

## CHAPTER TEN

### SHAREHOLDER LIABILITY TO THIRD PARTIES

#### Section 10.01 Generally

As a general rule, shareholders are not personally liable for the debts of their corporations beyond their capital contributions. *Alexander v. U.S. Tank & Const. Co., Inc.*, 130 Or App 590, 592 n 2, 883 P2d 858 (1994); *Shlim v. CML, Inc.*, 112 Or App 597, 829 P2d 1012 (1992); *Carlson v. Crater Lake Lumber Co.*, 103 Or App 190 (1990), *opinion adhered to and modified on reconsideration in part*, 105 Or App 314, 804 P2d 511 (1991); *Miller Lumber Corp. v. Miller*, 225 Or 427, 357 P2d 503 (1961); *Fields v. Synthetic Ropes, Inc.*, 215 A2d 427 (Del 1965). Although it has not always been the case (See Chapter One of this book), the limited liability of shareholders has been one of the cornerstones of corporation law for more than a century. Today, ORS 60.151(1) continues this policy. It limits a shareholder's liability to any unpaid consideration owed to the corporation for its shares.

Throughout history, creditors have tried to circumvent this strong policy. In doing so, they have urged courts to disregard the corporation and instead impose liability directly on its shareholders and on others who control the corporation.

Courts use a variety of terms to describe disregarding the corporation in order to impose liability directly on its shareholders. Some courts use the term "piercing the corporate veil." *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 481, 719 P2d 899, 903 (1986); *Scott v. AZL Resources, Inc.*, 107 NM 118, 753 P2d 897, 900 (1988). Other courts have said that liability may be imposed when a corporation is the "alter ego" of the persons in control. *Grayson v. Nordic Construction Co., Inc.*, 92 Wash 2d 548, 599 P2d 1271 (1979). Some courts have said that a corporation is a "mere instrumentality" of another (often another corporation). *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 104, 654 P2d 1092 (1982); *United States v. Lehigh Valley R Co.*, 220 US 257, 268 (1911). Other courts have spoken of "disregarding" the corporate form or the corporate entity. *Oregon RSA No. 6 v. Castle Rock Cellular of Oregon Limited Partnership*, 840 F Supp 770, 779 (D Or 1993); *Morgan v. Burks*, 22 Wash App 768, 770, n 1, 592 P2d 658, 659, n 1 (1979), *reversed on other grounds*, 93 Wash 2d 580, 611 P2d 751 (1980).

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Essentially, this terminology is interchangeable. In recent years, Oregon courts have favored the term "piercing the corporate veil" over these other terms.

### **A. Successor corporation & agency distinguished.**

There are other, distinct theories which are sometimes used to impose liability on shareholders. For instance, although cases commonly involve facts which give rise to discussion of both theories, the theory supporting piercing of a corporate veil and the theory regarding "successor corporation" liability are distinct. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 645 P2d 689 (1982). The liability of a successor corporation is discussed in Section 11.05 of this book.

A corporation may be the agent of its shareholder (usually a parent corporation). *Elvalsons v. Industrial Covers, Inc.*, 269 Or 441, 525 P2d 105 (1974); *Summit Props., Inc. v. New Tech. Elec. Contrs., Inc.*, 2004 US Dist LEXIS 13053 (D Or 2004); *Glanzer v. St. Joseph Indian Sch.*, 438 NW2d 204 (S Dak 1989). If so, a shareholder's liability will be determined by agency principles. The theory supporting piercing a corporate veil is different from the theory of agency.

The [theory of corporate disregard] should be distinguished from the doctrine of agency, actual or apparent, or estoppel, equitable or promissory. If the facts permit the application of any of these doctrines, any one of them alone may be used to impose liability against the actual or apparent principal, or against the person whose conduct creates the estoppel. Agency and equitable or promissory estoppel principles, of course, are well understood. (citations omitted) *Soderberg Advertising, Inc. v. Kent-Moore Corp.*, 11 Wash App 721, 732, 524 P2d 1355, 1363 (1974).

In another decision, the court stated:

Agency and alter ego are two different and distinct concepts. In the case of an alter ego, the court pierces the corporate veil. In the case of an agency the corporate identity is preserved but the principal is held liable for the acts of its agent. *Northern Natural Gas Company of Omaha, Nebraska v. Superior Court*, 64 Cal App 3d 983, 134 Cal Rptr 850, 857 (1976).

Agency is discussed in Chapter Six of this book.

### **B. Miscellaneous.**

As discussed below, the theory supporting piercing a corporate veil allows a court to impose liability for corporate debts on shareholders who control the corporation. While this control is usually found in situations where the shareholder happens to also be an officer or director, this corporate veil piercing theory is largely one used for imposing liability on shareholders, not usually a theory used for imposing liability on officers and directors, as such. But as discussed in Section 10.03 of this book, there are a few cases where a corporate piercing theory is used to impose liability for corporate debts on non-shareholder officers and directors. *See for example Shades Ridge Holding Co., Inc. v. U.S.*, 888 F2d 725 (11<sup>th</sup> Cir 1989); *Glenn v. Wagner*, 313 NC 450, 329

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SE2d 326 (1985). *But see Castillo v. First City Bancorporation of Texas*, 43 F3d 953 (5<sup>th</sup> Cir 1994).

Shareholders may be liable to the corporation and its creditors for other reasons. The two principal reasons for such liability – unpaid subscriptions and improper distributions - are discussed in Sections 10.11 and 10.12 of this book. In addition, a shareholder is individually liable for his/her own tortious acts, even acts taken on behalf of the corporation, as well as for contracts entered into on behalf of an undisclosed corporate principal. *Moore v. Barge*, 210 Ga App 552, 436 SE2d 746 (1993); *Roderick Timber Co. v. Willapa Harbor Cedar Products, Inc.*, 29 Wash App 311, 627 P2d 1352 (1981). Shareholders can also be liable when they personally guarantee a corporate debt.

### Section 10.02 Piercing the Corporate Veil

Typically, a corporation is considered an entity separate and distinct from its shareholders. *Salem v. H.S.B.*, 302 Or 648, 733 P2d 890 (1987); *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 618 P2d 1017 (1980). There is a strong public policy in favor of the limited liability rights of shareholders, but the courts have long exercised their equitable powers to disregard the corporate form where fairness and justice so require. In an early case, the Oregon Supreme Court stated:

There are cases where in order to prevent fraud or injustice it is necessary to disregard the fiction of a distinct corporate existence, as where one corporation is so organized and controlled and its affairs are so conducted as to make it a mere instrumentality, conduit or adjunct of another corporation; or where a corporation is fraudulently organized to take over the assets of another corporation in order to defraud its creditors.

It is a general principle that equity will disregard the corporate fiction for the purpose of preventing the successful perpetration of a fraud. (citations omitted) *Security Savings & Trust Co. v. Portland Flour Mills Co.*, 124 Or 276, 288, 261 P 432, 436 (1928).

More recently, the Washington Supreme Court stated:

It is a well-recognized principle of law that a corporation may not be used as a cloak or disguise to escape corporate liability, and that the corporate veil may be pierced when necessary to do justice in particular cases. *Superior Portland Cement, Inc. v. Pacific Coast Cement Co.*, 33 Wash 2d 169, 212, 205 P2d 597, 620 (1949).

Despite the strong public policy in favor of the limited liability of shareholders, corporate creditors commonly endeavor to hold the shareholders personally liable for corporate debts. In fact, a study published in 1991 found that piercing the corporate veil is the most litigated issue in corporate law. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L REV 1036 (1991).

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In disregarding the corporate form, a court exercises its equitable powers. *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 103, 654 P2d 1092, 1096 (1982); *Hiller Corp. v. Port of Port Angeles*, 96 Wash App 918, 982 P2d 131 (1999).

### **A. Extraordinary remedy.**

This equitable power to disregard the corporation is an extraordinary one which is exercised only where there is clear evidence that those who control the corporation have used the corporation to defeat justice by perpetuating fraud, improperly shielding themselves from contractual or tort responsibility or in other unique situations. It is a power which courts emphasize is exercised "reluctantly" and "cautiously." *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F2d 681, 683 (4<sup>th</sup> Cir 1976).

The disregard of a legally established corporate entity is an extraordinary remedy which exists as a last resort, where there is no other adequate and available remedy to repair the plaintiff's injury. *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 103, 654 P2d 1092 (1982).

See also *State ex rel Neidig v. Superior National Insurance Co.*, 343 Or 434, 173 P3d 123 (2007); *Rapid Displays, Inc. v. Gorder*, 155 Fed Appx 962, 2005 US App LEXIS 26355 (9<sup>th</sup> Cir 2005); *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1228 (9<sup>th</sup> Cir 2005).

Long ago, the United States Supreme Court said:

Normally, the corporation is an insulator from liability on claims of creditors. The fact that incorporation was desired to obtain limited liability does not defeat that purpose. Limited liability is the rule, not the exception; and on the assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted. But there are occasions when the limited liability sought to be obtained through the corporation will be qualified or denied. Mr. Justice Cardozo stated that a surrender of that principle of limited liability would be made "when the sacrifice is essential to the end that some accepted public policy may be defended or upheld." (citations omitted) *Anderson v. Abbott*, 321 US 349, 361-2, *rehearing denied*, 321 US 804 (1944).

Harm alone is not sufficient grounds for disregarding the corporate form. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 811 P2d 221 (1991). "The absence of an adequate remedy alone does not establish corporate misconduct." *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 411, 645 P2d 689, 693 (1982).

Oregon courts have been reluctant to ignore the strong public policy favoring the limited liability of shareholders. The US District (Oregon) Court has emphasized the extraordinary nature of piercing the corporate veil, stating:

Disregard of the corporate structure is generally viewed as an extraordinary remedy because it strips the shareholders of the immunity which is the very heart of the corporate fiction. *Oregon RSA No. 6 v. Castle Rock Cellular of Oregon Limited*

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*Partnership*, 840 F Supp 770, 779 (D Or 1993).

See also *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1228 (9<sup>th</sup> Cir 2005); *AcryMed, Inc. v. ConvaTec*, 317 F Supp2d 1204 (D Or 2004).

The Oregon courts have held that piercing the corporate veil to be an extraordinary remedy, one to be used only as a last resort:

Piercing the corporate veil to hold shareholders liable beyond their capital contribution is an extraordinary remedy to be used only as a last resort when a party is unable to obtain an adequate remedy from the corporation. *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 481, 719 P2d 899, 903 (1986).

Yet, to prevent fraud and inequity, courts will pierce the corporate veil under the proper circumstances.

### **B. Question of facts.**

"The question of whether the corporate form should be disregarded is a question of fact." *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 643, 618 P2d 1017, 1021 (1980). It is a "fact specific inquiry." *Legacy Wireless Servs. v. Human Capital, L.L.C.*, 314 F Supp 2d 1045 (D Or 2004). Courts have reviewed de novo the legal conclusions drawn to support the disregarding of the corporate form. *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 103, 654 P2d 1092, 1096 (1982); *Hiller Corp. v. Port of Port Angeles*, 96 Wash App 918, 982 P2d 131 (1999).

### **C. Which state law applies?**

As a general rule, the law of the state of incorporation – not the state in which the shareholder resides – will determine whether the corporate veil should be pierced. *Bartholomae Oil Corp. v. Booth*, 146 Or 154, 28 P2d 1083 (1934); *Garetson-Hilton Lumber Co. v. Hinson*, 69 Or 605, 140 P 633 (1914). But see footnote 2 in *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000).

**NOTE:** In footnote 2 of *Vuyksteke*, the Court noted the parties believed the issue of gross undercapitalization was controlled by Oregon law, not the law of the state of incorporated (New York). The Court made no finding on this issue, but this assumption appears to be contrary to earlier cases cited above.

This author believes the better view is that the law of the state of incorporation should apply. For example, some states do not recognize gross undercapitalization as a basis for piercing a corporation. Shareholders of such corporations should not be shielded from personal liability in their home state, but subject to personal liability to creditors who live in other states. Shareholders who obey the rules in the state of

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incorporation should be shielded from personal liability everywhere.

By analogy, the Oregon courts have held that the law of the state of incorporation (rather than the law of the state where the action is brought) apply to issues related to whether a derivative action may be maintained. *Munson v. Valley Energy Inv. Fund, US, LP*, 264 Or App 679, 703, 333 P3d 1102 (2014); *Kollman v. Cell Tech Int'l, Inc.*, 250 Or App 163, 172, 279 P3d 324 (2012). See also *Roberts v. Triquint Semiconductor, Inc.*, 358 Or 413, 428, 364 P3d 328 (2015).

### **D. Early cases.**

Until relatively recently, courts have disregarded the corporate form on a case by case basis. There was no universally accepted test, nor even universally accepted terminology. Each case turned on its own merits. "The question of whether the corporate entity should be disregarded depends upon the particular circumstances of each case." (citations omitted) *Hogan v. Mayor & Alderman of Savannah*, 171 Ga App 671, 673, 320 SE2d 555, 558 (1984).

Over time, courts developed a laundry list of acts which justified disregarding the corporate form.

While, for all ordinary purposes, a corporation is regarded as a legal entity separate and distinct from its shareholders, yet, . . . "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." (citations omitted) *McIver v. Norman*, 187 Or 516, 537-8, 205 P2d 137, *reversed*, 213 P2d 144, 149 (1949).

Fraud was often present in one form or another, but it was not the only basis for disregarding the corporate form. *Anderson v. Abbott*, 321 US 349, *rehearing denied*, 321 US 804 (1944). Gross undercapitalization and other acts against public policy were sometimes deemed sufficient to disregard the corporate form.

### **E. Amfac test.**

Eventually, courts and commentators distilled common themes running throughout these cases and a three-prong test emerged to justify piercing a corporate veil. These three factors were found to be present in most cases in which a court disregarded the corporate form: (i) the person sought to be held liable controlled the corporation, and usually also had control over the act which caused the injustice; (ii) the corporation had engaged in some illegal or improper conduct; and (iii) there was some causal link between the improper conduct and the creditor's inability to collect payment.

In Oregon, a corporate disregard test was first articulated in *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982), a case which includes a thorough analysis of earlier Oregon case law. *Amfac* stated the test as follows:

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We state the exception to the rule as follows: When a plaintiff seeks to collect a corporate debt from a shareholder by virtue of the shareholder's control over the debtor corporation rather than on some other theory, the plaintiff must allege and prove not only that the debtor corporation was under the actual control of the shareholder but also that the plaintiff's inability to collect from the corporation resulted from some form of improper conduct on the part of the shareholder. This causation requirement has two implications. The shareholder's alleged control over the corporation must not be only potential but must actually have been exercised in a manner either causing the plaintiff to enter the transaction with the corporation or causing the corporation's default on the transaction or a resulting obligation. Likewise, the shareholder's conduct must have been improper either in relation to the plaintiff's entering the transaction or in presenting or interfering with the corporation's performance or ability to perform its obligations toward the plaintiff. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 108-9, 654 P2d 1092, 1101-2 (1982).

Since the *Amfac* decision, the Oregon Court of Appeals has condensed the language of this test, restating it as follows:

There are three criteria for imposing liability on a shareholder:

- (1) The shareholder must have controlled the corporation.
- (2) The shareholder must have engaged in improper conduct in his exercise of control over the corporation; and
- (3) The shareholder's improper conduct must have caused plaintiff's inability to obtain an adequate remedy from the corporation. (footnotes omitted) *Rice v. Oriental Fireworks Co.*, 75 Or App 627, 633, 707 P2d 1250, 1255 (1985).

See also *Acrymed, Inc. v. Convatec*, 317 F Supp2d 1204, 1214 (D Or 2004).

Each of these three elements will be discussed in greater detail in the following Sections of this Chapter.

Additional discussion of piercing the corporate veil is included in the following law review articles: 22 N KY L REV 541 (1995); 68 TULANE L REV 1008 (1994); Knight & Knight, *Disregarding of the Corporate Entity and Nominee Corporations after Bolinger*, 21 U TOLEDO L REV 203 (1989); Barber, *Piercing the Corporate Veil*, 17 WILL L REV 371 (1981); Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253 (1981).

### **F. Similar tests.**

The precise wording of the test used for disregarding the corporate form varies widely, but the essential elements are the same in most states. For instance, the New Mexico courts have expressed the test as follows:

New Mexico decisions have held that piercing the corporate veil is an equitable remedy. three requirements must be satisfied to obtain this relief: a showing of instrumentality or domination, improper purpose and proximate cause. *Scott v. AZL Resources, Inc.*, 107 NM 118, 753 P2d 897, 900 (1988).

In Washington, the test for disregarding the corporate form has been

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expressed as follows:

The corporate entity is disregarded and liability assessed against shareholders in the corporation when the corporation has been intentionally used to violate or evade a duty owed to another. The court's statement of the doctrine identifies two essential factors: (1) the corporate form must be intentionally used to violate or evade a duty and (2) disregard must be necessary and required to prevent unjustified loss to the injured party. (footnotes, citations & internal quotes omitted) *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 398-9, 811 P2d 221, 222-3 (1991).

In Alabama, the test for disregarding the corporate form has been expressed as follows:

In an attempt to circumvent some of the difficulties in applying conclusory terms such as "instrumentality," "alter ego" and "adjunct," we announced, in *Kwick Set Components, Inc. v. Davison Ind., Inc.*, 411 So2d 134 (Ala 1982), a standard to be applied in order to determine whether the corporate entity should be disregarded when excessive control is the ground. While acknowledging that the dominating party may be an individual or another corporation, we stated the elements essential for imposition of liability on the dominant party as follows:

- 1) The dominant party must have complete control and domination of the subservient corporation's finances, policy and business practices so that at the time of the attacked transaction the subservient corporation had no separate mind, will, or existence of its own;
- 2) The control must have been misused by the dominant party. Although fraud or the violation of a statutory or other positive legal duty is misuse of control, when it is necessary to prevent injustice or inequitable circumstances, misuse of control will be presumed;
- 3) The misuse of this control must proximately cause the harm or unjust loss complained of.

*Messick v. Moring*, 514 So2d 892, 894-5 (Ala 1987).

Other states have expressed this test in much the same way. See for example *Dwyer v. Ing Investment Co., Inc.*, 889 SW2d 902 (Mo App 1994); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F2d 157, 160 (7<sup>th</sup> Cir 1963).

The Fourth Circuit has expressed the test differently:

we articulated several factors that guide the determination of whether one entity constitutes the alter ego of another. These factors include gross undercapitalization, insolvency, siphoning of funds, failure to observe corporate formalities and maintain proper corporate records, non-functioning of officers, control by a dominant stockholder, and injustice or fundamental unfairness. Other factors properly considered by the district court in this case include intermingling of funds; overlap in ownership, officers, directors, and other personnel; common office space; the degrees of discretion shown by the allegedly dominated corporation; and whether the dealings of the entities are at arm's length.

At its core, the question of whether to pierce the corporate veil is a fact-intensive inquiry, because the circumstances necessarily vary according to the circumstances of each case, and every case where the issue is raised is to be regarded as *sui generis* to be decided in accordance with its own underlying facts. Instead of a firm rule, the general principle ... has been that liability is imposed when doing so would



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achieve an equitable result. In applying these factors a court must focus on reality and not form, on how the corporation operated and the individual defendant's relationship to that operation. (citations & internal quotations omitted) *Vitol, S.A. v. Primerose Shipping Co.*, 708 F3d 527, 544 (4<sup>th</sup> Cir 2013).

At least in the ERISA context, the Ninth Circuit's test for piercing is:

When considering whether to pierce the corporate veil and hold a corporation's shareholders liable for the corporation's withdrawal liability, courts consider three factors: "the amount of respect given to the separate identity of the corporation by its shareholders, the degree of injustice visited on the litigants by recognition of the corporate entity, and the fraudulent intent of the incorporators." *Seymour v. Hull & Moreland Eng'g*, 605 F.2d 1105, 1111 (9th Cir. 1979) ; see *Bd. of Trs. of Mill Cabinet Pension Tr. Fund v. Valley Cabinet & Mfg. Co.* , 877 F.2d 769, 772–74 (9th Cir. 1989) (applying the Seymour factors to an action to collect withdrawal liability). A plaintiff "must prevail on the first threshold factor and on one of the other two." *Nor-Cal* , 48 F.3d at 1475. (footnote omitted). *Bd. of Trs. of the Employers-Shopmen's Local 516 Pension Trust v. Columbia Wire & Iron Works, Inc.*, 233 F Supp3d 873, 883 (D Or 2017).

### **G. Reverse piercing.**

Although nearly all piercing cases are brought by corporate creditors seeking to hold a shareholder, officer, director, or another control person liable for a corporate debt, there are a few cases where a control person seeks to have the court disregard his/her own corporation. Most such attempts have been unsuccessful. See for example *In re Morgan-Stanley Lumber Co., Inc.*, 70 BR 1986 (Bkrtcy D Or 1986)(bankruptcy trustee, standing in shoes of corporation, may not sue officers of debtor corporation on theory of piercing the corporate veil); *West Bearing & Parts, Inc. v. Peet*, 253 Or 639, 456 P2d 993 (1969)(new corporation unsuccessfully sought to have Department of Employment disregard its corporate form and base its unemployment rate on the experiences of its shareholder before he incorporated the business); *Salem v. H.S.B.*, 302 Or 648, 733 P2d 890 (1987)(in a condemnation case, corporation whose shareholders owned adjacent condemned properties could not assert unity of ownership to claim severance damages); *Mays v. Transamerica Ins. Co.*, 103 Or App 578, 799 P2d 653 (1990)(corporate shareholder could not show sufficient control over wrongful corporate act to claim benefit of corporate insurance policy); *Hogan v. Mayor & Alderman of Savannah*, 171 Ga App 671, 320 SE2d 555 (1984)(corporate officer unsuccessfully sought to have corporation disregarded so that he could claim coverage under corporate insurance policy); *Garvin v. Matthews*, 193 Wash 152, 74 P2d 990 (1938)(receiver, standing in shoes of corporation, could not sue shareholder on theory that shareholder was alter ego of the corporation).

*But see McKay v. Horsehoe Lake HopHarvesters, Inc.*, 260 Or 612, 491 P2d 1180 (1971)(payment by shareholders deemed made for corporation);

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*Crum v. Krol*, 99 Ill App 3d 651, 425 NE2d 1081 (1981)(court permitted shareholder to recover damages suffered by his corporation in a breach of contract action in which shareholder, but not corporation, was a party); *Roepke v. Western National Mutual Insurance Co.*, 302 NW2d 350 (Minn 1981)(court pierced corporate veil to treat sole shareholder as an insured on corporate auto insurance policy).

#### **H. Limited liability companies.**

"The veil-piercing doctrine may be applied to LLCs under the same circumstances in which it is applied to corporations." *Saldaña v. Slingsluff*, 2011 US Dist LEXIS 117509 (D Or 2011) (citing *BLD Products, LTC v. Tech. Plastics of Or.*, Case No. 05-556-KI, 2006 US Dist LEXIS 89874, 2006 WL 3628062 (D Or 2006). See also *Greenhunter Energy, Inc. v. W. Ecosystems Tech., Inc.*, 2014 WY 144, 337 P3d 454 (2014); *Hector v. Mo-Dad Env'tl. Serv., LLC*, 134 So3d 133 (La App 2014); *Kubican v. Tavern, LLC*, 232 W Va 268, 752 SE2d 299 (2013); *Westmeyer v. Flynn*, 382 Ill App3d 952, 889 NE2d 671 (2008)(applying Delaware law); *d'Elia v. Rice Development, Inc.*, 147 P3d 515 (Utah Ct App 2006).

#### **I. Piercing claim is separate count in complaint.**

"Oregon law requires plaintiffs to plead an alter ego theory of recovery as a separate count of their complaint." *Bates v. Bankers Life & Cas. Co.*, 993 F Supp2d 1318, 1354 (D Or 2014) (citing *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, n 12, 654 P2d 1092 (1982)).

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"Control" is the first of the three elements set out in the *Amfac* test. In this context, "control" must be "actual control."

The shareholder's alleged control over the corporation must not be only potential but must actually have been exercised in a manner either causing the plaintiff to enter the transaction with the corporation or causing the corporation's default on the transaction or a resulting obligation. Likewise, the shareholder's conduct must have been improper either in relation to the plaintiff's entering the transaction or in presenting or interfering with the corporation's performance or ability to perform its obligations toward the plaintiff. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 108-9, 654 P2d 1092, 1101-2 (1982).

Control alone is not enough. "[N]either 'entire management' of a corporation nor ownership of substantially all of its stock constitute an adequate basis for disregarding the corporate entity." *Justin Kraft & Kraft Piano Servs., LLC v. Arden*, 2008 US Dist LEXIS 91001 (D Or 2008)(citing *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971)).

Shareholder control is necessary, but not alone sufficient to pierce the corporate veil.

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*Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1228 (9<sup>th</sup> Cir 2005).

One or more persons control every corporation. All three prongs of the test must be met for a court to pierce a corporate veil and impose liability on those in control.

### **A. Early development.**

The earliest discussions of control in this context usually arose in connection with a parent and its subsidiary corporation. Often, a creditor tried to force a parent corporation to pay the debts of its subsidiary. Early cases turned on whether the subsidiary was a mere "instrumentality" of the parent.

The first major attempt to synthesize these early case was in a 1931 book by Frederick J. Powell, *Parent and Subsidiary Corporations*:

In 1931 Frederick J. Powell published a monumental study, *Parent and Subsidiary Corporations*, which attempted to synthesize those cases which had disregarded the corporate entity. Powell described an "instrumentality" test which he perceived to be the test for determining whether a subsidiary is in fact so dominated by its parent that its veil should be pierced to find the parent liable. Although Powell's test was derived from a study of the parent-subsidiary relationship and may have been meant to apply exclusively to that relationship, it has been applied with equal force to pierce the veil of closely held corporations to hold the individual shareholders liable. Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DEN L J 1, 11 (1978).

Powell developed a list of eleven factors which he believed had been relied upon by courts in determining whether actual control existed. (Powell used the term "instrumentality" rather than the term "actual control"). Although no single factor or set of factors is determinative, Powell identified eleven circumstances which indicate that a subsidiary is a mere instrumentality of its parent. These circumstances are:

1. The parent corporation owns all or most of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation.
5. The subsidiary has grossly inadequate capital.
6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation, or no assets except the ones conveyed to it by the parent corporation.
8. In the papers of the parent corporation or in the statements of the officers, the subsidiary is described as a department or division of the parent

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corporation, or its business or financial responsibility is referred to as the parent corporation's own.

9. The parent corporation uses the property of the subsidiary as its own.
10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the latter's interest.
11. The formal legal requirements of the subsidiary are not observed. Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DEN L J 1, 16-17 (1978).

The *Amfac* case cited Powell and his book. See also *Old Town Development Co. v. Langford*, 349 NE2d 744, 778 n 39 (Ind App 1976); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F2d 157, 161 (7<sup>th</sup> Cir 1963).

#### **B. Control is not enough.**

Control alone is not enough to pierce a corporate veil. All three prongs of the test must be met.

What is meant is this: that simply because a company is reduced in number to one or two, or a very few stockholders, does not warrant for a single instant, per se, the disregard of the corporate entity. Whether there is one shareholder in a corporation or whether there are ten thousand makes no difference, in other words, unless some of the circumstances aforementioned which warrant a disregard of the theory of corporate entity are present. *Miller Lumber Corp. v. Miller*, 225 Or 427, 431-2, 357 P2d 503, 506 (1961)(quoting from 12 COL L REV 496 (1912).

Merely owning 100% of a corporation's stock is not enough to create personal liability for that shareholder. *Levine v. Alpha Anesthesia, Inc.*, 145 Or App 549, 931 P2d 812 (1997); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971); *Miller Lumber Corp. v. Miller*, 225 Or 427, 357 P2d 503 (1961). Two corporations will not be treated as one solely because both are entirely owned by a single shareholder, *Howco Leasing Corp. v. Oregon Lumber Export Co.*, 283 Or 225, 582 P2d 4 (1978); *Finn v. George T. Mickle Lumber Company of Oregon*, 41 F2d 676 (9<sup>th</sup> Cir 1930), or because one is the wholly-owned subsidiary of the other. *Schlecht v. Equitable Builders, Inc.*, 272 Or 92, 535 P2d 86 (1975); *Agristor Credit Corp. v. Schmidlin*, 601 F Supp 1307 (D Or 1985).

Similarly, a principal shareholder is not liable merely because he/she controls and participates in the management and operations of the corporation. *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971).

**NOTE:** Shareholders, particularly corporate shareholders, have sometimes been held liable on the theory that the subsidiary corporation was acting as an "agent" of its parent in connection with the transaction for which the creditor seeks to hold the parent liable. These cases apply theories of principal and agent, not theories of corporate disregard. See for example *Davis v. Tyee Industries, Inc.*, 58 Or App 292, 648 P2d 388

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(1982), *affirmed*, 295 Or 467, 668 P2d 1186 (1983); *Elvalsons v. Industrial Covers, Inc.*, 269 Or 441, 525 P2d 105 (1974); *Portland Trust & Savings Bank v. Lincoln Realty Co.*, 180 Or 96, 170 P2d 568 (1946); *St. Louis Union Trust Co. v. Oregon Annual Conference of the Methodist Episcopal Church*, 14 F Supp 35 (D Or 1935).

### **C. Who has actual control?**

Actual control may exist in any number of circumstances. It is obviously present when a single person owns all the stock and serves as the corporation's sole director and officer. But a shareholder can have actual control even if the shareholder is neither an officer or director. Such will always be the case when a corporation is a shareholder since directors and officers must be natural persons. *Amfac* involved a lawsuit against a parent corporation for the obligations of its subsidiary.

The Oregon Court of Appeals held that the shareholder sought to be held liable on a piercing claim must have control over the corporation, not merely a degree of control over the transaction giving rise to the liability.

plaintiff urges that, in situations in which a shareholder such as Simon plays a substantial role in carrying out "improper conduct" by way of misrepresentation, that shareholder should not be immune from personal liability for the debts of the corporation caused by that improper conduct. In particular, plaintiff posits that, for purposes of piercing the corporate veil, the inquiry should be limited to whether the defendant had control over the improper acts, not whether the defendant had control over the entire corporation.

We disagree. Plaintiff's proposed approach misconstrues *Amfac's* "actual control" requirement and impermissibly conflates the "improper conduct" and "actual control" elements. Under *Amfac*, shareholder liability can be imposed only in circumstances where "the debtor corporation was under the actual control of the shareholder." 294 Or at 108 (emphasis added). Here, Simon was both an active participant in the affairs of Pamcorp and an active participant in much of the conduct at the core of this case. However, he never held a significant interest in either Pamcorp or Pamcorp Holdings, and was not ultimately responsible for the financial decisionmaking of either corporation. In sum, Simon did not possess, or exercise, "actual control."

We note, moreover, that plaintiff's proposed approach--equating "control" over the alleged "improper conduct" with "actual control" of the corporation--would effectively delete the "actual control" requirement from the *Amfac* test. Presumably, one who engages in improper conduct has "actual control" over his or her own actions. Thus, plaintiff's formulation would collapse "actual control" into "improper conduct." We decline to do so. *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 430-1, 83 P3d 350, 363 (2004).

In a later decision, the Court of Appeals stated:

A plaintiff seeking to hold a corporation's shareholder personally liable for a corporate debt must allege that the shareholder was in actual control of the corporation and that the plaintiff's inability to collect from the corporation is the result of the shareholder's improper conduct. *Amfac Foods v. Int'l Systems*, 294 Or. 94, 108, 654 P.2d 1092 (1982). The shareholder's conduct must have been improper either in relation to the plaintiff's entering the transaction in which the debt was

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incurred or in preventing or "interfering with the corporation's performance or ability to perform its obligations toward the plaintiff." *Handam v. Wilsonville Holiday Partners, LLC*, 221 Or App 493, 496, 190 P3d 480 (2008).

According to a leading commentator, a defendant must have "control, not merely majority or complete stock control, but complete domination." FLETCHER CYC CORP § 41.10 (Perm Ed). One court has said that:

The control necessary to invoke what is sometimes called the "instrumentality rule" is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal. It must be kept in mind that *the control must be shown to have been exercised at the time the acts complained of took place in order that the entities be disregarded at the time.* (emphasis in original). *Glenn v. Wagner*, 67 NC App 563, 313 SE2d 832, 841 (1984)(quoting from *Acceptance Corp. v. Spencer*, 268 NC 1, 9, 149 SE2d 570, 576 (1966)).

### **D. Active & latent control distinguished.**

"Actual control" may take many forms. Control may be "active" or "latent".

Active control is power which is exercised on a regular basis. In many corporations, active control is exercised by management (*i.e.*, officers and employees who manage the business on a day to day basis).

"Latent" control is "power that is exercised intermittently, often in times of stress". *Corporate Power*, 83 COL L REV 215, 242 (1983). Such control may be exercised by a majority shareholder not actively involved in management. A shareholder who controls the purse-strings may possess latent control.

### **E. Control by non-shareholders.**

Generally, only shareholders have the type of "control" necessary to be liable under the theory of corporate disregard. *Brodle v. Lochmead Farms, Inc.*, 2011 US Dist LEXIS 119000 (9<sup>th</sup> Cir 2011). However, some cases impose liability on non-shareholders who control the corporation.

Affiliated corporations can be held liable even though they do not own stock in the corporation being pierced. *State ex rel Neidig v. Superior National Insurance Co.*, 343 Or 434, 454, 173 P3d 123 (2007). "It is well established that where corporate affairs are confused with those of the stockholders, a subsidiary or an affiliate corporation the corporate veil may be lifted to protect persons whose rights have been jeopardized by the corporate device." *Abbott v. Bob's U-Drive*, 222 Or 147, 161-62, 352 P2d 598 (1960).

A jury verdict which held a shareholder owning non-voting stock was liable on a piercing theory where that shareholder had lent substantial sums to the corporation, keeping the corporation alive for a long period, was upheld without analysis in *Computer Concepts, Inc. v. Brandt*, 137 Or App 572, 905 P2d

1177 (1995).

In *Glenn v. Wagner*, 313 NC 450, 329 SE2d 326 (1985), the North Carolina Supreme Court upheld a jury verdict against an affiliate corporation under common control with the debtor corporation.

In *Shades Ridge Holding Co., Inc. v. United States*, 888 F2d 725 (11<sup>th</sup> Cir 1989), a father was held liable to the IRS for a debt of a corporation owned by family members. The father owned no stock in the debtor corporation, but financially supported the corporation. See also *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*, 483 F2d 1098, 1104 (5<sup>th</sup> Cir 1973).

In *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 524 P2d 1355 (1974), a judgment was upheld against a person who had previously held an **option** to acquire stock in the debtor corporation even though the option was never exercised and the option holder had no power to vote as a shareholder. This holding turned on the fact that the option holder had provided the funds necessary to keep the debtor corporation alive.

KM contends the doctrine of disregarding the corporation entity is or should be confined to shareholders and not extended to one who holds an option to purchase all the shares of a corporation. It is true the doctrine of disregard is often applied in parent-subsidary corporation cases to impose liability upon a shareholder for the debts of his corporation. F. Powell, *Parent and Subsidiary Corporations* §§ 3-20 (1931). However, for all practical purposes, the optionee KM had all the powers of a shareholder and much more. KM possessed and exercised life and death power over PK through its fiscal control. *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 524 P2d 1355, 1363 (1974).

On the other hand, more recently a court granted summary judgment in favor of a law firm, holding that there needed to be some ownership relation in order to impose liability on an alter ego theory. *Castillo v. First City Bancorporation of Texas*, 43 F3d 953 (5<sup>th</sup> Cir 1994). *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 83 P3d 350 (2004) would seem to be consistent with this Fifth Circuit decision.

## Section 10.04 Improper Conduct

Improper conduct is the second, key element in all cases involving the piercing of a corporate veil. The improper conduct must be committed by the corporation and those who control it.

We state the exception to the rule as follows: When a plaintiff seeks to collect a corporate debt from a shareholder by virtue of the shareholder's control over the debtor corporation rather than on some other theory, the plaintiff must allege and prove not only that the debtor corporation was under the actual control of the shareholder but also that the plaintiff's inability to collect from the corporation resulted from some form of **improper conduct** on the part of the shareholder. (emphasis added) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 108, 654 P2d 1092, 1101 (1982).

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*Amfac* mentions several examples of improper conduct, including inadequate capitalization, milking, misrepresentation, commingling, holding out and violations of statute. *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 109-110, 654 P2d 1092, 1102-3 (1982). Other factors may include:

Factors which can prompt the piercing of the corporate veil include the inadequate capitalization of the controlled corporation, the siphoning of its funds by those who dominate it, the absence of adequate corporate records, and the debtor corporation's insolvency. (citations omitted) *Copley Triangle Associates v. Apparel America, Inc.*, 96 NC App 263, 385 SE2d 201, 203 (1989).

Sections 10.05 through 10.09 below discuss some examples of improper conduct.

*Amfac* also alluded to "moral culpability," citing its earlier decision in *Schlecht v. Equitable Builders*, 272 Or 92, 97, 535 P2d 86 (1975). More recently, the Oregon Supreme Court has clarified this statement to mean that

the context in which *Schlecht* and *Amfac* used the phrase "moral culpability" makes it clear that the term refers less to abstract notions of morality and more to dishonest or deceitful conduct intended to harm a third party, whether or not that conduct violates a statute or other legal obligation. . . . Rather, the Court of Appeals [below], like this court in *Amfac*, used "moral culpability" as one way of describing the kind of improper conduct that is required to pierce the corporate veil. Understood in context, then, the Court of Appeals' use of the term "moral culpability" [below] was not erroneous. That phrase narrows the range of illegal or tortious conduct that can be considered "improper" for purposes of piercing the corporate veil, and it also serves as a reminder that oppressive or manipulative conduct that uses a corporate form to harm a creditor or evade regulation may be improper for those purposes, even if it is not separately actionable. *State ex rel Neidig v. Superior National Insurance Co.*, 343 Or 434, 459, 173 P3d 123 (2007).

See also *Brodle v. Lochmead Farms, Inc.*, 2011 US Dist LEXIS 119000 (9<sup>th</sup> Cir 2011).

Failing to properly insure a corporation against potential liability claims does not alone constitute improper conduct because failing to obtain insurance is not "dishonest or deceitful conduct intended to harm a third party." *Handam v. Wilsonville Holiday Partners, LLC*, 221 Or App 493, 497, 190 P3d 480 (2008).

In many cases, more than one allegation of misconduct is present when the corporate form is disregarded. This often makes it difficult to determine the weight given to each alleged type of misconduct. See Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, 260 n 38 (1981).

Misrepresentation was said to be a separate theory for piercing the corporate veil in *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 433, 83 P3d 350, 364-5 (2004).



## Section 10.05 Inadequate Capitalization

### A. Generally.

At one time, a corporation was required to raise a minimum amount of capital before it could begin doing business. *Statutory Minimum Capitalization Requirements*, 5 WILL L REV 331 (1969). This is no longer true in Oregon. But courts sometimes cite failure to contribute sufficient capital as one basis for piercing the corporate veil.

It has been held that gross undercapitalization of the debtor corporation, by itself, may suffice to hold the shareholder liable to a creditor who is unable to collect against the corporation because it was inadequately capitalized. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 109, 654 P2d 1092, 1102 (1982).

“The gross undercapitalization of a debtor corporation by itself could suffice to hold a shareholder liable to a creditor who is unable to collect against the corporation because of inadequate capitalization.” *Stirling-Wanner v. Pocket Novels, Inc.*, 129 Or App 337, 341, 879 P2d 210 (1994).

The United States Supreme Court once stated:

An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in denying stockholders their defense of limited liability. *Anderson v. Abbott*, 321 US 349, 362, *rehearing denied*, 321 US 804 (1944).

Although *Amfac* cites no prior Oregon corporate disregard decision involving inadequate capitalization (this author has found none), later Oregon decisions have examined this issue.

*Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (Or 1985) involved an escrow company into which its shareholders initially contributed a mere \$500, despite the fact that the corporation would be handling millions of dollars in transactions and despite the risk that the corporation's potential liabilities could be substantial. The court permitted plaintiff to recover against the shareholders and, in doing so, discussed inadequate capitalization, stating:

Inadequate capitalization of a corporation is a form of improper conduct. Although there is no statutory minimum capitalization requirement in Oregon, a corporation must have sufficient capital to cover its reasonably anticipated liabilities, measured by the nature and magnitude of its undertaking, the risks attendant to the particular enterprise and normal operating costs associated with its business. Sufficiency of capital is measured at the time a corporation is formed and begins operations. (citations omitted) *Gardner v. First Escrow Corp.*, 72 Or App 715, 723, 696 P2d 1172, 1177-8 (1985).

See also *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1229 (9<sup>th</sup> Cir 2005).

Another court has said:

‘Inadequate capitalization’ ... means capitalization very small in relation to the nature

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of the business of the corporation and the risks the business necessarily entails. Inadequate capitalization is measured at the time of formation of the corporation. A corporation that was adequately capitalized when formed but has suffered losses is not undercapitalized. Whether a corporation is undercapitalized ... presents a question of fact that turns on the nature of the business of the particular corporation. *Lichtenstein v. Consolidated Services Group, Inc.*, 978 F Supp 1 (D Me 1997).

### **B. Other states.**

Some other states also recognize gross undercapitalization as a basis for disregarding the corporate form.

Where it is sought on the one hand to make available to general or tort creditors only an illusory amount compared with the size of the business and the public responsibility inherent in its very nature, while on the other hand advancing necessary expenses through secured devices, it would be a gross inequity to allow such a flimsy organization to provide a shield for personal liability. Courts will not tolerate arrangements which throw all the risks on the public and which enable stockholders to reap profits while being insulated against losses. *Mull v. Colt Co.*, 31 FRD 154, 164-5 (SD NY 1962).

A few states refuse to recognize inadequate capitalization as a basis for piercing the corporate veil. In a Washington case, the shareholders initially capitalized the corporation with only \$500. In refusing to disregard the corporate form, the court noted it knew "of no rule of law requiring a corporate stockholder to commit additional funds to an already faltering corporation." (footnote omitted) *Truckweld Equipment Co. v. Olson*, 26 Wash App 638, 618 P2d 1017, 1022 (1980). Likewise, a Georgia court held:

Appellant readily acknowledged that the holding company was not sufficiently capitalized to begin operations; however, undercapitalization of a corporation will justify piercing the corporate veil only when "coupled with evidence of an intent at the time of the capitalization to improperly avoid future debts of the corporation." Here, appellant offered a valid business reason for the manner in which the acquisition was financed and gave an un rebutted explanation of the investors' capitalization plans and the ultimate failure of that effort. Thus, there is no evidence of fraudulent intent at the time of capitalization. (citations omitted) *Marett v. Professional Insurance Careers, Inc.*, 201 Ga App 178, 181, 410 SE2d 373, 375 (1991).

Washington is among the states which do not recognize inadequate capitalization as a basis for disregarding the corporate form. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 399-400, 811 P2d 221, 223 (1991); *Kriegman v. Schultz (In re LLS Am., LLC)*, 520 BR 841 (ED Wash 2014); *Wehlage v. Empres Healthcare, Inc.*, 2011 US Dist LEXIS 125681(ND Cal 2011).

### **C. Funds considered as part of capitalization.**

By "capitalization," courts are referring to the consideration paid for a corporation's shares. Of course, this includes cash and other physical property paid for the stock. It may also including intangible assets, such as an employment contract with an experienced manager and potential contracts with

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customers. *Murphy Logging Co. v. United States*, 378 F2d 222 (9<sup>th</sup> Cir 1967).

Some courts consider shareholder loans in determining whether or not a corporation is undercapitalized. *Hartkopf v. Heinrich Ad. Berkemann*, 200 Ga App 355, 408 SE2d 450 (1991). "A shareholder loan is deemed a capital contribution if it is made to an initially undercapitalized corporation." *Houston's Inc. v. Hill*, 111 Or App 502, 506, 826 P2d 644, 646 (1992). See also *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968).

Other decisions exclude shareholder loans in determining inadequate capitalization. "Under Oregon law, a loan is not a capital investment because it does not increase the corporation's worth." *XDP, Inc. v. Watumull Props. Corp.*, 2004 US Dist LEXIS 12057 (D Or 2004)

While a loan by a shareholder may be considered part of the corporation's capitalization, a loan by a third party is not because such loans do not increase the worth of a corporation. *XDP, Inc. v. Watumull Props. Corp.*, 2004 US Dist LEXIS 12057 (D Or 2004); *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (1985). Therefore, a "corporation is undercapitalized if the shareholders do not place at risk assets that are reasonably related to the corporation's anticipated business and liabilities." *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, 912 P2d 929, 929 (1996).

Appropriate insurance may be considered in determining whether a corporation is inadequately capitalized. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, n 7, 912 P2d 929, 929 (1996).

### **D. When measured?**

In Oregon, inadequate capitalization is measured at a corporation's formation or at the beginning of its operations. *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000); *Stirling-Wanner v. Pocket Novels, Inc.*, 129 Or App 337, 879 P2d 210 (1994); *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (1985)(also significant that the defendant corporation had a long history of inadequate capitalization).

Other courts have stated that inadequate capitalization can be measured at any point in a corporation's existence. *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F2d 681 (4<sup>th</sup> Cir 1976).

### **E. How much is enough?**

The United States Supreme Court has indicated that the adequacy of the capitalization should be "measured by the nature and magnitude of the corporate undertaking." *Anderson v. Abbott*, 321 US 349, 362, *rehearing denied*, 321 US 804 (1944). In Oregon, adequate capitalization takes into account the assets placed at risk by the shareholders in relation to the corporation's

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anticipated business and liabilities. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, 912 P2d 929, 929 (1996).

Some commentators have suggested a reasonable person standard while others have suggested a comparative analysis of corporations in the same industry. *Comment*, 14 BALT L REV 311 (1985).

In *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000), the Court of Appeals upheld the trial court's decision to pierce the corporate veil even though the defendant corporation had been capitalized with over \$150,000; but this capital was contributed only after the corporation breached a contract – the conduct giving rise to the liability.

On the other hand, in *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217 (9<sup>th</sup> Cir 2005), the court found that a capitalization of \$2500 was alone insufficient to justify imposing the extraordinary remedy of piercing the corporate veil.

**NOTE:** Most cases finding an undercapitalization involve corporations initially capitalized with only a nominal sum. The corporation's \$150,000 capitalization in *Vuyksteke* is at the outer edge of the capitalization cases.

The Oregon Court of Appeals has said:

There can be no doubt that, as the trial court found, Classic was undercapitalized at its formation and continued to be undercapitalized until the Greyhound sale. A total capital of \$1,000, which the shareholders may not even have paid, is completely inadequate to the magnitude and risks of the undertaking that Classic contemplated and to the normal operating costs associated with its intended business. That amount was not even an attempt to provide adequate capitalization; rather, it was the result of Classic's decision, for tax reasons, to have a merely nominal capitalization. In allowing tax considerations to control that decision, Classic exposed its shareholders to potentially unlimited liability for its normal business debts. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 406, 912 P2d 929 (1996).

The mere fact that a corporation goes out of business and cannot pay its debts is not a sufficient basis to conclude that it was undercapitalized. *Aero Planning International, Inc. v. Air Associates, Inc.*, 94 Or App 143, 764 P2d 610 (1988).

### **F. Miscellaneous.**

In one case involving the purchase of a home from the homebuilder. After the sale, the homebuilder borrowed money from a bank and secured the loan by the purchaser's lot. At the time it borrowed these funds, the homebuilder was insolvent and unable to repay the loans. The Court of Appeals upheld the trial court's finding that this constituted improper conduct sufficient to pierce the corporation veil. *Gemignani v. Pete*, 187 Or App 584, 71 P3d 87 (2003).

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Some authorities believe that a distinction should be drawn between inadequate capitalization cases involving contracts and cases involving torts. See *Amfac Foods, Inc. v. International Systems & Controls Corp*, 294 Or 94, 109, n 15, 654 P2d 1092, 1102 (1982); *Secon Service System, Inc. v. St. Joseph Bank and Trust*, 855 F2d 406, 413-4 (7<sup>th</sup> Cir 1988); Wuepper, *Piercing the Corporate Veil: A Comparison of Contract Versus Tort Claimants Under Oregon Law*, 78 OR L REV 347 (1999); Barber, *Piercing the Corporate Veil*, 17 WILL L REV 371 (1981); *Comment*, 14 BALT L REV 311 (1985).

Additional discussion of undercapitalization appears in Downs, *Piercing the Corporate Veil: Do Corporations Provide Limited Personal Liability?*, 53 UMKC L REV 174 (1985) and Gelb, *Piercing the Corporate Veil: The Undercapitalization Factor*, 59 CHI-KENT L REV 1 (1982).

### Section 10.06 Milking

#### A. Generally.

"Milking" is a term used to describe various forms of misconduct by which those in control of a corporation improperly transfer corporate assets to themselves in order to avoid paying corporate creditors.

"Milking" has been defined as: "To deprive or defraud (a person, etc.) (from, of money, etc.), esp. by taking regular amounts over a period of time; to exploit, turn into a source of (freq. illicit) profit, advantage, information, etc.; to extract all possible advantage from." *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1230 n 11 (9<sup>th</sup> Cir 2005)(quoting IX Oxford English Dictionary 772 (2d ed 2001)).

Milking is another basis for disregarding the corporate form.

Shareholders have been held liable for a corporation's debts because they have milked a corporation by the payment of excessive dividends, by the sale of products to the shareholders at a reduced price, or by exacting unreasonable management charges. (citations and footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp*, 294 Or 94, 109, 654 P2d 1092, 1102 (1982).

Other courts have used more colorful language in describing "milking." In *Morgan v. Burks*, 93 Wash 2d 580, 585, 611 P2d 751, 755 (1980), the court stated that the corporation had been "gutted and left without funds" by those controlling it. In *Harrison v. Puga*, 4 Wash App 52, 64, 480 P2d 247, 255 (1971), the court held liable a shareholder who "stripped the corporation of all its assets."

Milking involves excessive dividends or diversion of corporate assets – it goes well beyond the payment of normal dividends and salaries. "Piercing a corporate veil based on "milking" of "excessive dividends" makes sense in cases of corporate manipulation where corporate assets are systematically and

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extensively removed from the corporation.” *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1231 (9<sup>th</sup> Cir 2005).

There have been several Oregon cases in which milking formed the basis for piercing the corporate veil.

In *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986), at dissolution a corporation transferred all of its assets to its officers/shareholders for past services. Outside creditors were not paid. The court pierced the corporate veil and allowed the creditors to recover from the shareholders and their new corporation.

In *Vermeer v. Dismantling Contractors, Inc.*, 90 Or 74, 751 P2d 796 (1988), the court found that the principal shareholder of one business formed another business primarily, if not exclusively, to avoid contractual obligations to a union. Applying federal law, the court pierced the corporate veil.

In *Peterson v. Harville*, 445 F Supp 16 (D Or 1977), a corporation transferred its principal asset to a second corporation for little consideration. The two corporations had common owners. The court imposed liability on the corporation's shareholders.

In *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 83 P3d 350 (2004), the Court of Appeals upheld a trial court finding that by transferring \$1 million to themselves, the controlling shareholders had “milked” the corporation because the reduction in operating capital had reduced the chances of the corporation attracting additional investors and, without these additional investors, the corporation fail.

Many milking cases involve shareholders of a failing corporation setting up a new corporation and then transferring all of the old corporation's assets to the new corporation for insufficient (often no) consideration. See for example *Allen v. Meinig*, 109 Or App 341, 819 P2d 744 (1991); *Vermeer v. Dismantling Contractors, Inc.*, 90 Or 74, 751 P2d 796 (1988); *Culinary Workers and Bartenders Union No. 596 Health and Welfare Trust v. Gateway Café, Inc.*, 91 Wash 2d 353, 588 P2d 1334 (1979).

Disregarding the corporate form may be inappropriate where the controlling shareholders pay sufficient consideration for the corporate assets. *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 85 Wash App 695, 934 P2d 715 (1997), *affirmed in part, reversed in part on other grounds*, 135 Wash 2d 894, 959 P2d 1052 (1998).

### **B. Related grounds for imposing liability.**

Many of the earlier cases which involved milking and piercing the corporate veil might today be litigated under a fraudulent conveyance theory.

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For instance, in *Bennett v. Minott*, 280 Or 339, 39 P 997, 44 P 283 (1896), a shareholder unsuccessfully attempted to avoid a personal judgment by transferring his business and assets to a newly created corporation owned by his wife and himself. The court disregarded the corporation.

In *Dairy Co-operative Association v. Brandes Creamery*, 147 Or 488, 30 P 2d 338 (1934), the court held that an old corporation was dissolved, a new corporation formed, and all the assets of the old transferred to the new, solely to avoid a disadvantageous contract between the old corporation and the plaintiff. Presumably, little consideration was paid by the new corporation for the assets of the old. Although the plaintiff's claim was against the old corporation, the court granted plaintiff relief against the new corporation. For another case with similar facts and a similar result, see *Diamond Fruit Growers, Inc. v. Goe Co.*, 242 Or 397, 409 P2d 909 (1966).

**NOTE:** Many milking cases involve "black box" facts: (i) a corporation starts by owning all assets and liabilities; (ii) an undocumented transaction occurs, often a transaction which its shareholders have difficulty explaining; and (iii) the old corporation's shareholders end up owning the old corporation's assets while the old corporation is left still in possession of the old liabilities.

To avoid charges of milking, a corporation or its shareholders should document what happens inside the black box. Agreements should recite in detail the consideration paid for the old corporation's assets. If the consideration equals or exceeds the value of the assets received, charges of milking likely will fail.

In a milking case, alternative theories of recovery may be present – such as creditor's bills, derivative suits, and direct actions against directors. *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, n 16, 654 P2d 1092, 1102 (1982); *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 85 Wash App 695, 934 P2d 715 (1997), *affirmed in part, reversed in part on other grounds*, 135 Wash 2d 894, 959 P2d 1052 (1998).

## Section 10.07      Commingling & Confusion

Commingling or confusion of corporate assets is another basis for which courts have pierced the corporate veil.

In some number of cases, shareholders have been held liable for corporate debts because of misrepresentations by the shareholder to the creditor, confusion or commingling of assets, or because the respective enterprises were not held out to the public as separate enterprises. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, 654 P2d 1092, 1102 (1982).

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If a corporation and its shareholder do not act as if there is a difference between corporate property and shareholder property, courts are inclined to do the same. One court noted, "if the officer has demonstrated disregard of the corporate form, treating the corporation essentially as a conduit for personal business affairs, the court may likewise disregard the corporate entity to avoid injustice." *Weeks v. Kerr*, 486 NE2d 10, 12 (Ind App 1985).

It is well established that where corporate affairs are confused with those of the stockholders, a subsidiary or an affiliate corporation the corporate veil may be lifted to protect persons whose rights have been jeopardized by the corporate device. (citations omitted) *Abbott v. Bob's U-Drive*, 222 Or 147, 161-2, 352 P2d 598, 605 (1960).

A single act or two of commingling is likely not enough; there needs to be significant confusion. The degree of commingling is a significant factor. *Aero Planning International, Inc. v. Air Associates, Inc.*, 94 Or App 143, 764 P2d 610 (1988).

There must be such a commingling of property rights or interests as to render it apparent that they are intended to function as one, and, further, to regard them as separate would aid the consummation of a fraud or wrong upon others. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 401, 811 P2d 221, 224 (1991)(quoting from *J.I. Case Credit Corp. v. Stark*, 64 Wash 2d 470, 475, 392 P2d 215 (1964)).

There are many Oregon cases in which confusion and/or commingling play a significant role in the court's decision to disregarding the corporate form. For example, one case held a corporation's shareholders personally liable for corporate debts citing the "commingling of personal and corporate assets." *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 482, 719 P2d 899, 903 (1986).

In *Offenbacher v. Ahart*, 2009 US Dist LEXIS 16231 (D Or 2009), defendant did not keep separate books for the corporations he owned and pushed money back and forth between the corporations and himself as needed. He deposited the proceeds from the sale of corporate assets into his personal account. The court pierced the corporate veil.

In *Emrich v. Emery*, 216 Or 88, 337 P2d 972 (1959), the court found that transactions and accounts between the corporation and its shareholder to be so hopelessly interwoven that both should be treated as one.

In *Martinson v. Andrews*, 219 Or 280, 347 P2d 53 (1959), the plaintiffs had rights to a percentage of the profits from defendant's invention. Defendant owned all of the stock of a corporation which had an nonexclusive license to the invention. All of the profits from the invention were made by the corporation and defendant received these profits through rents on the corporate offices and



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through other means. The plaintiffs did not share in the profits. The court disregarded the corporate form.

There are also several Oregon cases where personal liability has been imposed after the principals failed to disclose that they were now acting as agents of a corporation, rather than as principals. *Salem Tent & Awning v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986); *Mackenzie Engineering v. Peters*, 263 Or 20, 500 P2d 699 (1972); *Burke Machinery Co. v. Copenhagen*, 138 Or 314, 6 P2d 886 (1932).

### Section 10.08 Violations of Statute

#### A. Generally.

A violation of a statute is another basis upon which courts have pierced the corporate veil.

In a number of cases involving regulations, courts have enjoined conduct of parent corporations which, in order to evade federal or state regulation, were doing business by means of wholly-owned subsidiaries. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, 654 P2d 1092, 1102 (1982).

For example, in *United States v. Reading Co.*, 253 US 26 (1920), the court enjoined a parent railroad company from conducting mining operations through a subsidiary. At the time, railroads were themselves legally prohibited from engaging in mining operations.

On the other hand, organizing a corporation merely to obtain a tax advantage is not improper conduct sufficient to set aside the corporate form. *El Salto, S.A. v. PSG Co.*, 444 F2d 477 (9<sup>th</sup> Cir 1971).

A discussion of the liability of parent corporations for their subsidiaries' acts under particular statutes is contained in 99 HARV L REV 986 (1986)(illegal disposal of hazardous wastes) and 35 U FLA L REV 701 (1983)(workers' compensation).

An interesting issue is whether or not a corporation may recover under an insurance policy when damages are caused by an illegal act by one of its shareholders. In an action by a corporation against its fire insurance carrier for a fire intentionally set by a 50% shareholder, the Court of Appeals held that "a corporation will not be precluded from recovery simply because the arsonist owned fifty percent of its stock. Without evidence that the other shareholders acquiesced in the arsonist's conduct, the corporation is innocent of wrongdoing and should be allowed to recover for its loss." *Minnesota Bond Ltd. v. St. Paul Mercury Insurance Co.*, 72 Or App 187, 695 P2d 579, reversed on other grounds, 300 Or 85, 706 P2d 942 (1985).

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### **B. Licensing & administrative cases.**

Closely related to this issue are licensing cases where the licensing authority looks through the corporate entity at a shareholder or at a predecessor corporation to determine whether to issue or revoke a license. For example, in *Palm Gardens, Inc. v. Oregon Liquor Control Commission*, 15 Or App 20, 514 P2d 888 (1974), the OLCC was permitted to look through the corporate form at past liquor violations of the principal shareholder. See also *A.J. Rose & Son, Inc. v. Board of Funeral Directors and Embalmers*, 31 Or App 537, 570 P2d 1008 (1977).

In a 2007 Oregon Supreme Court case, the Court reversed the Court of Appeals and held an affiliated corporation liable for the debts of a failed insurance company where the two corporations were under common control and had filed untimely and inaccurate reports to the Department of Consumer and Business Services (“DCBS”) stating:

Although we agree with the general statement by the Court of Appeals that one company's failure to file timely and accurate forms or to make required deposits ordinarily would not constitute the kind of improper conduct required to pierce the corporate veil, the facts in this case lead us to conclude that CCCC and SNIC, and the individuals who controlled both of those companies, took those actions to evade government regulation and deceive DCBS. *State ex rel Neidig v. Superior National Insurance Co.*, 343 Or 434, 462,173 P3d 123 (2007).

Under the Oregon tax code (ORS 317.705), parent and subsidiary corporations can be treated as “unitary business” for tax purposes if among other things there is centralized management or a common executive force between the corporations. In *Rent-A-Center, Inc. v. Dep't of Revenue* (Or Tax May 12, 2014), the tax court found that having two executives of the parent serve on the subsidiary's board of directors, granting stock options to the CEO of the subsidiary in the parent's stock and that the promotion of the subsidiary's CEO to become CEO of the parent was insufficient to make the two corporations a “unitary business.”

## **Section 10.09 Corporate Formalities**

While a corporation's failure to observe corporate formalities is not one of the grounds for piercing the corporate veil mentioned in *Amfac*, it has been cited as a basis in a number of other cases. See for example *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000); *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986); *Rice v. Oriental Fireworks Co.*, 75 Or App 627, 707 P2d 1250 (1985); *Lambert v. Farmers Bank, Frankfort, Indiana*, 519 NE2d 745 (Ind App 1988).

However, the mere failure to conduct regular directors meetings or to

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keep proper minutes alone does not appear to be reason enough to disregard the corporation.

Although it would have been more orderly and businesslike, if the directors of the corporation had evidenced the understandings between the different stockholders by formal resolutions, rather than to proceed in the informal manner which they chose, nevertheless in such an instance as this, wherein all the stock of the corporation is owned by a few, and all or most of the stockholders are actively engaged in the enterprise of the corporation, it is often the practice to transact ordinary business without formal resolutions. (citations omitted) *Roles v. Roles Shingle Co.*, 147 Or 365, 371, 31 P2d 180, 182 (1934).

See also *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967); *Uni-Com Northwest, Ltd. v. Argus Publishing Co.*, 47 Wash App 787, 737 P2d 304 (1987); *Truckweld Equipment Co. v. Olson*, 26 Wash App 638, 618 P2d 1017 (1980).

Particularly in close corporations, courts seldom rely on this ground alone. "As to closely held corporations, in particular, action taken informally can be valid even though corporate formalities are not followed." *White v. Thatcher Financial Group, Inc.*, 940 P 2d 1034, 1037 (Colo App 1996).

[A] failure of shareholders in a closely held corporation to strictly observe corporate formalities is not relevant to our decision of whether to pierce the corporate veil of a close corporation absent evidence indicative of and amounting to a true disregard of the corporate entity. (footnote omitted) *Consumer's Co-op of Walworth County*, 142 Wis 2d 165, 419 NW2d 211, 220 (1988).

See also *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 604 P2d 1317 (1979); Section 4.04 herein.

The one corporate formality to which courts do attach particular attention is the keeping of separate financial books and records. If shareholder and corporate assets are commingled, there is a risk that a court will permit corporate creditors to look to shareholder assets for repayment. See Section 10.07 of this book.

In a divorce action, a court may look behind the corporate veil at the assets and income of a corporation owned entirely by one spouse. *State ex rel Grabhorn v. Grabhorn*, 28 Or App 357, 559 P2d 923 (1977).

On the other hand, organizing a corporation merely to obtain a tax advantage is not improper conduct sufficient to set aside the corporate form. *El Salto, S.A. v. PSG Co.*, 444 F2d 477 (9<sup>th</sup> Cir 1971).

### Section 10.10 Proximate Cause

#### A. Generally.

Injury alone is not enough to disregard the corporation. If injury alone were sufficient, the corporate form would provide little protection to

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shareholders because creditors of insolvent corporations are nearly always injured. To be held liable on a theory of corporate disregard, there must be some link between a shareholder's misconduct and the creditor's harm. Proximate cause is the third element of the *Amfac* test.

Given improper conduct by the shareholder exercising control over the corporation, the plaintiff must also demonstrate a relationship between the misconduct and the plaintiff's injury. If a shareholder's improper conduct causes no injury to a corporate creditor, there is no basis for a recovery from the shareholder. Consistent with the general policy of shareholder immunity, a shareholder's improper conduct does not give a hunting license to a corporate creditor to redress a general wrong. Surprisingly, this requirement has received little express attention in many of the appellate court opinions. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 111, 654 P2d 1092, 1103 (1982).

*Amfac* cites two examples where the absence of a causal link prevented a creditor from recovering from shareholders: *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971) and *Schlecht v. Equitable Builders, Inc.*, 272 Or 92, 535 P2d 86 (1975). In both cases, the court refused to hold a shareholder liable when the a creditor introduced insufficient evidence that the shareholder's misconduct was linked to the creditor's right to payment.

Since *Amfac*, at least five Oregon decisions have analyzed the proximate cause prong of this piercing test.

In *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (1985), plaintiffs were induced to use the corporation's escrow services through the fraud of one of its shareholders. The corporation was inadequately capitalized. After a transaction resulted in plaintiffs' loss, the corporation was unable to satisfy the judgment.

There was evidence from which the jury could have found that Daniels' and Reiersen's control was exercised in a manner "either causing plaintiff to enter the transaction with the corporation or causing the corporation's default on the transaction or the resulting obligation." Daniels negotiated the escrow services for office space agreement with Praggastis. Laeger, Praggastis' agent, was responsible for having the escrow transferred from Nevada to First Escrow. First Escrow and its shareholders had a financial interest in acting as escrow agent, because providing such services for Praggastis was in lieu of rent. A jury could have found that plaintiffs would not have agreed to have First Escrow close the exchange had they been aware of the relationship between First Escrow and Praggastis. Plaintiffs recovered a judgment against First Escrow. Because it has no assets, it has been unable to satisfy that judgment. A jury could have found that First Escrow's lack of assets was directly attributable to the failure of Daniels and Reiersen to provide adequate capital for the corporation. (citations omitted) *Gardner v. First Escrow Corp.*, 72 Or App 715, 724, 696 P2d 1172 (1985).

In *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 83 P3d 350 (2004), the Court of Appeals upheld a trial court's finding of causation between the act of the shareholders' in transferring \$1 million to themselves (thus reducing operating capital and the probability of

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attracting outside investors) and the collapse of the corporation.

The analysis in two cases is much briefer. In each, the court merely concluded that the improper conduct - primarily inadequate capitalization and milking - caused the plaintiff to have an inadequate remedy against the corporation. *Rice v. Oriental Fireworks Co.*, 75 Or App 627, 707 P2d 1250 (1985); *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986). See also *Federal Savings and Loan Insurance Corp. v. Umpqua Savings and Loan Association*, 97 Or App 250, 776 P2d 24 (1989)(party's failure to allege inability to collect debt defeats claim).

In *J.C. Compton Co. v. Brewster*, 185 Or App 382, 59 P3d 1288 (2002), *other issues reconsidered and affirmed*, 187 Or. App. 709 (2003), the court upheld jury findings that there had been improper conduct, but no damages resulting from that conduct.

In addition, a federal trial court granted summary judgment on a piercing claim because there was no evidence in the record that the corporation was unable to pay the debt. *Summit Props., Inc. v. New Tech. Elec. Contrs., Inc.*, 2004 US Dist LEXIS 13053 (D Or 2004). See also *Agristor Credit Corp. v. Schmidlin*, 601 F Supp 1307 (D Or 1985).

### **B. Recovery may be limited to sum milked.**

In cases involving inadequate capitalization or milking, a shareholder's liability to a corporate creditor may be limited to no more than the amount milked by the shareholder or to an amount no more than the difference between adequate capitalization and the amount actually contributed.

The rule contained in the text, 294 Or at 108-09, although easily stated, may not be easily applied. The damages which flow from, say, improper capitalization or milking, may or may not be limited to the amount of the shortage of capital or amount milked from the corporation. In some cases the causal relationship will be clear. In others, the causal relationship will be less clear, but still sufficient to create a question for the trier of fact. For example, if the sole effect of a shareholder milking \$200,000 from a corporation is to reduce the amount available for creditors, the shareholder's liability to corporate creditors would be limited to \$200,000. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 111, n 18, 654 P2d 1092, 1103 (1982).

Although *Gardner*, *Rice*, and *Salem Tent* each involved allegations of inadequate capitalization, none of these cases address the issue of whether a creditor could recovery an amount in excess of the initial adequate capitalization.

*Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 912 P2d 929 (1996), involved undercapitalization and milking. After noting that damages flowing from cases may involve "significant factual issues," the court upheld the decision of the trial court to limit damages against one shareholder to the sum

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improperly transferred to that shareholder alone, not the total amount milked by all shareholders.

### Section 10.11 Unpaid Subscriptions

#### A. Generally.

A shareholder is liable to the corporation for the difference between the subscription price (the amount offered for the shares in the subscription) and the amount actually paid for the shares.

At one time, each share was assigned a "par value" and a corporation could not issue a share for less than its par value. *Frankowski v. Palermo*, 47 App Div 2d 579, 363 NYS 2d 159 (1975). In effect, the aggregate par value of all of a corporation's issued and outstanding shares was deemed to be a corporation's minimum capitalization and was sometimes considered to be a trust fund for its creditors.

As discussed in Section 3.09, Oregon no longer requires that a par value be assigned to corporate shares, although a designation of par value is still permitted. ORS 60.047(2)(c)(D).

Today, there is no minimum price that a corporation must receive for its shares. But shareholders are still liable for the price they agreed to pay for the shares in their subscriptions. If a portion of this price is not paid upon issuance of the shares, the non-paying shareholders are liable to the corporation, and ultimately to its creditors, for the unpaid portion of the subscription price.

A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued or specified in the subscription agreement. ORS 60.151(1).

If the holder of a share which is not fully paid up transfers the share, the transferor ceases to be liable for the unpaid balance, provided the transfer is not made for the mere purpose of evading liability. *Walton Lumber Co. v. Commonwealth Lumber Co.*, 95 Wash 295, 163 P 762 (1917). This might occur if the transfer is made to a knowingly insolvent transferee.

After a transfer, a transferee who takes with notice that the share is not paid up becomes liable for any sum still unpaid on the original shareholder's subscription. *Smith v. Schmitt*, 112 Or 687, 231 P 176 (1924); *McAllister v. American Hospital Ass'n.*, 62 Or 530, 125 P 286 (1912); *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917); *Walton Lumber Co. v. Commonwealth Lumber Co.*, 95 Wash 295, 163 P 762 (1917). There is presumption, however, that stock is fully paid. *Smith v. Schmitt*, 112 Or 687, 231 P 176 (1924); *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917).

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**NOTE:** Article XI, Section 3 of the Oregon Constitution also provides that the liability of stockholders is limited to their unpaid subscriptions. However, Article XI, Section 3 also provides that stockholders of state banks are liable to bank depositors for an amount equal to double the par value of the shares, except if the bank is covered by federal deposit insurance.

### **B. Failure to issue shares.**

As discussed more fully in Section 3.10 of this book, a person whose subscription is accepted acquires all of the rights of a shareholder even though the corporation never actually issues a share certificate. *Babbitt v. Pacco Investors Corp.*, 246 Or 261, 425 P2d 489 (1967); *Nickum v. Burckhardt*, 30 Or 464, 47 P 788 (1897); *Lee v. Imbrie*, 13 Or 510, 11 P 270 (1886). This is true even if the subscriber has not yet paid for the shares. *Pfeifer v. DME Liquidating, Inc.*, 91 Or App 47, 753 P2d 1389 (1988), *appeal after remand*, 101 Or App 106, 753 P2d 266 (1990). "One who has subscribed and paid for corporate stock is entitled to all the rights and responsibilities of ownership, whether the stock certificates have been issued to him or not." *Haas v. Koskey*, 138 Ga App 448, 226 SE2d 279, 283 (1976).

There can be no question that an actual subscription is not always necessary in order to establish a stockholder's status as that of a subscriber.

"Any agreement by which a person shows an intention to become a stockholder is sufficient to bind both him and the corporation. When one accepts or assumes the position and duties, and claims the rights and privileges and emoluments, of a stockholder, and the corporation accepts or acquiesces therein, such person is estopped to deny that he is a subscriber, even though there may have been something irregular or defective in the form or manner of his subscription, or there may have been no formal subscription at all." *Davies v. Ball*, 64 Wash 292, 299, 116 P 833, 835 (1922)(quoting Cook on Stock & Stockholders).

Likewise, a subscriber's obligation to pay for the accepted subscription attaches even if the subscriber's name is not entered on the transfer ledger or even if a certificate is not issued. *Shiffer, Trustee v. Okenbrook*, 75 Ind App 149, 130 NE 241, 244 (1921).

### **C. Consideration permitted.**

A corporation may accept just about anything of value in exchange for its shares. *Hills v. Skagit Steel & Iron Works*, 122 Wash 22, 210 P 17 (1922). Cash is the most common consideration, but real, personal and intellectual property, promissory notes, past services and promises of future services are now all acceptable forms of consideration. ORS 60.147(2).

Before a corporation issues shares, the board of directors must make a determination as to the adequacy of the consideration. If made in good faith,

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this determination is conclusive. ORS 60.147(3); *Huson v. Portland & Southeastern Railway Co.*, 107 Or 187, 211 P 897, 213 P 408 (1923); *In the Matter of Delk Road Associates, Ltd.*, 37 BR 354 (ND Ga 1984); *Garbe v. Excel Mold, Inc.*, 397 NE2d 296 (Ind App 1979).

One older case indicates that if the form of the consideration to be paid for shares is not stated in the subscription, the consideration is deemed to be cash. *Brockway v. Ready Built House Co.*, 95 Or 386, 187 P 1038 (1920).

Once issued, there is a presumption that a share was issued for consideration and that it was fully paid. *Frisch v. Victor Industries, Inc.*, 51 Wash App 377, 753 P2d 1000 (1988); *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917).

### **D. Calls & assessments.**

A corporation's demand for the unpaid portion of a subscription is generally referred to as a "call." An "assessment" is a demand for pro rata payment by the shareholders over and above the subscription price. (Sometimes a call is also referred to as an assessment.)

Strictly speaking, the word "assessment" means a demand upon stockholders for payments above the par value of their stock to meet the money demands of creditors of the corporation; while the word "call" or "installments," strictly speaking, means the action of the board of directors or corporation demanding the payment of all or a portion of unpaid subscriptions. These two words, however, are used interchangeably in the statute of this state, and the strict legal distinction as herein given is not observed. *Wall v. Basin Mining Co.*, 16 Idaho 313, 101 P 733, 736 (1909).

Once a shareholder pays the consideration promised in the subscription, that shareholder is not liable for any additional sum. ORS 60.151(1). This is consistent with the common law.

Under the common law full paid up stock could not be assessed, and we believe it is now accepted as the general doctrine by the courts of this country that in the absence of statutory authority, or power given by the articles of incorporation, there can be no assessment against or on the paid-up stock of a corporation. To warrant the respondent, therefore, in making an assessment against the stock of the appellant, which it is conceded was fully paid up, the authority to make such assessment must be found in either the statute or the Constitution of this state or the provisions of the articles of incorporation of the respondent company. *Wall v. Basin Mining Co.*, 16 Idaho 313, 101 P 733, 734-5 (1909).

If a corporation indicates on a certificate that the share is "non-assessable," that provision becomes part of the contract between the corporation and the shareholder and the corporation is prohibited from later levying an assessment on the shares. *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 586, 21 P2d 253 (1933).

Revised Model Act § 2.02(b)(2)(v) permits a corporation to provide in its articles of incorporation that its shareholders may be liable for a specified



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amount of a corporation's debts, over and above the subscription price. Oregon did not adopt this provision.

### **E. Actions by corporation.**

The amount left unpaid on a subscription is an asset of the corporation. *Tintic Indian Chief Min. & Mill. Co. v. Clyde*, 79 Utah 337, 10 P2d 932 (1932); *Adamant Manufacturing Co. v. Wallace*, 16 Wash 614, 48 P 415 (1898).

If a subscriber gives a note in exchange for the shares, the corporation may either sue on the note or sue on the underlying subscription debt. *Doyle v. Chladek*, 240 Or 598, 401 P2d 18, *modified*, 403 P2d 381 (1965). A shareholder may not use personal debts owed to the shareholder by the corporation as an offset against the shareholder's subscription debt. *Amacher v. Western Realty Corp.*, 148 Or 611, 38 P2d 64 (1935); *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917). *But see Selig v. Hamilton*, 234 US 652 (1914).

A corporation may seek interest from the shareholder on the unpaid subscription price from the date that the subscription price was due and payable. *Mountain Timber Co. v. Case*, 65 Or 417, 133 P 92 (1913).

A subscriber's debt to a solvent corporation is an individual debt to the corporation; a subscriber is not jointly liable with other subscribers who have not paid their subscriptions. *Laing v. Hutton*, 138 Or 307, 6 P2d 884 (1932); *Shipman v. Portland Const. Co.*, 64 Or 1, 128 P 989 (1913); *Bergman v. Evans*, 92 Wash 158, 158 P 961 (1916). Subscribers may, however, seek contribution from other subscribers who have also failed to pay their full amount due. *Brundage v. Monumental Gold and Silver Mining Co.*, 12 Or 322, 7 P 314 (1885); *Hodges v. Silver Hill Mining Co.*, 9 Or 200 (1881); *Davis v. Olson*, 4 Wash App 390, 482 P2d 795 (1971); *Wilson v. Cruthers*, 176 Okla 481, 56 P2d 416 (1936).

The law in effect on the date of a subscription applies. Changes in the law which modify a subscriber's liability, at least changes which increase that liability, are unconstitutional. *Schramm v. Done*, 135 Or 16, 293 P 931 (1930); *Norris Safe & Lock Co. v. Weaver*, 81 Or 670, 160 P 807 (1916).

Subscription debts are assignable by a corporation. *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913).

### **F. Actions by creditors.**

Whether a creditor can sue a single subscriber or whether the creditor must name all creditors and all subscribers as parties to the lawsuit (e.g., through a receivership proceeding or a creditor's suit) depends on whether the corporation is solvent. If a corporation is solvent and is a going concern, an individual creditor may sue an individual shareholder. However, if a corporation is insolvent and the purpose of the lawsuit is to wind up the affairs of the

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corporation, such a lawsuit must include as parties all creditors and all shareholders within the jurisdiction.

In a suit by a creditor to enforce the individual liability of a stockholder for a debt of the corporation, it is not necessary that all the creditors of the corporation be joined, nor that all the stockholders be made defendants.

In such a suit, if a defendant stockholder desires other stockholders to be made parties, he must bring them in at his own expense by an answer or other proper proceeding.

When the object of the suit is to wind up the affairs of an insolvent corporation, and it becomes necessary to ascertain the whole amount of the indebtedness, and to whom due, and who are liable to contribute upon unpaid stock subscriptions, such suit should be in the name and for the benefit of all the creditors, and against all the stockholders found within the jurisdiction. *Rasor v. West Coast Development Co.*, 98 Or 581, 587, 192 P 631, 633 (1921)(quoting from *Brundage v. Monumental Gold & Silver Min. Co.*, 12 Or 322, 7 P 314).

See also *Wakeman v. Paulson*, 264 Or 524, 506 P2d 683 (1973).

The doctrine of laches may apply to lawsuits by creditors against shareholder for improper distributions. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1980).

## Section 10.12 Distributions Upon Dissolution

### A. Generally.

It is a well-established doctrine that upon dissolution, the assets of a corporation are to be applied first to the payment of corporate debts and then, if there are assets remaining, to its shareholders. *Smyth v. Kenwood Land Co.*, 97 Or 19, 190 P 962 (1920); *Georgia, Florida & Alabama R. Co. v. Bankers Trust Co.*, 170 F2d 733 (5<sup>th</sup> Cir 1948); *United States v. Butterworth Corp.*, 269 US 504 (1926). It is not clear what happens if the assets of the dissolved corporation are distributed to its shareholders before payment of corporate debts.

ORS 60.367(1) creates a cause of action in the corporation against directors who negligently authorize the illegal distribution.

ORS 60.367(2) provides that a director so liable may seek contribution for other, similarly situated directors and against “each shareholder for the amount the shareholder accepted knowing the distribution was” illegal.

ORS 60.367 does **not** create an action at law by creditors against directors or shareholders for illegal distributions. *Wakeman v. Paulson*, 264 Or 524, 506 P2d 683 (1973). However, creditors may be able to impose liability upon “bad faith” shareholders and negligent directors through an equitable proceeding, a bankruptcy trustee, a receiver or some other proceeding in equity. *Id.* See also *In re Sheffield Steel Corp.*, 320 BR 405 (NE OK 2004); *Rosebud Corp. v. Boggio*, 39 Colo App 84, 561 P2d 367 (1977).

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In the event assets of a dissolved corporation are distributed to the shareholders before payment of the corporation's debts, creditors may seek satisfaction from the shareholders to the extent of the distributed assets. ORS 60.645(2); *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385 (1983); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39 (1982); *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975).

More important, a creditor of a corporation can satisfy his claim against the corporation out of the assets distributed to stockholders upon dissolution. (citations omitted) *Wakeman v. Paulson*, 257 Or 542, 546-7, 480 P2d 434, 437 (1971).

*But see Walter A. Wood Reaping and Mowing Manufacturing Co. v. Angemeier*, 51 Ind App 258, 99 NE 500 (1912).

The law which sends a corporation into the world with the capacity to act imposes upon its assets liability for its acts. The corporation cannot disable itself from responding by distributing its property among its stockholders and leaving remediless those having valid claims. In such a case the claims after being reduced to judgments may be satisfied out of the assets in the hands of the stockholders. *Pierce v. United States*, 255 US 398, 402 (1921).

In such case, the creditor may recover debts owed to the corporation by shareholders only through an equitable proceeding naming all creditors and shareholders located within the jurisdiction. This also true in actions to collect improper distributions after dissolution.

From the principle thus established in this state the proper remedy of a creditor of an insolvent corporation to reach the fund alleged to have been paid to a stockholder as a dividend in liquidation is by a suit in equity and not by an action at law as commenced in the case at bar. *Garetson Lumber Co. v. Hinson*, 69 Or 605, 610, 140 P 633, 635 (1914).

While it appears certain that creditors can – using the proper procedures – impose liability upon “bad faith” shareholders, it is less clear whether shareholders who innocently accepted illegal distributions are liable.

Under Oregon law, an illegal distribution made while the corporation is insolvent is void. *Field v. Hauptert*, 58 Or App 117, 647 P2d 952 (1982); *In re Enron Corp.*, 323 BR 857 (Bankr SDNY 2005). The same is true in Washington. *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975).

The doctrine of laches applies to lawsuits by creditors against shareholders for improper distributions. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1980).

It is also possible that ORS Chapter 95 (Oregon’s fraudulent transfer statute) offers a remedy to a corporate creditor against a shareholder who received a dividend from an insolvent corporation. ORS 95.240(1) provides:

(1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the

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debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor becomes insolvent as a result of the transfer or obligation.

Some cases have held other state fraudulent transfer statutes apply to unlawful dividends. *Mancuso v. Champion*, 119 BR 106 (Bankr ND Tex 1990); *United States v. Neidorf*, 522 F2d 916 (9<sup>th</sup> Cir 1975) (interpreting California law).

The liability of directors for illegal distributions is discussed in Section 9.07 of this book.

### **B. Procedures for cutting off corporate debts after dissolution.**

As discussed in more detail in Section 12.04 of this book, ORS 60.641 and 60.644 describe the procedure for cutting off liabilities after a corporation dissolves.

In order to cut off liability for known claims, ORS 60.641 requires that a written notice be sent to claimants setting forth specific information.

In order to cut off unknown claims, ORS 60.644 requires publication of a notice and other information in a newspaper of general circulation in the county in which a corporation's principal office is located (or if its office is not in this state, then published in the county where the registered office is or was located).

Under these procedures, a claim is barred if the claimant fails to act within certain time periods. *Indiana National Bank v. Churchman*, 564 NE2d 340 (Ind App 1990); *Pacific Scene, Inc. v. Penasquitos, Inc.*, 46 Cal3d 407, 758 P2d 1182, 250 Cal Rptr 651 (1988).

But this limitation period may not apply to a known claimant who does not receive notice as required by the statute. *University of Alaska v. Thomas Architectural Products, Inc.*, 907 P2d 448 (Alaska 1995) (interpreting Washington law).