



# New Mexico Law Review

---

21 N.M. L. Rev. 429 (Spring 1991 1991)

---

Spring 1991

## Corporate Law - Piercing the Corporate Veil in New Mexico: *Scott v. AZL Resources, Inc.*

Harry Demetri Chambers

---

### Recommended Citation

Harry D. Chambers, *Corporate Law - Piercing the Corporate Veil in New Mexico: Scott v. AZL Resources, Inc.*, 21 N.M. L. Rev. 429 (1991).  
Available at: <https://digitalrepository.unm.edu/nmlr/vol21/iss2/9>

This Notes and Comments is brought to you for free and open access by The University of New Mexico School of Law. For more information, please visit the *New Mexico Law Review* website: [www.lawschool.unm.edu/nmlr](http://www.lawschool.unm.edu/nmlr)

# CORPORATE LAW — Piercing the Corporate Veil in New Mexico: *Scott v. AZL Resources, Inc.*

## I. INTRODUCTION

It is a well-settled legal fiction that corporations have independent identities separate from their owners.<sup>1</sup> Corporate assets are owned, and corporate liabilities are owed, by the corporation rather than the individual shareholders.<sup>2</sup> This limitation on shareholder liability often serves as the primary purpose of incorporation.<sup>3</sup> Once incorporated, a corporation is considered an independent entity endowed with many of the rights and responsibilities of a natural person.<sup>4</sup> Under special circumstances, however, courts disregard the separate corporate identity and hold the shareholders directly responsible for the corporation's liability. This process has been labelled "piercing the corporate veil."

This note discusses the various structural and legal contexts under which the issue of piercing the corporate veil arises<sup>5</sup> and examines New Mexico's "corporate veil" doctrine in light of *Scott v. AZL Resources, Inc.*,<sup>6</sup> a case in which the New Mexico Supreme Court refused to pierce the corporate veil. This note analyzes each of the three elements of New Mexico's corporate veil doctrine and offers an explanation for the supreme court's refusal to pierce the corporate veil in *Scott*.<sup>7</sup>

## II. GENERAL BACKGROUND

The issue of piercing the corporate veil commonly arises in a number of structural settings that pertain to the relationship between the owners and the corporation. These settings include, but are not limited to, actions against: (1) a single individual shareholder or small group of shareholders of a closely held corporation;<sup>8</sup> (2) an affiliated group of corporations with a common shareholder or shareholders;<sup>9</sup> or (3) a parent corporation with one or more subsidiaries.<sup>10</sup>

---

1. H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 14-15 (1983). The theory that corporations are imaginary but legal persons in and of themselves, separate from their owners, goes back as far as Roman and Canon law. *Id.*

2. *See id.* at 344.

3. *Id.*

4. For example, like natural persons, the United States Constitution protects corporations against unreasonable searches and seizures, deprivation of liberty or property without due process of law, and denial of equal protection of the law. Corporations, however, do not enjoy the fifth amendment privilege against self-incrimination. *Bellis v. United States*, 417 U.S. 85 (1974); *Oklahoma Press Publishing Co. v. Walling*, 327 U.S. 186, 208-09 (1946); *Sinking-Fund Cases*, 99 U.S. 700 (1879); *Munn v. Illinois*, 94 U.S. 113 (1877).

5. *See infra* notes 8-34 and accompanying text.

6. 107 N.M. 118, 753 P.2d 897 (1988). For an in depth discussion of *Scott*, see *infra* notes 35-89 and accompanying text.

7. *See infra* notes 90-106.

8. *See, e.g.*, *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968).

9. *See, e.g.*, *Walkovszky v. Carleton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).

10. *See, e.g.*, *Berger v. Columbia Broadcasting Sys., Inc.*, 453 F.2d 991 (5th Cir.), *cert. denied*, 409 U.S. 848 (1972).

In addition to the structural settings, the notion of disregarding the corporate entity arises in various legal contexts as well. For example, the corporate entity itself is usually a taxpayer. Yet, if the owner of a corporation forms and operates a corporation for the sole purpose of avoiding or minimizing taxes, as opposed to any other legitimate business purpose, the corporate entity will be ignored.<sup>11</sup>

In the context of criminal statutory law, the issue of disregarding corporateness sometimes arises when a state desires to hold a corporation's officers and directors criminally liable for the corporation's violation of anti-trust laws.<sup>12</sup> In *Nelson Radio & Supply Co. v. Motorola*,<sup>13</sup> the plaintiff filed a Sherman Anti-Trust<sup>14</sup> suit against a corporation for alleged conspiracy with the corporation's officers in restraint of trade. Although the officers were not named as defendants, the plaintiff wanted the court to hold the officers individually liable, along with the corporation, for the corporation's misconduct.<sup>15</sup> The court held<sup>16</sup> that the officers could not be separated from the corporation because the officers did not act in their own interest, disregarding the concerns of the corporation.<sup>17</sup>

Because a parent corporation may become a creditor of its subsidiary, the issue of disregarding corporateness occasionally arises in bankruptcy, receivership, and corporate reorganization proceedings where the subsidiary has become insolvent<sup>18</sup> while owing money to the parent.<sup>19</sup> Under these circumstances, the court must determine whether to uphold the entity, and thereby allow a parent/creditor's claim against the subsidiary, or to determine that the two corporations are one and the same entity, and therefore disallow the claim made by the parent.<sup>20</sup> Courts often reach their decision regarding this issue by applying what is known as the "fairness" test.<sup>21</sup> This test simply requires a court to base its decision on the fairness and equities of the case.<sup>22</sup>

---

11. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

12. See H. HENN & J. ALEXANDER, *supra* note 1, at 365.

13. 200 F.2d 911 (5th Cir. 1952), *cert. denied*, 345 U.S. 925 (1953).

14. Sherman Anti-Trust Act, 15 U.S.C. §§ 1-7 (1985 & Cum. Supp. 1991).

15. *Nelson Radio*, 200 F.2d at 914.

16. *Id.* "A corporation cannot conspire with itself any more than a private individual can, and the general rule is that the acts of [officers] are the acts of the corporation." The court acknowledged, however, that a corporation and its subsidiaries can be guilty of a conspiracy in restraint of trade. *Id.*

17. *Id.*; see also *Johnston v. Baker*, 445 F.2d 424 (3d Cir. 1971); *Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd.*, 416 F.2d 71 (9th Cir. 1969), *cert. denied*, 396 U.S. 1062 (1970); *Tamaron Distrib. Corp. v. Weiner*, 418 F.2d 137 (7th Cir. 1969); *Cott Beverage Corp. v. Canada Dry Ginger Ale, Inc.*, 146 F.Supp. 300 (S.D.N.Y. 1956), *appeal dismissed*, 243 F.2d 795 (2d Cir. 1957) (holding that individual directors, who were persons acting for the corporation within the scope of their employment, could be held personally liable under the Clayton Act and the Robinson-Patman Price Discrimination Act).

18. See *Kapp v. Naturell, Inc.*, 611 F.2d 703 (8th Cir. 1979); *Bass v. Shutan*, 259 F.2d 561 (9th Cir. 1958).

19. See H. HENN & J. ALEXANDER, *supra* note 1, at 369-71.

20. *Id.*

21. *Id.* at 370-71.

22. See *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939).

The corporate entity is rarely ignored solely for the purpose of benefiting the shareholder.<sup>23</sup> In *Colin v. Altman*,<sup>24</sup> a corporate landlord sought a certificate of eviction for a tenant of an apartment owned by the corporation. Pursuant to a New York rent control regulation, the court could issue a certificate of eviction when the landlord, in good faith, sought to recover possession of housing accommodations for his own use because of immediate and compelling necessity. The landlord, who was the sole shareholder of the corporation owning the apartment, urged the court to regard him and the corporation as one and the same entity for the purpose of recovering possession of the rental property. The court refused, declaring that "[i]t must be obvious that the landlord . . . is an individual owner as distinct from other legal entities. A corporation has no compelling necessity to occupy housing accommodations. . . ."<sup>25</sup> The court stated further that "the corporate veil is never pierced for the benefit of the corporation or its shareholders."<sup>26</sup>

The area of law in which the corporate veil issue is most common, however, is imposition of liability<sup>27</sup> for a corporation's obligations resulting from tortious conduct or a breach of contract.<sup>28</sup> The injured party may be a tort victim wronged by a poorly financed corporation.<sup>29</sup> In this situation, the question is typically whether the shareholder has acted improperly to avoid liability by establishing a "dummy" corporation with insufficient funds to cover potential tort liability.<sup>30</sup>

In contract cases<sup>31</sup> where the issue of disregarding the corporate entity arises, courts frequently look to the factors which the contracting parties relied upon, the persons who performed particular obligations, and the parties' intentions concerning responsibility for resulting liability.<sup>32</sup> In *Scott v. AZL Resources, Inc.*,<sup>33</sup> the New Mexico Supreme Court refused to disregard the corporate fiction and refused to hold the shareholder parent corporation liable for its subsidiary's breach of contract. After acknowledging that disregarding the corporate entity is an equitable remedy in New Mexico, the court declared that only upon a showing that the parent corporation controls or dominates a subsidiary for an improper

23. See H. HENN & J. ALEXANDER, *supra* note 1, at 307.

24. 39 A.D.2d 200, 333 N.Y.S.2d 432 (App. Div. 1972).

25. *Colin*, 39 A.D.2d at 201, 333 N.Y.S.2d at 433.

26. *Id.*

27. Injured plaintiffs do not always seek to disregard corporateness for the purpose of overstepping a financially weak corporation in order to reach the "deep pockets" of its owners. In *John Willey & Son v. Livingston*, 376 U.S. 543 (1964), a small corporation merged into a larger corporation, and the large corporation was held bound by the small corporation's agreement to arbitrate with a union.

28. See H. HENN & J. ALEXANDER, *supra* note 1, at 348-52.

29. See, e.g., *Black & White, Inc. v. Love*, 236 Ark. 529, 367 S.W.2d 427 (1963).

30. *Id.* at 532, 367 S.W.2d at 430.

31. See Clark, *Piercing The Corporate Veil In Florida: The Requirement of "Improper" Conduct*, 16 STETSON L. REV. 59 (1986).

32. See H. HENN & J. ALEXANDER, *supra* note 1, at 351.

33. 107 N.M. 118, 753 P.2d 897 (1988).

purpose will the court ignore the corporate entity and consider the parent corporation and the subsidiary to be one entity.<sup>34</sup>

### III. STATEMENT OF THE CASE<sup>35</sup>

AZL Resources, Inc. ("AZL"), an Arizona corporation, was a holding company which owned several subsidiary businesses throughout the United States. Included in AZL's holdings were three ski resorts: Baca Grande, Breckenridge, and Angel Fire. Baca Grande and Breckenridge were separately incorporated in Colorado, and Angel Fire was incorporated in New Mexico.<sup>36</sup> All three resorts experienced financial losses from 1974 to 1979. As a result, in October of 1979, Baca Grande entered into a five-year contract with James Scott to serve as Chairman and Chief Executive Officer ("CEO") of Baca Grande, Angel Fire, and Breckenridge. The contract was executed by S. M. Spangler, the President and CEO of AZL. Spangler, however, did not sign the contract in his capacity as president of AZL.<sup>37</sup> Spangler had held a number of high level positions, including president, with Baca Grande until approximately two weeks prior to the signing of the contract. When the contract was signed, Spangler was not the president of Baca Grande, although he did hold a managerial position with the company. Some of Baca Grande's letterheads, however, represented Spangler to be in the capacity of president.

The arrangement specifically required Scott to devote his full time to assisting in the development and management of the three resorts. He was barred from engaging in any other business activities during the contract period. As of February 1980, however, Scott had not applied more than two-thirds of his full time under the contract. As a result, he was relieved as Chairman and CEO of Baca Grande and Breckenridge.<sup>38</sup> He then filed a contract claim in the Santa Fe County District Court against AZL, Baca Grande, Breckenridge, and Angel Fire.<sup>39</sup>

Subsequently, on the merits, the jury found that there was a valid contract between James Scott and Baca Grande and returned a verdict

---

34. *Id.* at 121, 753 P.2d at 900; *see also* Harlow v. Fibron Corp., 100 N.M. 379, 682 P.2d 40 (Ct. App.), *cert. denied*, 100 N.M. 439, 671 P.2d 1150 (1983); Ize Nantan Bagowa, Ltd. v. Scalia, 118 Ariz. 439, 577 P.2d 725 (Ct. App. 1978).

35. Brad Coryell contributed much of the information concerning the facts and history of the case. Mr. Coryell was one of the trial attorneys retained by the defendants.

36. Interview with Brad Coryell, attorney for defendants. Early in the case, Baca Grande and Breckenridge moved for summary judgment on grounds of lack of personal jurisdiction. Their motion was denied.

37. *Id.* Spangler also served as CEO of Baca Grande at one time. It is unknown, however, whether he was CEO of Baca Grande at the time the contract was signed. Upon special interrogatories, the jury found that the contract was between Baca Grande and James Scott.

38. *Id.* Scott had previously been relieved of his duties at Angel Fire. He was reassigned the position of consultant to Baca Grande. However, he rejected the assignment and filed suit in the District Court of Santa Fe County.

39. *Id.* The complaint also named Tosco Corporation, Maurice F. Strong, as CEO of AZL, and S. M. Spangler, as President and CEO of AZL.

in favor of Scott against Baca Grande for \$583,971.00.<sup>40</sup> Baca Grande, however, did not have adequate funds to cover the damage award. The court then, *sua sponte*, concluded that each of the subsidiaries were the "alter ego" of AZL, disregarded the corporate entity, and held each defendant jointly and severally liable for the judgment against Baca Grande.

On appeal, the supreme court reversed, declaring that "only under special circumstances will the courts disregard the corporate entity to pierce the corporate veil holding individual shareholders or a parent corporation liable. This is done where the corporation was set up for fraudulent purposes or where to recognize the corporation would result in injustice."<sup>41</sup> The court followed the general rule concerning piercing of the corporate veil, holding that "[t]hree requirements must be satisfied to obtain this relief: a showing of instrumentality or domination, improper purpose, and proximate cause."<sup>42</sup> The following sections discuss this general rule and its application in *Scott* and other related New Mexico cases.<sup>43</sup>

#### IV. RATIONALE

In *Scott*,<sup>44</sup> the New Mexico Supreme Court announced that there must be a showing of "instrumentality or domination, improper purpose, and proximate cause" in order to obtain relief under the equitable remedy of piercing the corporate veil. The main inquiry in most cases is the scope of the rule's application. While most courts have no trouble stating the legal principle with respect to disregarding the corporate entity, they struggle with the facts of a specific case to define "instrumentality" and "improper purpose." Thus, the next section highlights some of the circumstances courts have recognized as "instrumentalities" and "improper purposes."<sup>45</sup>

##### A. Instrumentality

Instrumentality has been recognized as the most difficult element of the equitable remedy of piercing the corporate veil.<sup>46</sup> This element requires a plaintiff to prove that the corporation was not established or operated in a legitimate fashion to serve its valid goals, but rather functioned

---

40. *Scott*, 107 N.M. at 118, 753 P.2d at 897. The jury found that the contract was valid and that Scott's termination was unjustified. The award of \$583,971.00 included the following: \$390,466 for Scott's salary; \$17,100 for fringe benefits; \$3,907 for unpaid expenses; and \$172,498 for incentive compensation.

41. *Id.* at 121, 753 P.2d at 900.

42. *Id.* at 118, 753 P.2d at 897.

43. There will also be various references to cases from other jurisdictions.

44. 107 N.M. 118, 753 P.2d 897 (1988).

45. See Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENVER L.J. 1, 16 (1978). Instrumentality and improper purpose have proved to be the rule's most difficult elements. This article does not discuss proximate cause in great detail because proximate cause seems to be presumed when the other elements are met.

46. *Id.*

under the domination, control, and for the purpose of the shareholder or shareholders.<sup>47</sup> This domination must be more than the general domination that all shareholders exert over their corporations. Additionally, the domination and control must be substantially related to the transaction under attack.<sup>48</sup> The difficult question is how much domination and control is sufficient to render the subsidiary an instrumentality of the parent corporation.

Although there is no single set of factors which define all of the factors relating to instrumentality, Professor Powell has provided some guidance. Powell suggests that a combination of the following factors may indicate that the corporation is a mere instrumentality of its shareholders:

- (a) The parent corporation owns all or most of the capital stock of the subsidiary.
- (b) The parent and the subsidiary corporations have common directors or officers.
- (c) The parent corporation finances the subsidiary.
- (d) The parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation.
- (e) The subsidiary has grossly inadequate capital.
- (f) The parent corporation pays the salaries and other expenses of the subsidiary.
- (g) The subsidiary has substantially no business except with the parent corporation, or no assets except the one conveyed to it by the parent corporation.
- (h) In the papers of the parent corporation or in statements by the officers, the subsidiary is described as a department of the parent corporation.
- (i) The parent corporation uses the property of the subsidiary as its own.
- (j) 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.
- (k) The formal legal requirements of the subsidiary are not observed.<sup>49</sup>

The difficulty is that these factors have been said to be merely "indicia," and even the presence of all of these factors will not compel a holding of instrumentality. In many cases, the presence of some or most of these factors tends to establish the subsidiary as a mere instrumentality of the parent corporation and not a separate entity.<sup>50</sup> In other cases, however, courts find the instrumentality factor satisfied even if most of these factors are not present.<sup>51</sup> This suggests two things: first, the Powell factors are by no means a fully satisfactory test for determining instrumentality;

---

47. *Id.*

48. See F. POWELL, PARENT AND SUBSIDIARY CORPORATIONS § 6 (1931).

49. *Id.*

50. Krendl & Krendl, *supra* note 45, at 16.

51. See *Cable v. Raynel Camper, Inc.*, 90 Nev. 341, 526 P.2d 334 (1974)

and second, courts assign various and differing weights to the factors.<sup>52</sup>

In New Mexico, the instrumentality element is referred to as the "alter ego" doctrine.<sup>53</sup> In *Cruttenden v. Mantura*,<sup>54</sup> the New Mexico Supreme Court established the general guidelines for determining instrumentality in New Mexico. In *Cruttenden*, the plaintiff served a writ of garnishment on the Marriott Corporation ("Marriott")<sup>55</sup> for collection of an unpaid debt incurred by an employee of Marriott's foreign subsidiary.<sup>56</sup> The court held that there was insufficient evidence to support a finding that the foreign subsidiary was the alter ego of Marriott. In making its decision, the court recognized factors similar to those identified by Professor Powell.<sup>57</sup> The court noted that the only facts in the record relating to the relationship between Marriott and the subsidiary were: (1) the latter was organized under Maryland law as a subsidiary of Marriott; and (2) all foreign activities which were previously conducted by Marriott were assigned to the foreign subsidiary. According to the court, these factors did not establish instrumentality.<sup>58</sup>

Sometimes the court is not as willing to look closely at the actions of the defendant corporation, but rather looks at what the plaintiff knew or should have known about the relationship between the contracting parties.<sup>59</sup> In *Southern Exploration Co. v. Wynn Exploration Co., Inc.*,<sup>60</sup> Southern Union sued R.C. Wynn on a contract between Wynn Oil and Southern Union. R.C. Wynn was the sole shareholder of Wynn Oil.<sup>61</sup> The basis of the plaintiff's argument was that Wynn Oil was the alter ego of R.C. Wynn and, therefore, the court should disregard the corporate entity of the former and hold the latter liable on the contract. The court concluded that because the plaintiff "knowingly" contracted with Wynn Oil, rather than with R.C. Wynn individually, an asserted inability to collect all of the judgment from Wynn Oil was not a basis for relieving the plaintiff from a choice knowingly made.<sup>62</sup>

*Southern Exploration* demonstrates that a court may scrutinize another factor when determining instrumentality in contract cases: it may consider what the plaintiff knew about the party with whom he was contracting. If the plaintiff was aware that he was dealing with the subsidiary and

---

52. Krendl & Krendl, *supra* note 45, at 17.

53. See *Harlow v. Fibron*, 100 N.M. 379, 671 P.2d 40 (Ct. App.), *cert. denied*, 100 N.M. 439, 671 P.2d 1150 (1983); *Cruttenden v. Mantura*, 97 N.M. 432, 640 P.2d 932 (1982); *Scott Graphics, Inc. v. Mahaney*, 89 N.M. 208, 549 P.2d 623 (Ct. App. 1976).

54. 97 N.M. 432, 640 P.2d 932 (1982).

55. Apparently, plaintiff attempted to sue Marriott because there was no jurisdiction over the subsidiary. *Id.* at 434, 640 P.2d at 934.

56. *Id.* The subsidiary was a foreign corporation organized by Marriott for the purpose of conducting all foreign activities.

57. *Id.* at 435, 640 P.2d at 935.

58. *Id.*

59. See *Bank of New Mexico v. Northwest Power Products*, 95 N.M. 743, 626 P.2d 280 (Ct. App. 1980).

60. 95 N.M. 594, 624 P.2d 536 (Ct. App. 1981).

61. R.C. Wynn also owned Wynn X, a separate corporation. *Id.* at 597, 624 P.2d at 539.

62. *Id.* at 600, 624 P.2d at 542.

not with the parent corporation, the court will be less likely to find the subsidiary to be the alter ego of the parent.<sup>63</sup>

In *Scott*, the defendants argued that the court should not disregard the corporate entity of Baca Grande because Scott knew with whom he was dealing when he entered into the contract with Baca Grande.<sup>64</sup> The New Mexico Supreme Court then reviewed the factors recognized by the trial court in its determination that each of the three resorts were the alter ego of AZL.<sup>65</sup> The supreme court, however, did not draw its own conclusion with regard to the instrumentality issue. Rather, it avoided the question by stating:

Nonetheless, it is clear that the ownership by one corporation of all or a majority of the stock of the other, or that the corporations have common officers and directors, or both, is not sufficient by itself to render a parent liable on its subsidiary's contract. . . . Mere control by a corporation is not enough to warrant piercing the corporate veil. . . . [W]e must still determine whether AZL's dominion or control was used for fraud or other improper purposes.<sup>66</sup>

The New Mexico Court of Appeals stated a similar proposition in *Harlow v. Fibron*.<sup>67</sup> "[A]ssuming, but not deciding, that the alter ego doctrine is applicable . . . , the dispositive question is whether the three defendants used [the corporation] for an improper purpose."<sup>68</sup>

This discussion demonstrates the difficulty of determining when control of a corporation crosses the line and reduces the corporation to the mere instrumentality of its owners. In fact, courts often skip the instrumentality inquiry and move to the second requirement—"improper purpose." The following section discusses what kinds of purposes the New Mexico courts consider improper.

### B. Improper Purpose

In addition to establishing that the subsidiary corporation was a mere instrumentality of the parent, the piercing the corporate veil rule requires a showing that the parent used the subsidiary for an "improper purpose."<sup>69</sup> In *Scott*, the court described "improper purpose" as "[s]ome form of moral culpability attributable to the parent, such as use of the subsidiary to perpetrate a fraud. . . ."<sup>70</sup> The policy supporting the element of im-

63. This problem is elevated in situations where the plaintiff contracts with a "one [person] corporation." What should courts do when the corporation and the shareholder are the same person? The "one [person] corporation" is in a unique position. The law requires the shareholder to treat the corporation as something apart from himself. A failure to maintain this distinction may result in creating the impression that the business is a purely personal and individual venture. See Wittman v. Whillingham, 85 Cal. App. 140, 259 P. 63 (1927).

64. *Scott*, 107 N.M. at 121, 753 P.2d at 900.

65. *Id.*

66. *Id.* at 121-22, 753 P.2d at 900-01.

67. 100 N.M. 379, 671 P.2d 40 (Ct. App.), cert. denied, 100 N.M. 439, 671 P.2d 1150 (1983).

68. *Id.* at 382, 671 P.2d at 43.

69. *Scott*, 107 N.M. at 122, 753 P.2d at 901.

70. *Id.*

proper purpose is that although the instrumentality requirement might be met, there still might not be improper intent on the part of the parent corporation.<sup>71</sup>

"Fraud" and "lack of economic substance" are the two major factors contributing to a finding of improper purpose.<sup>72</sup> It is easiest for a plaintiff to show fraud. A plaintiff can establish fraud by demonstrating that the parent corporation used the subsidiary to intentionally deceive creditors or other contracting parties.<sup>73</sup> Under New Mexico law, however, proving fraud is generally difficult because it "requires a false representation with intent to deceive, and this must be established by clear and convincing evidence."<sup>74</sup> Additionally, the New Mexico Rules of Civil Procedure provide that claims for fraud must be plead with particularity.<sup>75</sup>

Undercapitalizing a corporation and operating it at a loss show lack of economic substance.<sup>76</sup> Merely operating a corporation at a loss may be insufficient to establish improper purpose.<sup>77</sup> However, when the owners deceitfully drain all monetary funds from the corporation, thus rendering it incapable of covering legal liabilities, the improper purpose requirement is met.<sup>78</sup> Although some courts<sup>79</sup> have held that undercapitalization is one of the only factors necessary to establish improper purpose, New Mexico requires more.<sup>80</sup> In *Scott*, there was evidence that the three ski resorts were financially weak. The court announced, however, that "a party seeking to pierce the corporate veil must show that the financial setup . . . is a sham and caused an injustice. Mere proof that the [subsidiary] is now insolvent is insufficient."<sup>81</sup>

In addition, mismanagement resulting in lost profits has also been shown to be insufficient in establishing improper purpose. In *Scott Graphics, Inc. v. Mahaney*,<sup>82</sup> where the directors and officers ignored corporate operations to a substantial degree, the court held "[t]hese things in and of themselves are not enough to warrant disregarding the corporate entity."<sup>83</sup>

---

71. See Krendl & Krendl, *supra* note 45, at 18. In fairness to the parent corporation and in support of the policy of limited liability, there must be a showing of improper purpose.

72. *Id.* at 28. Other improper purposes include evasion of statutes, misrepresentation, and participation.

73. See Clark, *supra* note 31, at 76.

74. See Harlow, 100 N.M. at 384, 671 P.2d at 45.

75. Sup. Ct. Rules Ann. 1-009(B) (Recomp. 1986) (N.M.R. Civ. P.). It is not clear, however, whether this statute requires the same standard for allegations of fraud for the purpose of disregarding the corporate entity. See also *Scott Graphics, Inc. v. Mahaney*, 89 N.M. 208, 212, 549 P.2d 623, 627 (1976); *Unser v. Unser*, 86 N.M. 648, 653, 526 P.2d 790, 795 (1974).

76. See Krendl & Krendl, *supra* note 45, at 35.

77. *Id.*

78. *Id.*

79. *Id.* at 34. Some California cases have emphasized undercapitalization to the exclusion of other factors to justify a finding of improper purpose. See, e.g., *Minton v. Cavaney*, 56 Cal.2d 576, 364 P.2d 473 (1961); W. CARY, CORPORATIONS 127 (4th ed. 1976).

80. See *Scott*, 107 N.M. at 122, 753 P.2d at 901; *Harlow*, 100 N.M. at 383, 671 P.2d at 45.

81. *Scott*, 107 N.M. at 122, 753 P.2d at 901; see also *Ize Nantan Bagowa, Ltd. v. Scalia*, 118 Ariz. 439, 443, 577 P.2d 725, 729 (Ct. App. 1978).

82. 89 N.M. 208, 549 P.2d 623 (1976).

83. *Id.* at 212, 549 P.2d at 627.

Likewise, in *Scott*, the court noted that the mere fact that "Baca Grande lost large sums of money" was insufficient to support a finding of undercapitalization or any other improper purpose.<sup>84</sup> The court did, however, suggest the circumstances under which the lack of economic substance may constitute an improper purpose. "It must be shown that the losses or mismanagement resulted from fraudulent manipulation of the corporation."<sup>85</sup> Here, the requirements of culpability or intent to deceive arise again.

Finally, the court recognized the legitimacy of "zero balance accounts." Under this system, surplus from all of AZL's subsidiaries went into a central bank account controlled by the subsidiaries. As a result, each subsidiary showed a zero cash balance at the end of each accounting period. Management chose this form of accounting to enable subsidiaries to borrow money from the central account rather than obtaining a loan from a commercial bank. This procedure also eliminated the risk of not qualifying for loans from commercial banks. The system additionally required borrowing subsidiaries to repay both the borrowed money and interest at the market rate. Moreover, the depositing subsidiaries earned interest on their money. *Scott* argued that this method of accounting was used to avoid having enough money to pay for potential liabilities.<sup>86</sup> The New Mexico Supreme Court held that the use of this form of accounting was insufficient to satisfy a showing of improper purpose because AZL did not profit in any way from the use of this type of accounting.<sup>87</sup>

### C. Proximate Cause

The general policy supporting the requirement of proximate cause is that liability resulting from disregarding the corporate entity will not be recognized unless the plaintiff can prove that damages actually resulted from the parent corporation's control over the subsidiary for an improper purpose. Finally, there must be a showing that the control by the parent corporation and the improper purpose caused the plaintiff some damage.<sup>88</sup> No New Mexico corporate veil cases discuss proximate cause in great detail.<sup>89</sup> Aside from stating this requirement in the rule, the court in *Scott* did not offer any discussion of proximate cause. Apparently, the court regarded this issue as moot because it had already concluded that there was no improper purpose.

## V. ANALYSIS

In New Mexico, a plaintiff must prove three elements before a court will disregard the corporate entity for the purpose of imposing liability

---

84. 107 N.M. at 122, 753 P.2d at 901.

85. *Id.*

86. *Id.*

87. *Id.* The court did not go into detail in explaining why the use of zero balance accounting alone was insufficient to establish a showing of improper purpose.

88. See Krendl & Krendl, *supra* note 45, at 21.

89. *Id.* at 22.

on a shareholder:<sup>90</sup> (1) instrumentality; (2) improper purpose; and (3) proximate cause.<sup>91</sup> Although it has been suggested that courts have the most difficulty determining how much control and domination is sufficient to meet the first requirement of instrumentality, the mere existence of a parent/subsidiary relationship often satisfies this element.<sup>92</sup> The third requirement, proximate cause, is rarely discussed by the courts,<sup>93</sup> probably because it is unnecessary to inquire into the issue of proximate cause if improper purpose is not established.

Although there has been substantial discussion of instrumentality, and some discussion of proximate cause, most New Mexico cases focus on the second element of improper purpose. If the plaintiff can show a substantial degree of culpability or dishonesty on the part of the parent corporation, the court is likely to find that the parent corporation used the subsidiary for an improper purpose.<sup>94</sup> If the court finds improper purpose, there is generally no difficulty finding that the other two requirements are also satisfied.<sup>95</sup>

Most jurisdictions appear to be unwilling to disregard the separateness of corporations for the purpose of assigning liability to the owners.<sup>96</sup> One of the reasons for this unwillingness is the fact that "piercing the corporate veil" is an equitable concept.<sup>97</sup> Therefore, courts are required to decide whether or not to pierce the veil based upon fairness, rather than a particular rule of law.<sup>98</sup> In most cases, courts, after applying the three elements of the rule, do not find sufficient unfair conduct to justify disregarding the separateness of corporations.<sup>99</sup>

In *Scott*, the supreme court concentrated on the improper purpose requirement for piercing the corporate veil and failed to adequately discuss the instrumentality and proximate cause requirements.<sup>100</sup> The court proclaimed that neither mismanaging nor undercapitalizing a corporation are improper purposes.<sup>101</sup> The court acknowledged, however, that a parent's use of a subsidiary for the purpose of perpetrating a fraud is an improper purpose.<sup>102</sup> The court did not discuss what types of purposes, other than the fraudulent manipulation of a corporation, may meet the element of

---

90. See *Scott*, 107 N.M. at 121, 753 P.2d at 900.

91. *Id.*

92. Krendl & Krendl, *supra* note 45, at 16.

93. The research involved in drafting this note revealed no cases or articles offering any significant discussion regarding the "proximate cause" element.

94. See Krendl & Krendl, *supra* note 45, at 18.

95. In fact, there is often an overlapping of factors recognized in considering instrumentality and improper purpose. See *Harlow v. Fibron*, 100 N.M. 379, 383, 671 P.2d 40, 44 (Ct. App.), *cert. denied*, 100 N.M. 439, 671 P.2d 1150 (1983). "Undercapitalization is considered a factor in determining whether the alter ego doctrine applies . . . and is also a factor to be considered in determining . . . improper purpose." *Id.*

96. See generally Krendl & Krendl, *supra* note 45; Clark, *supra* note 31.

97. Krendl & Krendl, *supra* note 45, at 2; Clark, *supra* note 31, at 65.

98. *Id.*

99. See generally Krendl & Krendl, *supra* note 45; Clark, *supra* note 31.

100. *Scott*, 107 N.M. at 121, 753 P.2d at 900.

101. *Id.* at 122, 753 P.2d at 901.

102. *Id.*

improper purpose.<sup>103</sup> This fact leaves the corporate lawyer with the impression that a parent corporation's fraudulent manipulation of its subsidiary is the only conduct that will satisfy the improper purpose element.

Because the court did not discuss any other improper purposes, it is unclear whether the court could have found that AZL used Baca Grande for an improper purpose and ultimately pierced the veil.<sup>104</sup> If a corporate attorney follows the guidelines established by Professor Powell<sup>105</sup> relating to the existence of instrumentality, there are strong indications that Baca Grande was a mere instrument of AZL. Moreover, there is no question that had the court found that the elements of mere instrumentality and improper purpose existed, the court would have also found that proximate cause existed.

## VI. CONCLUSION

There may be a partial explanation for the failure of New Mexico courts to pierce the corporate veil. The principal purpose of incorporation is to avoid shareholder liability for the acts of the corporation.<sup>106</sup> If a New Mexico court disregards the separateness of a corporation and holds its owner liable when there is no evidence of any culpable behavior on the part of the owner, other potential shareholders may be discouraged from incorporating in New Mexico. New Mexico corporations might also change their state of incorporation. Relative to other states, New Mexico currently suffers a dearth of corporations to support its economy. Although New Mexico Courts have never discussed this concern, it is probable that this economic concern was considered in *Scott* and the other cases involving the issue of piercing the corporate veil.

HARRY DEMETRI CHAMBERS

---

103. *Id.*

104. *Id.*

105. See *supra* text accompanying note 49.

106. See H. HENN & J. ALEXANDER, *supra* note 1, at 14-15.