing \textit{Iron City},\footnote{\textit{Iron City Sand & Gravel Div. of McDonough County v. W. Fork Towing Corp.}, 298 F.Supp. 1091, 1099 (N.D. W. Va. 1969), rev'd on other grounds, 440 F.2d 958 (4th Cir. 1971).} a piercing case under a contract claim decided by the United States District Court for the Northern District of West Virginia, for the presumption that most parties assume an adequate level of capitalization,\footnote{\textit{Laya}, 352 S.E.2d at 100.} the court, noting that capitalization levels would most often occur in cases dealing with close corporations, defined “grossly inadequate capitalization.”\footnote{Id. at 101.} The court stated that “grossly inadequate capitalization” was a “substantial deficiency of capital compared with that level of capitalization deemed adequate in the case by financial analyst experts.”\footnote{Id.} These experts, according to the court, could rely on various methods to compute the capital level of the business at issue in relation to similar businesses.\footnote{See id.} Some methods suggested by the court were “current ratio, acid-test ratio, [and] debt/equity ratio.”\footnote{Id.} The comparison of these industry averages to the corporation at issue could be, according to the court, “buttressed by expert testimony from certified public accountants, securities analysts, investment counselors or other qualified financial analysts.”\footnote{Id.}

The West Virginia Supreme Court stated that under West Virginia law, the fact that a corporation’s capitalization level is grossly inadequate along with the disregard of corporate formalities causing unfairness is “sufficient to pierce the corporate veil in order to hold the shareholders . . . personally liable,”\footnote{Id. at 103.} and
that the fact-based nature of the piercing analysis made these cases rarely, if ever, proper for summary judgment.135 Noting this, the court reversed the trial court’s grant of summary judgment on the issue of shareholder liability and remanded the case for further factual development.136

2. The Significance of Laya

The West Virginia Supreme Court’s holding in Laya showed a movement toward a greater willingness to pierce, at least when dealing with undercapitalized corporations. The Court recognized, though, that undercapitalization alone would not be enough to pierce the corporate veil: “it is clear that grossly inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil.”137

The most significant aspect of Laya is the third prong commented upon in dicta by the Court.138 While an addition to the traditional two-prong test summarizing the “totality of the circumstances” approach, the third prong places a significant amount of weight on the corporation’s level of capitalization. In the third prong of the test developed in Laya,139 the West Virginia Supreme Court stated that some sophisticated contract creditors would be charged with the knowledge of the corporation’s capitalization level at the time just before the contractual obligation was incurred.140 This places West Virginia in the narrow group of jurisdictions that measure capitalization levels at a time other than the date of incorporation.141

As noted earlier, most courts list undercapitalization as just one of the factors used in the piercing analysis.142 In Laya’s third prong, the West Virginia Supreme Court stated that gross undercapitalization, if present before contracting, would prevent the sophisticated entity with the ability to conduct a credit check from piercing.143 Such a bright-line rule concerning capitalization is quite a departure from the traditional “totality of the circumstances” approach that many jurisdictions use under their piercing analyses.144 This bright-line rule is appropriate because of the timing of the credit check that some creditors are charged with conducting under West Virginia law.

135 Id.
136 Id.
137 Id. at 101 (emphasis added).
138 See id. at 100.
139 Id.
140 Id.
141 See PRESSER, supra note 18, § 2:54.
142 See id. § 1:9.
144 See Barber, supra note 5, at 374-75.
In jurisdictions where capitalization is measured back at the date of incorporation, the alleged wrong may be many months or years after the date on which the level of capitalization is measured. The further removed the alleged injustice is from the date that capitalization is measured, the less significance this factor would have on the analysis because of the other factors that could arise between the date of incorporation and the alleged wrong. The amount of capital a company has immediately before contracting has a greater bearing on its ability to pay its obligations than the amount of capital with which the corporation was formed. Also, the inability of the corporation to fulfill its contractual obligations (i.e. failure to pay for goods/services) would be the only justification for bringing a purely contractual claim to pierce. Because of this, the extreme importance the *Laya* court placed on capitalization is proper.

Through its comments on the third prong, the court did recognize some limits to the piercing doctrine under a contract claim. The court, with its addition to the normal two-prong test, "appeared to take a cautious step backwards in the direction of remembering that there were some valid constraints on discretion to pierce the veil, particularly in contract actions." The addition of this other prong put West Virginia in line with many jurisdictions that mandate a higher burden for contract creditors than tort creditors under the piercing doctrine. However at the same time, this prong raises the importance of capitalization under the piercing doctrine in West Virginia, at least for sophisticated commercial entities, to a level much higher than in other jurisdictions.

The West Virginia Supreme Court, while discussing the third prong, recognized that under some circumstances certain sophisticated commercial entities will not be permitted to pierce the corporate veil. However, the court's comments on this third prong leave many questions regarding when and how it should be applied. The court did not lay out any clear guidelines under which courts could deem that an entity had assumed the risk of undercapitalization nor did it give any clear definition of a "sophisticated commercial entity" save for the example of a corporate lender.

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145 See *Fletcher*, *supra* note 20, at 652.
146 See *Laya*, 352 S.E.2d at 100.
147 *Presser*, *supra* note 18, § 2:53.
149 Compare *Laya*, 352 S.E.2d at 100 (if undercapitalization present, and the sophisticated entity was in a position to know about it, is the entity is precluded from piercing), with *Riddle v. Simmons*, 922 So.2d 1267, 1279-1280 (La. Ct. App. 2006) (undercapitalization, whether known by the creditor or not, just one of the factors used in the analysis).
150 *Laya*, 352 S.E.2d at 100.
B. Kinney Shoe Corp. v. Polan: A Misapplication of the Laya Test?

1. Factual Summary and the Fourth Circuit’s Ruling

A few years after Laya, the United States Court of Appeals for the Fourth Circuit, in Kinney Shoe, had the opportunity to expound upon the “sophisticated commercial entity prong” that was first laid out in Laya. In this case, the Fourth Circuit, without deciding whether the prong should be extended beyond “the context of the financial institutional lender mentioned in Laya,” allowed a sophisticated commercial entity to pierce the corporate veil in a contract claim by reasoning that Laya’s third prong was merely permissive and should not be used when its application would not lead to an equitable result.

In this case, Kinney Shoe, a New York corporation that was a subsidiary of the F.W. Woolworth Corporation, contracted with Industrial Realty Company, a West Virginia corporation owned by Lincoln Polan, for the sublease of a building leased by Kinney Shoe Corporation. At the time of the sublease agreement, Industrial Realty Company had “no assets, no income and no bank account.” Industrial then leased part of the building to Polan Industries, Inc., another company owned by Polan. After one month, Industrial stopped paying rent on the sublease to Kinney Shoe thereby breaching the lease agreement. Kinney Shoe filed suit against Industrial and obtained a judgment in excess of $160,000. Industrial subsequently filed bankruptcy and Kinney Shoe filed suit in the United States District Court for the Southern District of West Virginia against Lincoln Polan, Industrial’s owner, for the corporation’s debts under a piercing theory.

The district court found that the first two prongs of the Laya test had been satisfied because there was such a unity of interest between Lincoln Polan and Industrial that the corporation had no separate existence (the disregard of formalities requirement), and an equitable result would not occur if the actions of Industrial were solely attributed to the company (the fairness requirement). The fact that Industrial’s capitalization level was grossly inadequate and that

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152 Id. at 212-13.
153 Id. at 213.
154 See Kathleen McDermott, Retail Revolutionary: Kinney Shoe Corporation’s First Century in Footwear 74 (Winthrop Group 1994).
155 Kinney Shoe, 939 F.2d at 210.
156 Id.
157 Id. at 209-10.
158 Id. at 209.
159 Id. at 210.
160 Id.
161 Id. at 212.
Polan had failed to carry out the corporate formalities aided the court in the conclusion that Laya’s first two prongs had been met.\textsuperscript{162} However, the District Court, after applying Laya’s third “sophisticated commercial entity prong,” ruled that Kinney Shoe could not pierce the corporate veil because it “‘assumed the risk of Industrial’s defaulting’ and that ‘the application of the doctrine of ‘piercing the corporate veil’ ought not and does not [apply].’”\textsuperscript{163}

The plaintiff appealed to the United States Court of Appeals for the Fourth Circuit.\textsuperscript{164} The Fourth Circuit reversed the district court’s ruling, stating that the lower court improperly applied Laya’s third prong.\textsuperscript{165} The Fourth Circuit held that the district court had correctly found that the first prong of Laya (the disregard of formalities requirement) had been met because Polan “kept no minutes, and elected no officers for Industrial.”\textsuperscript{166} The court also held that the district court correctly found that the second prong of Laya (an equitable result, or fairness requirement) had likewise been met because:

Polan gave no explanation or justification for the existence of Industrial as the intermediary between Polan Industries, Inc. and Kinney. Polan was obviously trying to limit his liability and the liability of Polan Industries, Inc. by setting up a paper curtain constructed of nothing more than Industrial’s certificate of incorporation.\textsuperscript{167}

The court further concluded that the third prong of Laya was permissive and not mandatory because the use of the third prong in the case would lead to an inequitable result.\textsuperscript{168} According to the Fourth Circuit, “Polan set up Industrial to limit his liability and the liability of Polan Industries, Inc. in their dealings with Kinney... [t]his corporation was no more than a shell - a transparent shell.”\textsuperscript{169} The court, again focusing on the defendant’s lack of adherence to any semblance of corporate formalities and his failure to invest any capital into the “shell company,” stated that “this is not a factual situation that calls for the third prong, if we are to seek an equitable result.”\textsuperscript{170}

The court stated that the normal rule of limiting shareholder liability in the corporation to the amount invested did not apply in this instance because “[w]hen nothing is invested in the corporation, the corporation provides no pro-

\textsuperscript{162} Id.
\textsuperscript{163} Id. (quoting the district court).
\textsuperscript{164} Id. at 211.
\textsuperscript{165} Id.
\textsuperscript{166} Id. at 212.
\textsuperscript{167} Id.
\textsuperscript{168} Id. at 213.
\textsuperscript{169} Id.
\textsuperscript{170} Id.
tection to its owner; nothing in, nothing out, no protection. If Polan wishes the protection of a corporation to limit his liability, he must follow the simple formalities of the corporation." The Fourth Circuit then explicitly left the bounds of Laya’s third prong in doubt, stating that “[w]ithout deciding whether the third prong should be extended beyond the context of the financial institution lender mentioned in Laya, we hold that, even if it applies to creditors such as Kinney, it does not prevent Kinney from piercing the corporate veil in this case.” The Fourth Circuit held Polan personally liable for the debts of Industrial and remanded with instruction to enter judgment for the plaintiff.

2. Analysis of Kinney Shoe

The Fourth Circuit, in its holding, effectively collapsed Laya’s three-prong test for sophisticated contract creditors into two prongs. The district court found that the first two prongs of the Laya test had been met because Polan did not run the business as a separate entity (the disregard of formalities requirement) and the corporation had no capital and was set up solely to limit the liability of Polan and Polan Industries, Inc. (the fairness or equity requirement). As previously noted, the Fourth Circuit held that the district court correctly found that the first two prongs had been satisfied. However, the Fourth Circuit stated that since Polan had invested nothing into the corporation and had set it up solely to be a “paper curtain” in order to limit his personal liability, he would be offered no limited liability under Laya’s third prong because allowing that would lead to an inequitable result. The court offers the same justifications for stating that the third prong should not apply as it did in finding that the first two prongs had been met. Under the Fourth Circuit’s analysis of the third prong, focusing on the fairness of the situation and Polan’s failure to adhere to the requirements of the corporate form; (such as adequately capitalizing the corporation), any instance in which the first two prongs will be met would also exclude the use of the third prong. Under the Fourth Circuit’s reasoning, it seems difficult to imagine a situation in which any creditor, even a sophisticated commercial entity like the commercial lender commented upon in Laya, would be denied the ability to pierce the corporate veil.

In Laya, the West Virginia Supreme Court of Appeals stated that the limitation of liability shareholders enjoy is one of the chief facets of the corpo-
rate entity, and that "courts have been reluctant to pierce the corporate veil, even when the express purpose of incorporation was to limit the liability of the incorporators. Indeed courts of every jurisdiction have recognized the legitimacy of incorporating to avoid personal liability."\(^{179}\) One of the major facets of the corporate form is the limitation of liability that it offers its shareholders, and any time a contract creditor goes unpaid, the result will be inequitable to the creditor. This result is one of the consequences of contracting with a corporation, which, by definition, limits the liability of its shareholders.

Also, the Fourth Circuit simply stated that because Polan invested nothing into Industrial he would not be able to limit his liability in the case.\(^{180}\) This statement leaves many questions unanswered. How much capital would Polan have needed to invest in the corporation to permit the application of the third prong? What if Polan had invested one dollar, or one hundred dollars, into the corporation, would the prong have been applied? The Fourth Circuit offered no assistance in this area.

Furthermore, the fact that Industrial had "no assets, no income and no bank account"\(^{181}\) makes the argument in favor of holding Kinney Shoe to Laya's third prong in this case even stronger. The Fourth Circuit stated that "[w]ithout deciding whether the third prong should be extended beyond the context of the financial institution lender mentioned in Laya, we hold that, even if it applies to creditors such as Kinney, it does not prevent Kinney from piercing the corporate veil in this case."\(^{182}\) The court made this assertion without offering any justification as to why it made the distinction between the corporate lender example in Laya's third prong and the equally sophisticated corporate plaintiff in the case.\(^{183}\)

Here, any type of "investigation of the credit of the corporation prior to entering into the contract" as stated in Laya's third prong,\(^{184}\) would have given Kinney Shoe notice that the corporation with which it was contracting had no assets whatsoever. This was not an instance in which Industrial had capital which ultimately was inadequate to meet its contractual obligations, or a situation in which Industrial had adequate capital that was later withdrawn by Polan. Even the most cursory investigation by Kinney Shoe, a corporation that, by all accounts, was every bit as sophisticated as the corporate lender example in Laya, would have put Kinney Shoe on notice that Industrial had no assets with


\(^{181}\) Id. at 210.

\(^{182}\) Id. at 212-13.

\(^{183}\) PRESSER, supra note 18, § 2:53 n.28. Kinney Shoe was quite a large business entity. In the 1970s Kinney Shoe became the parent corporation of Foot Locker, Inc. See MCDERMOTT, supra note 154, at 74. In 1994, just three years after the Fourth Circuit case, Kinney Shoe contributed, mainly through its Footlocker shoe stores, $3.5 billion in sales and sixty percent of the profits of the entire Woolworth organization. See id. at 105.

\(^{184}\) 352 S.E.2d at 100.
which to meet its contractual obligations. In this instance, as stated in Laya, "such an investigation would [have] disclose[d] that the corporation [was] grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking."

Accordingly, under Laya's third prong, the party should have been deemed to have assumed the risk of the gross undercapitalization and should not have been permitted to pierce the corporate veil.

C. Mills v. USA Mobile Communications, Inc.: Comments on the Tort/Contract Distinction

1. Factual History and the Court's Comments on the Distinction

A few years later, the West Virginia Supreme Court of Appeals heard another case involving veil piercing by a contract creditor. In Mills, an individual owned a corporation that he later sold to USA Mobile Communications, Inc. The plaintiff alleged that shareholders of the purchasing corporation promised him a long-term employment contract to work for the purchasing corporation after the sale. Relying upon this assertion, he quit his job of seventeen years and began working for the corporation. Less than one year later, he was fired and summarily filed suit against the corporation and its individual shareholders for wrongful termination. The circuit court found only the corporation liable.

Fearing that the corporation would not have adequate capital from which to satisfy the judgment, the plaintiff appealed to hold the shareholders personally liable for the judgment under a piercing theory.

The West Virginia Supreme Court of Appeals, citing various authorities, elaborated on the distinction between piercing in the tort versus the contract context. The court noted that "[b]ecause a contract with a corporation is a contract with that legal entity and not the individual stockholders, courts are even more reluctant to disregard the corporate entity when the dispute involves a contract as opposed to a tort." The court also elaborated on instances in which contract creditors may pierce the corporate veil. Citing the Mississippi Supreme Court, the West Virginia Supreme Court of Appeals stated that corporate
creditors must demonstrate: "(a) some frustration of contractual expectations regarding the party to whom he looked for performance; (b) the flagrant disregard of corporate formalities by the defendant corporation and its principals; (c) a demonstration of fraud or other equivalent misfeasance on the part of the corporate shareholder." The Court, however, did not give any indication as to what type of misfeasance would be equivalent to fraud except to state that the corporate shareholder’s “inflated promises” of long-term employment did not meet that level. Noting this, the West Virginia Supreme Court of Appeals affirmed the lower court’s judgment against only the corporation.

2. Analysis of Mills

In this case, the West Virginia Supreme Court of Appeals shifted somewhat back to a stricter standard for all contract creditors. This stance moved West Virginia more in line with various jurisdictions cited by the West Virginia Supreme Court of Appeals in Laya that mandate a much higher burden for contract creditors, even individual creditors, seeking to pierce the corporate veil. The court’s reasoning, however, was still in line with West Virginia’s traditional two-prong test for contract creditors in Laya. The “frustration of contractual expectations” prong under Mississippi law, cited by the West Virginia Supreme Court of Appeals, is analogous to the second, “fairness prong” in Laya, and the “disregard of corporate formalities” prong is essentially the same as Laya’s first prong.

The Mills case moved West Virginia in line with jurisdictions that make a strong distinction between veil piercing under tort and contract claims. The court also recognized some instances in which contract creditors would be able to pierce the corporate veil absent an initial financial investigation. The third prong cited by the court allows contract creditors the ability to pierce if they can demonstrate “fraud or other equivalent misfeasance on the part of the corporate shareholder.” This third “fraud or equivalent misfeasance” prong expressed by the court is far from a new concept. In fact, many jurisdictions have permitted the piercing of the corporate veil by contract creditors for this reason.

196 Mills, 438 S.E.2d at 5 (citing Gray, 541 So.2d at 1047).
197 Id.
198 Id.
201 See, e.g., Menetti v. Chavers, 974 S.W.2d 168, 174 (Tex. 1998).
202 Mills, 438 S.E.2d at 5.
203 Id.
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The “fraud or equivalent misfeasance” prong of Mills, while hardly a novel invention, is worth focusing on because it helps to define the limits of the Laya decision. This prong, while applicable to the contract creditor, would actually mandate that the contract creditor prove tortious activity, either in the form of fraud, or some activity on that level on the part of the corporate shareholders. This prong, in essence, mandates that the contract creditor also be a tort creditor in order to recover damages from the corporate shareholders.\(^\text{205}\) Once this happens, the claim moves from contract to tort and out of the realm of the holdings of Laya and Kinney Shoe, which dealt with purely contractual claims for piercing.\(^\text{206}\)

This case moved West Virginia law beyond the dicta in Laya concerning sophisticated contract creditors. Mills permits sophisticated contract creditors that would normally be precluded from piercing under Laya the opportunity to pierce if they can show tortious activity such as fraud or equivalent misfeasance by the shareholders.\(^\text{207}\) This is because all sophisticated commercial entities, even the financial lender cited in Laya, must have accurate information concerning the corporation’s finances upon which to base its decision to contract with the defendant corporation.\(^\text{208}\)

D. The Current State of Piercing Under a Contract Claim in West Virginia

Currently, the corporate veil may be pierced under a purely contractual claim in West Virginia when there is a unity of interests between the corporation and the shareholders, an inequitable result would occur if the corporate fiction was adhered to.\(^\text{209}\) Also, depending upon the circumstances, some sophisticated commercial entities, such as financial lending institutions that are able to conduct a credit check before contracting with the corporation, will be deemed to have assumed the risk of undercapitalization and will not be permitted to pierce the corporate veil.\(^\text{210}\) However, the courts have left open which entities will be deemed sophisticated enough to warrant the application of Laya’s third prong, and under what circumstances the sophisticated commercial entity would be charged with the assumption of the risk of undercapitalization.

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\(^{205}\) See Presser, supra note 18, § 1:10.


\(^{207}\) Mills, 438 S.E.2d at 5.


\(^{209}\) See Laya, 352 S.E.2d 100.

\(^{210}\) Id.
V. THE EXTENSION OF LAYA TO ALL SOPHISTICATED COMMERCIAL ENTITIES

All sophisticated commercial entities, not just commercial lenders, are able to protect themselves through evaluating and allocating the risk associated with the corporation's capitalization level during pre-contractual negotiations. Accordingly, the extension of Laya's third prong to all sophisticated commercial entities is appropriate. Under West Virginia law, all contract creditors that are deemed by the court to be "sophisticated commercial entities," should not be permitted to pierce the corporate veil under a purely contractual claim.  

A. Foreign Jurisdictions Prohibiting Certain Creditors from Piercing Under a Contract Claim

There are already several jurisdictions that have denied many types of contract creditors the ability to pierce the corporate veil in addition to the sophisticated commercial lender cited in Laya. In one such case, the United States District Court for the Northern District of Maine held that a group of labor unions could not pierce the corporate veil because the unions had the ability to protect themselves in the bargaining process. The court stated that: "[c]ontracts are private, consensual relationships in which each party has a clear and equal obligation to weigh the potential benefits and risks of the agreement," and that unless some tortious activity is involved, "there can be little justification for disregarding corporate entities which the parties obviously expected to remain intact." The Supreme Court of Washington denied a contract creditor's attempt to pierce the corporate veil under similar reasoning. The contract creditor, an individual who had sold eggs to the defendant chicken hatchery, filed suit under a piercing theory against the corporation's shareholders for the debts owed by the then bankrupt hatchery. The court stated that the corporate creditor could not pierce the veil since the plaintiff "made no attempt whatever to obtain any

211 See supra note 18, defining a "purely contractual claim."
213 Laya, 352 S.E.2d at 100.
215 Id.
216 Id. at 618.
217 Id.
218 Critzer, 326 P.2d 53.
219 Id. at 54-55.
information regarding the financial status of the corporation... before commencing to sell eggs to it.\textsuperscript{220}

In another case, \textit{Hanson v. Bradley},\textsuperscript{221} the Supreme Judicial Court of Massachusetts denied an individual contract creditor's attempt to pierce the corporate veil because he had adequate knowledge of the corporation's lack of capital before contracting.\textsuperscript{222} The Supreme Court of Massachusetts did not allow the veil to be pierced because, according to the Court:

\begin{quote}
[\text{t}he\ right\ and\ the\ duty\ of\ courts\ to\ look\ beyond\ the\ corporate\ forms\ are\ exercised\ only\ for\ the\ defeat\ of\ fraud\ or\ wrong,\ or\ the\ remedying\ of\ injustice.\ In\ the\ present\ case\ we\ have\ a\ corporation\ formed\ without\ substantial\ capital,\ relying\ on\ borrowing\ money\ to\ make\ valuable\ a\ hotel\ that\ it\ was\ buying\ on\ credit. The\ plaintiff\ dealt\ with\ the\ corporation. There\ is\ nothing\ to\ show\ that\ he\ was\ deceived. The\ fair\ inference\ is\ that\ he\ knew\ the\ worthlessness\ of\ the\ corporation\ with\ which\ he\ contracted, and\ he\ knew\ that\ his\ contract\ was\ of\ no\ value\ unless\ the\ corporation\ could\ borrow\ money.}\textsuperscript{223}
\end{quote}

The court did not deem the individual plaintiff to be a "sophisticated" contract creditor.\textsuperscript{224} It focused instead on the plaintiff's knowledge or access to pertinent information, because of his unique position as an employee of the company, regarding the company's capitalization level.\textsuperscript{225} While the employee in \textit{Hanson} was not a sophisticated commercial entity within the meaning of \textit{Laya}, he did possess the main factor that precludes sophisticated commercial entities from piercing under contract claims in many jurisdictions: access to information concerning the corporation's capitalization level.

These cases, while dealing with piercing attempts by entities and individuals other than the commercial lender example in \textit{Laya}, and in many different circumstances, all arrive at the same conclusion: the access to information concerning the defendant corporation's capitalization level should preclude an entity that contracts with the corporation from later attempting to pierce the veil because the entity knew, or should have known, that the corporation did not have adequate capital with which to meet its obligations.\textsuperscript{226}

\begin{footnotesize}
\begin{enumerate}
\item Id. at 57.
\item Id. at 259 (Mass. 1937).
\item Id. at 264.
\item Id. (emphasis added).
\item See generally Hanson, 10 N.E.2d 259.
\item See id. at 264.
\item See id.; Critzer v. Oban, 326 P.2d 53 (Wash. 1958); see also Laya v. Erin Homes, Inc., 352 S.E.2d 93, 100 (W. Va. 1986).
\end{enumerate}
\end{footnotesize}
These jurisdictions all proffer the same policy behind the piercing doctrine as West Virginia courts: the remedying of injustice to the contract creditor.\textsuperscript{227} Several of these jurisdictions' "third prongs" have a very wide reach.\textsuperscript{228} Courts in Massachusetts and Washington have denied individual contract creditors the ability to pierce the corporate veil because these individuals could have determined the capitalization level of the defendant corporation before contracting.\textsuperscript{229} In contrast, West Virginia limits its third prong to "certain types . . . of contract creditors of the corporation."\textsuperscript{230}

If certain individual contract creditors can be charged with the knowledge that a pre-contractual capitalization investigation would disclose, certainly any sophisticated commercial entity with many more resources at its disposal than an individual, has the ability to conduct a similar investigation. In fact, these entities have something much more valuable than the mere ability to access information. These entities, because of their "sophistication," have the ability to bargain on this information for more favorable contract terms and allocate the risk associated with the corporation's capitalization level accordingly. Most individual contract creditors, like those whose attempts to pierce were denied by courts in Massachusetts and Washington,\textsuperscript{231} normally do not have the ability to bargain with the defendant corporation for better terms.\textsuperscript{232} These individuals usually must either accept the risk of undercapitalization or pass on the opportunity to contract with the corporation. It makes little sense to allow any sophisticated commercial entity, which has not only all the tools available to it to determine the capitalization level of the corporation, but also the bargaining power to take adequate steps to protect itself, the ability to hold the individual shareholders liable for the corporate debt if the corporation's capitalization level is ultimately found to be inadequate.

\textsuperscript{227} See United Paperworkers Int'l Union v. Penntech Papers, Inc., 439 F.Supp 610, 619 (N.D. Me. 1977) ("The corporate entity will be disregarded when used to cover fraud or illegality, or to justify a wrong."); \textit{Hanson}, 10 N.E.2d at 264 ("The right and the duty of courts to look beyond the corporate forms are exercised only for the defeat of fraud or wrong, or the remedying of injustice."); \textit{Critzer}, 326 P.2d 53, 57 (stating that one instance in which the veil will be pierced is when there is "such a confusion of identities and acts [between the corporation and its shareholders] as to work a fraud upon third persons").

\textsuperscript{228} See \textit{Hanson}, 10 N.E.2d 259; \textit{Critzer}, 326 P.2d 53.

\textsuperscript{229} \textit{Id.}

\textsuperscript{230} \textit{Laya}, 352 S.E.2d at 100.

\textsuperscript{231} See generally \textit{Hanson}, 10 N.E.2d 259; \textit{Critzer}, 326 P.2d 53.

\textsuperscript{232} This not to say that all individuals would not have the bargaining power to demand contractual terms consistent with the corporation's capitalization level. Consider an individual such as Donald Trump. While an individual creditor, Donald Trump would have all of the same protections available to him as would any sophisticated commercial entity because of his financial resources. However, most individual contract creditors in the consumer context would not have the financial resources to conduct the appropriate credit check or bargain with the corporation for better terms prior to contracting. \textit{See JAMES B. HERENDEEN, THE ECONOMICS OF THE CORPORATE ECONOMY} 29 (Dunellen Pub. Co. 1975) (stating that most consumers are "price takers" and cannot bargain for better terms).
B. Defining “Sophisticated Commercial Entities”

The West Virginia Supreme Court of Appeals, unlike other jurisdictions, has limited the application of its third prong to sophisticated commercial entities. However, the West Virginia Supreme Court of Appeals has not defined a “sophisticated commercial entity” in the context of corporate veil piercing save the example of the corporate lender noted in Laya. Because the piercing doctrine in West Virginia, and in all jurisdictions for that matter, is fact-intensive, a precise “bright-line” definition of these entities would most likely be inappropriate.

There are many characteristics that courts in both West Virginia and foreign jurisdictions have deemed indicative of “sophisticated commercial entities” outside the piercing doctrine. These characteristics would be helpful for courts in West Virginia to use under the “totality of the circumstances” approach to determine if Laya’s third prong should be applied under the circumstances.

The West Virginia Supreme Court of Appeals has not definitively set out what constitutes a “sophisticated commercial entity,” but it has made several comments upon the characteristics of these entities in cases dealing with contract disputes over large-scale construction projects. Some of these characteristics include: competence in bargaining over the terms of the contract; the ability to be charged with knowledge of the laws in the state in which they are contracting; the ability to carefully, and at arm’s length, negotiate the terms of the agreement; and the opportunity to allocate economic risk through their bargaining power in negotiating the terms of contract.

Other jurisdictions have elaborated upon similar characteristics when discussing “sophisticated commercial entities.” These characteristics include: “the knowledge and ability to allocate liability in their [agreements],” bar-

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233 Laya, 352 S.E.2d at 100.
234 Id.
235 Id. See also Barber, supra note 5, at 385.
238 G.M. McCrossin, Inc., 355 S.E.2d at 37.
240 E. Steel Constructors, Inc., 549 S.E.2d at 278 (Maynard, J., dissenting).
241 MASB-SEG Prop./Cas. Pool, Inc., 586 N.W.2d at 554.
gaining power on par with the defendant corporation.\textsuperscript{242} "experience[ ] in [the] type of transaction" at issue,\textsuperscript{243} and the ability to obtain counsel in the negotiation process.\textsuperscript{244}

All of these authorities, including West Virginia, paint the same picture of the "sophisticated commercial entity": an entity that, through access to information regarding the defendant corporation's capitalization level, has the ability to competently evaluate the risks associated with contracting with the corporation and that has the opportunity to actively participate, through counsel, in the negotiation process and allocate the risks associated with the undertaking through contract negotiation. Under \textit{Laya}'s third prong, any entity that meets these criteria should be deemed a "sophisticated commercial entity" and able to "conduct an investigation of the credit of the corporation prior to entering into the contract."\textsuperscript{245} Accordingly, these entities should not be permitted to pierce the corporate veil under a purely contractual claim.

\textbf{C. The Bounds of Laya: Fraud or Equivalent Misfeasance by the Corporate Shareholders}

A contract creditor that is deemed by the court to be "sophisticated" enough to conduct a credit check before contracting with the defendant corporation under \textit{Laya} may still be able to pierce the corporate veil.\textsuperscript{246} The Fourth Circuit Court of Appeals was correct when it stated that there would be some instances in which deeming that the sophisticated commercial entity had assumed the risk of the corporation's undercapitalization would lead to an inequitable result.\textsuperscript{247} However, the instances in which the sophisticated contract creditor can pierce the corporate veil should be applied in much narrower circumstances than the Fourth Circuit suggested in \textit{Kinney Shoe}.\textsuperscript{248} The creditor should not be charged with assuming the risk of the corporation's level of capitalization only if the sophisticated contract creditor can show some sort of tortious activity by the corporate shareholders on the level of "fraud or other equivalent misfeasance" under \textit{Mills}.\textsuperscript{249} Before contracting with the corporation, the sophisticated creditor is presumed to know that he is doing business with a corporation

\textsuperscript{242} Id.

\textsuperscript{243} Purcell Tire & Rubber Co. v. Executive Beechcraft, Inc., 59 S.W.3d 505, 510-11 (Mo. 2001).

\textsuperscript{244} See Malan Realty Investors, Inc. v. Harris, 953 S.W.2d 624, 628 (Mo. 1997).

\textsuperscript{245} Laya v. Erin Homes, Inc., 352 S.E.2d 93, 100 (W. Va. 1986).

\textsuperscript{246} Id.


\textsuperscript{248} See \textit{id}.

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and it will be able to satisfy his claim. Courts often impose this burden "because limited liability is a permissible," and even encouraged, "object of incorporation." However, the "principle of limited liability does not protect the shareholder . . . whose conduct is calculated to defeat the reasonable expectations of the creditor."

In order for a sophisticated commercial entity to protect itself in the negotiation process, it must have accurate information upon which to base its decisions concerning the terms of the contractual agreement. Absent a full and fair disclosure on the part of the shareholders of the corporation concerning its level of capitalization, there can be no effective assessment and allocation of risk between the parties. Accordingly, entities that would otherwise be denied the ability to pierce under Laya should not be precluded from piercing the corporate veil if they can show fraud in the bargaining process or later misfeasance by the corporate shareholders that significantly affects the corporation's capitalization level.

Once the contract creditor alleges this type of activity by the corporate shareholders, the claim, in essence, transforms from a contract into a tort theory of piercing. This is not to say that the contract creditor would be permitted to pierce by merely alleging any type of tortious activity on the part of the corporate shareholders. The West Virginia Supreme Court of Appeals, through its language in Mills, recognized that precisely because many contract creditors are in a position to determine the capitalization level of the corporation, the creditor must allege actions on the level of fraud in the inducement or later actions that significantly affect capitalization, which are very different from other later tortious actions, such as simple negligence.

Once fraud or equivalent misfeasance is alleged, the focus is then on the tortious activity of the shareholders, rather than the breach of the contractual agreement between the parties, that gives rise to the imposition of personal liability on the shareholders. Accordingly, the application of Laya and Kinney

251 Cummins, supra note 6, at 442.
252 Id.
253 See Hamilton, supra note 208, at 987.
254 Id.
255 See Cummins, supra note 6, at 452-55 (discussing various tortious actions by the corporate shareholders, such as "fraud in the inducement," that have permitted contract creditors to pierce the corporate veil).
256 PRESSER, supra note 18, § 1:10.
258 See Walkowsky v. Carlton, 223 N.E.2d 6, 7 (N.Y. 1966). In this case, the plaintiff attempted to pierce under a tort theory (negligence) after he was hit by a cab owned by the defendant's corporation. Id.
259 See PRESSER, supra note 18, § 1:10.
Shoe (which dealt with purely contractual claims) would no longer be appropriate given the implications of the later test in Mills.\textsuperscript{260} Because such allegations move the claim into a tort theory of piercing, in light of the relatively narrow focus of this Note, an in-depth discussion of the various tortious activities on the part of the corporate shareholders rising to the level of "misfeasance" equivalent to the tort of fraud on the part of the corporate shareholders under Mills would be best left to another inquiry.

VI. \textbf{ECONOMIC AND PUBLIC POLICY JUSTIFICATIONS FOR THE EXTENSION OF \textit{LAYA}}

The Fourth Circuit Court of Appeals noted in one corporate veil piercing case 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[]."\textsuperscript{261} One commentator has stated: "contract creditors can protect themselves by bargaining with the controlling shareholder. . . . [T]o the extent contract creditors fail to do so, and accordingly fail to adequately protect their own interests, there seems little reason for the law to protect them."\textsuperscript{262} This is, in essence, one aspect of the reasoning behind extending the third prong of Laya to all sophisticated commercial entities.

The third prong expressed by the West Virginia Supreme Court of Appeals in Laya should be extended because all sophisticated entities, not just commercial lenders, have, because of their "sophistication," various means available to them to protect their interests during the negotiation process.\textsuperscript{263} These include: the ability to check the capitalization level of the corporations with which they contract, the ability to transfer the risk of the corporation defaulting back onto the corporation or its shareholders by their ability to ask for prepayment from the corporation, the ability to charge a higher price for the risk associated with the contracting corporation's level of capitalization, and the ability to obtain personal guarantees from the shareholders of the corporation with which they contract.

There are also several other economic arguments in favor of extending Laya, aside from the protections available to sophisticated commercial entities. The contract creditor is the "least cost avoider" of the contracting parties because it is in a better position to determine the risks associated with contracting than the shareholders of even a closely held corporation.\textsuperscript{264} Also, the imposition

\textsuperscript{260} 438 S.E.2d at 1.
\textsuperscript{261} Dewitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686 at n.13 (4th Cir. 1976).
\textsuperscript{262} Bainbridge, \textit{supra} note 46, at 501.
\textsuperscript{263} See Vincent M. Roche, "Bashing the Corporate Shield": The Untenable Evisceration of Freedom of Contract in the Corporate Context, 28 J. CORP. L. 289, 297-98 (2003).
\textsuperscript{264} Bainbridge, \textit{supra} note 46, at 502.
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of personal liability on shareholders of close corporations would force these individuals to incur great costs incumbent in closely monitoring the activities of other shareholders of the close corporation. Finally, allowing sophisticated contract creditors the ability to pierce would also, in essence, be permitting the creditor to receive a windfall because it could charge the corporation a higher price associated with the risk of the corporation's capitalization level, yet virtually eliminate its risk through veil piercing.

There are also two main public policy justifications for extending Laya to all sophisticated commercial entities. First, allowing sophisticated entities to pierce the veil of close corporations under a contract claim would directly violate one of the main justifications behind the rise of the limited liability corporation: permitting the access of investors of more modest means to business markets. Second, West Virginia's recognition of freedom of contract, and the West Virginia Supreme Court of Appeals' willingness to uphold contracts duly entered into, especially between sophisticated commercial entities that have the ability to protect their interests, should override any concerns West Virginia courts may have regarding injustice to sophisticated contract creditors.

A. Economic Justifications for the Extension of Laya

1. The Ability of All Sophisticated Commercial Entities to Conduct a Credit Check

Several jurisdictions have charged individual contract creditors with the knowledge of the corporation's capitalization level, and denied them the ability to pierce because of that knowledge. If an individual with far fewer resources than any sophisticated contract creditor can be charged with the knowledge that a credit check would provide, there is little reason why any sophisticated contract creditor should not be charged with this same knowledge. When most business creditors contract with corporations, the possibility of insolvency is understood and treated as just another cost associated with doing business with a limited liability corporation. This common recognition by corporate creditors of the possibility of insolvency is why limited liability corporations are required

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266 PRESSER, supra note 18, § 1:7.
to record information regarding their financial limitations and offer this information to the public.\textsuperscript{271}

The West Virginia Supreme Court has already noted the ability of corporate lenders, such as banks, to conduct a credit check before contracting with corporations.\textsuperscript{272} There is no reason why any other contract creditor that has been deemed by the court to be a "sophisticated commercial entity" cannot conduct a similar credit check of the corporation before contracting. Sophisticated commercial entities have many resources available to them and it would be much easier for them to ascertain the corporation's level of capitalization before contracting than it would be for an individual contract creditor.

2. Protections Available to Sophisticated Commercial Entities Because of Their Bargaining Power

Certain contract creditors, because of their "sophistication," have the ability to act on information concerning the corporation's level of capitalization in the negotiation process. Unlike the individual, who often has no ability to negotiate with the corporation for more favorable terms, the sophisticated commercial entity, through its access to counsel in the bargaining process and competence in negotiation, has various means available to protect itself in the negotiation process.\textsuperscript{273} These various protections act, in essence, to transfer the risk of the limited liability corporation defaulting back onto the corporation or its shareholders.\textsuperscript{274}

The sophisticated contract creditor may ask for prepayment for services rendered to the corporation.\textsuperscript{275} By demanding payment from the corporation up front, the contract creditor would all but eliminate the risk of default associated with contracting with a limited liability corporation. However, some corporations, particularly those that are closely held, may not be able to pay up front because of limited capital.

If the contract creditor has conducted a capitalization investigation and has reservations about the level of capitalization being adequate to meet the corporation's liabilities, the sophisticated contract creditor has the ability to ask the corporate shareholders for a personal guarantee.\textsuperscript{276} This guarantee would modify the "default" model of the corporation offering limited liability to the

\textsuperscript{271} Id.
\textsuperscript{272} Laya v. Erin Homes, Inc., 352 S.E.2d 93, 100 (W. Va. 1986).
\textsuperscript{273} See Herendeen, supra note 232, at 29 (stating that large corporations are "price makers" and consumers are "price takers").
\textsuperscript{274} See Roche, supra note 263, at 297-98.
\textsuperscript{275} See Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (Utah 1990) ("The fact that a company is undercapitalized can be overcome in many contractual settings, because the parties can allocate the risk of financial failure as they see fit.").
\textsuperscript{276} See J-R Grain Co. v. FAC, Inc., 627 F.2d 129, 135 (8th Cir. 1980).
shareholder and would hold the agreeing director or shareholder (in close corporations often the same person) personally liable for the corporation’s contractual obligation.

The sophisticated contract creditor, because of its relative equality in bargaining power with the corporation, may also raise its price to reflect the risk associated with the corporation’s level of capitalization. One common example of this type of “price manipulation” is practiced frequently by corporate lenders. Banks and other lending institutions routinely raise their interest rate (which is, in essence, the “price” of borrowing money) according to the risk inherent in the corporation’s capitalization level.

Sophisticated entities other than the corporate lender example in Laya can similarly manipulate the contractual price to reflect the risk associated with the corporation’s level of capitalization. One example would be the building owner in Kinney Shoe. In this instance, the sophisticated contract creditor would attempt to externalize the risk of contracting with the limited liability corporation by renting the building at a higher price than it would an individual with unlimited liability. By charging a higher rent, the contract creditor would recoup beforehand some of the possible loss associated with the corporation’s inability to meet the terms of the lease agreement. All sophisticated contract creditors, because of their bargaining power, can similarly raise their respective prices in proportion to the risk inherent in the corporation’s level of capitalization. These are just a few of the protections available to sophisticated contract creditors. There are many other means that contract creditors could use to transfer the risk of the corporation defaulting on the corporation or its shareholders.

3. The “Least Cost Avoider” and Veil Piercing

Another economic rationale for extending Laya to all sophisticated commercial entities is based upon the idea that the sophisticated contract creditor is the “least cost avoider” of the parties to the contract in terms of the costs associated with limiting the risk of the creditor going unpaid. In other words, the contract creditor is the party that could most cheaply take precautions to avoid the possible loss associated with the corporation defaulting on its contractual obligations. This is because even in close corporations with more than a

279 Id.
282 See Roche, supra note 263.
283 Bainbridge, supra note 46, at 502.
couple shareholders, the creditor rarely negotiates with all the corporate shareholders. In close corporations, managers contracting on behalf of the corporation and majority shareholders are often one and the same. These controlling shareholders are more likely to attempt to externalize risk onto creditors because they have much at stake.\textsuperscript{284} It is more cost-effective for the corporate creditor to demand protections on the front end than to force the individual minority shareholders of the close corporation to determine if the corporate creditor needs a personal guarantee from the contracting shareholder in order to avoid future personal liability through piercing.\textsuperscript{285}

4. Veil Piercing and the Increased Cost to Monitor Other Shareholders

Another justification for the extension of \textit{Laya} is that with a greater possibility of piercing, shareholders of closely-held corporations would have to engage in costly monitoring of the activities of other shareholders.\textsuperscript{286} Under a system of unlimited liability, the rational shareholder (because he or she would potentially be liable for the whole of the corporation’s contractual obligation) would have to spend valuable time and resources determining whether other shareholders of the corporation had adequate personal capital to “bear their share of any debts the corporation was unable to pay.”\textsuperscript{287} These individuals would also have to monitor the sale of the corporation’s stock to ensure that stock sold by other shareholders was being purchased by individuals with adequate personal wealth to cover their respective obligations if the veil was pierced.\textsuperscript{288} The imposition of this activity on shareholders would greatly increase the cost associated with investing in close-corporations and, consequently, negatively impact the level of corporate investment into these entities.

5. Veil Piercing and “Fairness” to the Sophisticated Commercial Entity

Under \textit{Laya}, one factor that must be met in order to pierce is that there must be unfairness to the contract creditor.\textsuperscript{289} However, allowing any sophisticated commercial entity to pierce under a contract claim would not be remedying an inequitable situation, but instead would be creating one. By definition, the corporate form limits the liability of its shareholders to the amount they have

\begin{itemize}
\item \textsuperscript{284} Id.
\item \textsuperscript{285} Id.
\item \textsuperscript{286} See Easterbrook & Fischel, supra note 265, at 95.
\item \textsuperscript{287} Presser, supra note 18, § 1:7.
\item \textsuperscript{288} See id.
\item \textsuperscript{289} See Laya v. Erin Homes, Inc., 352 S.E.2d 93, 99 (W. Va. 1986).
\end{itemize}
invested into the corporation.\textsuperscript{290} Sophisticated commercial entities such as commercial lenders have the ability to act on their knowledge of the corporation's capitalization level.\textsuperscript{291} Accordingly, they can raise the interest rate they charge according to the amount of risk associated with the corporation's capitalization level in relation to the amount borrowed.\textsuperscript{292} The same is true of any other type of sophisticated commercial entity. While these entities may not be lending money to the corporation, they would be offering some type of goods or services. The price involved in these contractual agreements would likewise reflect the risk inherent in the capitalization level of the corporation. All rational sophisticated contract creditors would attempt to externalize the risk associated with contracting with a corporation by raising their respective prices to cover the risk inherent in the corporation's level of capitalization.\textsuperscript{293}

Permitting any sophisticated commercial entity to pierce the corporate veil would not remedy an "inequitable" situation. Instead, it would create a situation in which the sophisticated contract creditor would actually receive a windfall. Assuming a sophisticated contract creditor checks the capitalization level of the corporation, it would raise its price according to the risk inherent in the corporation's capitalization level.\textsuperscript{294} Allowing the contract creditor the ability to minimize its risk to almost nothing through piercing, while still charging a price in proportion to the risk associated with contracting with the limited liability corporation would not be remedying an "inequitable" situation. Instead, this would be giving the sophisticated contract creditor a windfall.

\textbf{B. Public Policy Justifications for the Extension of Laya}

1. Veil Piercing and the Democratic Justification for the Limited Liability Corporation

As previously noted, one early justification for the limited liability corporation was that of democracy.\textsuperscript{295} Limiting the liability of shareholders allows people of modest means to invest in numerous risky corporations and affords them access to opportunities that would otherwise be available only to the wealthiest of investors.\textsuperscript{296} Because corporate veil piercing applies only to small, closely-held corporations,\textsuperscript{297} piercing generally impacts only stockholders of

\textsuperscript{290} See e.g., W. VA. CODE §31D-6-622(b) (2006) (stating that the liability of the shareholder is limited to the amount invested into the corporation).
\textsuperscript{291} See Bainbridge, supra note 46, at 490.
\textsuperscript{292} Id.
\textsuperscript{293} See Roche, supra note 263.
\textsuperscript{294} Id.
\textsuperscript{295} See PRESSER, supra note 18, § 1:3.
\textsuperscript{296} See id.
\textsuperscript{297} See Thompson, supra note 7, at 1055.
more modest means.\textsuperscript{298} Allowing veil piercing (particularly in the contract context where the sophisticated creditor had the opportunity to avoid the need to pierce by using its bargaining strength to protect itself) would directly violate one of the early justifications for the limited liability corporation; keeping the entry into business markets both democratic and competitive.\textsuperscript{299}

This argument has particular resonance in a state such as West Virginia, which has both a low level of corporate investment\textsuperscript{300} and a low level of per capita income.\textsuperscript{301} Because of this, companies incorporated in West Virginia are more likely to be small, closely-held corporations created by individuals with less personal wealth than corporations created in other states.\textsuperscript{302} The costs associated with permitting sophisticated contract creditors to pierce the corporate veil in West Virginia would fall squarely on the shoulders of these small-scale investors and entrepreneurs.

2. The Freedom of Contract in West Virginia and Veil Piercing Under a Purely Contractual Claim

Perhaps the most compelling justification for extending \textit{Laya}'s third prong to all sophisticated commercial entities is the policy of West Virginia courts regarding the freedom of contract. The West Virginia Supreme Court of Appeals has stated that “[t]he right of private contract is one of the highest importance, for nothing contributes more to the general welfare or to the liberties of the people than freedom of contract.”\textsuperscript{303} The Court has also stated that “the right of private contract is no small part of the liberty of the citizen. The usual and most important function of courts of justice is ... to maintain and enforce contracts.”\textsuperscript{304} The policy behind freedom of contract is especially pertinent

\textsuperscript{298} See 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 6, at 2 (3d ed. 1993). Investors in close corporations are often family members or close acquaintances that rely upon the corporation for not only investment income, but also employment. \textit{Id.}

\textsuperscript{299} See PRESSER, supra note 18, § 1:3.

\textsuperscript{300} See Debra E. Cohen, \textit{West Virginia Corporate Law: Is It “Broke”?} 100 W. VA. L. REV. 5, 52 (1997) (stating that “West Virginia is not considered a commercial state”).

\textsuperscript{301} See U.S. CENSUS BUREAU, \textit{STATISTICAL ABSTRACT OF THE UNITED STATES: 2004-2005} TABLE 653. The per capita income in West Virginia in 2003, as measured in year 2000 dollars, was $23,146 per year, ranking West Virginia 48th out of the 50 states. Only Arkansas and Mississippi had lower per capita income levels. Per capita income in West Virginia in 2003 was almost $7,000 less than the national average of $30,033. \textit{Id.}

\textsuperscript{302} See Cohen, supra note 300, at 52 n.237. Most corporations in West Virginia are closely-held corporations. In fact, there are less than twenty publicly traded companies incorporated in West Virginia. \textit{Id.} Also, the average West Virginian has less disposable income with which to invest into corporations than the average American. See supra note 301.


\textsuperscript{304} McLaugherty v. Bluefield Waterworks & Improvement Co., 68 S.E. 28, 30 (W. Va. 1910) (quoting Balt. & Ohio Sw. Ry. Co. v. Voigt, 176 U.S. 498, 505 (1900)).
when the contract at issue is between two commercial entities of equal sophistication. The West Virginia Supreme Court of Appeals has held on more than occasion that:

men of full age and competent understanding shall have the utmost liberty in contracting, and that their contracts, when entered into freely, shall be enforced by the courts of justice. Therefore, you have this paramount public policy to consider, - that you are not lightly to interfere with this freedom of contract.\(^{305}\)

Under West Virginia law, "a contract with a corporation is a contract with that legal entity and not the individual shareholders."\(^{306}\) All sophisticated entities have tools available to them to protect themselves in the negotiation process against the risk of the corporation defaulting: they have the ability to access the corporation's financial records; they can ask for prepayment for services; they can demand that the corporate directors agree to be held personally liable if the corporation cannot meet its obligations; and they can raise their prices according to the risk inherent in the corporation's level of capitalization. These abilities come from the relative equality in bargaining power between the parties during the negotiation process.

Because of this relative equality in bargaining power, sophisticated commercial entities can bargain for practically any terms in the agreement that they deem appropriate. This negotiation process allows commercial entities to evaluate and allocate risk accordingly in the contract terms. An entity, with the ability to ask for access to the corporation's financial records, the ability to demand personal liability from corporate directors and so on should not be able to void an otherwise valid contractual agreement with the corporation simply because it failed to avail itself of all the means of protection available to it in the negotiation process. Why should the law protect an entity that had every opportunity to protect itself in the contractual agreement yet failed to do so?

VII. CONCLUSION

The various jurisdictions have many different tests to determine if the corporate veil should be pierced in any particular case.\(^{307}\) These jurisdictions


\(^{306}\) Mills v. USA Mobile Commc'ns, Inc., 438 S.E.2d 1, 4-5 (W. Va. 1993) (emphasis added).

often apply their respective piercing tests in a discretionary manner.\textsuperscript{308} West Virginia is no exception. In a relatively short amount of time West Virginia has moved from a jurisdiction that had a somewhat restrictive approach to veil piercing under a contract claim, to a more liberal approach, and back again.\textsuperscript{309}

Currently, the circumstances under which a contract creditor will be permitted to pierce the corporate veil in West Virginia are anything but clear. The Fourth Circuit Court of Appeals allowed an extremely sophisticated contract creditor to pierce the corporate veil,\textsuperscript{310} yet just two years later, the West Virginia Supreme Court of Appeals denied an individual contract creditor’s claim to pierce.\textsuperscript{311} While there is an understandable hesitance to set out “bright-line” rules under a doctrine that is so fact-intensive, some judicial guideposts need to be set that corporations, and contract creditors, within the state can follow.

Lately, West Virginia courts have been moving toward a more restrictive view of veil piercing.\textsuperscript{312} The extension of \textit{Laya} to all sophisticated commercial entities would be consistent with this view. Other jurisdictions have denied individual contract creditors the ability to pierce the corporate veil because they possessed information concerning the capitalization level of the corporation with which they were contracting.\textsuperscript{313} Sophisticated commercial entities have the ability to access needed information concerning capitalization far easier than individual contract creditors. These entities also have something much more valuable than the mere access to the corporation’s financial information; they have the bargaining power to negotiate on the basis of this information.

The ability of sophisticated contract creditors to protect themselves through transferring the risk of default back onto the corporation or its shareholders; their position to best effectively bear the cost of acquiring the needed contractual protections; and the costly impact that imposing personal liability on shareholders would have on these individuals are compelling justifications for the extension of \textit{Laya}. Furthermore, the fact that imposing unlimited liability on

\textsuperscript{308} See e.g., Good \textit{v. Holstein}, 787 A.2d 426, 430 (Pa. Super. Ct. 2001) (“there appears to be no . . . well settled rule in Pennsylvania . . . as to exactly when the corporate veil can be pierced and when it may not be pierced”).


\textsuperscript{310} \textit{Kinney Shoe Corp. v. Polan}, 939 F.2d 209 (4th Cir. 1991).

\textsuperscript{311} \textit{Mills}, 438 S.E.2d 1.

\textsuperscript{312} \textit{See id.}

shareholders of close corporations is directly at odds with a main justification behind the creation of the limited liability corporation, along with West Virginia's policy of upholding contracts, especially between entities of equal sophistication, all but compels the extension of *Laya* to all sophisticated commercial entities. It makes little economic or legal sense for courts in West Virginia to reward any sophisticated contract creditor that had every opportunity to investigate the capitalization level of the contracting corporation and the bargaining power to adequately protect itself for its failure to do so.

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* J.D. candidate, West Virginia University College of Law, 2007. B.B.A. Economics, Marshall University, 2003. I wish to acknowledge all those at the College of Law who contributed to this article, especially Professor Kevin Outterson. I would like to thank my parents for their support and encouragement throughout the years. I dedicate this article to my father, James M. Jordan, the hardest working man I know, for teaching me the value of hard work and dedication, two attributes that any attorney needs in order to succeed.