The Alter Ego Doctrine: Alternative Challenges to the Corporate Form

Antoinette Sedillo Lopez
University of New Mexico - Main Campus

Follow this and additional works at: http://digitalrepository.unm.edu/law_facultyscholarship

Recommended Citation
Available at: http://digitalrepository.unm.edu/law_facultyscholarship/220

This Article is brought to you for free and open access by the School of Law at UNM Digital Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of UNM Digital Repository. For more information, please contact disc@unm.edu.
THE ALTER EGO DOCTRINE: ALTERNATIVE CHALLENGES TO THE CORPORATE FORM

INTRODUCTION

A corporation is ordinarily considered by law to be an entity separate from its shareholders. As such, the corporation’s shareholders have limited liability for obligations of the corporation. This rule of limited liability is challenged when someone seeks to “pierce the corporate veil” and impose liability for corporate debts or other obligations on the shareholders. In order to im-

1. One of the first cases to enunciate this rule was Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) (“A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.”). See also Sayers v. Texas Land & Mortgage Co., 78 Tex. 244, 247, 14 S.W. 578, 579 (1890) (“The creation of the corporation was authorized by law, and upon its formation it became an artificial being, distinct from its corporators.”). Courts are often preoccupied with whether a business concern is a “juristic entity” for various reasons. See, e.g., Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), where the court struggled with the issue of whether a business should be treated as a single piece of property or be divided up into inventory, cash receivables, fixtures, merchandise, etc., for capital gains treatment. The majority held that it should be divided up into its fragments and separately treated. The dissent opined that when a business is sold as a unit, the whole is greater than its parts.

2. There is no doubt that as a general principle the members are not liable for a corporation’s debts . . . . The principle is sometimes known as the rule of “limited liability,” because it does not relieve corporate members of liability for the amounts they have promised to contribute as the dues of membership, or in consideration for shares.

A. CONARD, CORPORATIONS IN PERSPECTIVE 424 (1976) (footnotes omitted).


4. “The converse of the recognition of corporateness in some instances of defective incorporation is the disregard of corporateness in various cases of technically-correct incorporation. Such disregard, in terms of metaphor, is often called ‘piercing the corporate veil.’” H. HENN, supra note 3, at 250 (footnotes omitted). See also Bartle v. Home Owners Coop., 309 N.Y. 103, 106, 127 N.E.2d 832, 833 (1955) (“Piercing the corporate veil” is necessary to prevent fraud.).

5. A corporation possesses the limited liability attribute of a separate entity only because state business corporation acts so provide. See Hamilton, The Corporate Entity, 49 Tex. L. Rev. 979, 981 (1971). See also, e.g., MODEL BUSINESS CORP. ACT § 25 (1979); “A holder of or subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the
pose personal liability on the corporation's shareholders in a particular case, the party raising the challenge must convince the court to disregard the concept of the corporation as a separate entity. Usually, the challenge is directed at the limited liability rule. A court's decision to ignore the perception of the corporation as a separate entity is commonly referred to as an application of the alter ego doctrine.6

obligation to pay to the corporation the full consideration for which such shares were issued or to be issued.”


In general, corporate authority is delegated, while partners have inherent authority to engage in partnership business. See E. LATTY & G. FRAMPTON, supra, at 43—44, 68—70. In addition, corporate shareholders enjoy limited liability, while partners are personally liable for partnership debts. See A. FREY, CASES AND MATERIALS ON CORPORATIONS AND PARTNERSHIPS 3—18 (1951), for an overview of the difference between partnership and corporation liability rules. When a person believes he or she is dealing with a partnership because of a representation of the entity, and he or she is in fact dealing with a corporation, the corporation can be said to be using the corporate form in “bad faith.”


In order to determine whether the separate corporate entity concept should be disregarded, the court considers several factors. These factors include: 1) whether the corporation is undercapitalized; 2) whether there was an attempt to adequately capitalize; 3) whether there was commingling of corporate and individual funds; 4) whether the corporation was an “instrumentality” of the shareholders; 5) whether the plaintiff was aware that the defendant and the corporation were not the same entities; 6) whether plaintiff relied upon plaintiff’s belief that he/she was dealing with some entity; 7) whether the corporation had by-laws; 8) whether the entities had the same employees and whether the employees received salaries; 9) whether there was an intent or desire on the part of the individuals and the corporation to act separately; 10) whether the entities employed the same attorney; 11) whether the corporation was used as a conduit for a single venture or the business of an individual or another corporation; 12) whether there was a disregard of formalities; 13) whether there was a
Sometimes, however, the concept of the corporation as a separate entity is challenged for reasons other than to impose personal liability on shareholders. Parties asserting these alternative challenges seek to benefit from the way the law affects business associations. Courts deciding these cases often employ the same alter ego analysis used in cases where the limited liability rule is challenged. The traditional alter ego analysis is often inadequate when applied in these cases and, as a result, rulings are often inconsistent. Further, the courts have failed to articulate adequate reasons for their decisions.

This Comment examines alternative challenges to the separation of entities: (1) whether the corporation was used as a subterfuge for illegal transactions; (2) whether the corporation failed to maintain arms-length relationships among related entities; (3) whether the corporation kept minutes. Courts examine this list in typical alter ego cases where creditors seek to pierce the corporate veil to impose liability on the shareholders. No single factor suffices to justify the challenge to the limited liability aspect of the separate entity concept. See DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681 (4th Cir. 1976); Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Zaist v. Olson, 154 Conn. 563, 227 A.2d 552 (1967); Walkovszky v. Carlton, 18 N.Y.2d 414, 222 N.E.2d 721, 276 N.Y.S.2d 585 (1966). See also infra notes 42—50 and accompanying text.

7. See infra notes 70—116 and accompanying text. This Comment will use the terms “alter ego” and “piercing the corporate veil” for instances when the corporate form is disregarded for the purpose of challenging the limited liability rule. The phrase “disregard the corporate entity” will be used when the corporate form is challenged for other purposes.

8. For example, some usury laws protect individual borrowers but not corporate borrowers. E.g., N.Y. GEN. OBLIG. LAW § 5-521(1) (McKinney 1978): “No corporation shall hereafter interpose the defense of usury in any action.” See also infra note 103. A challenge to the corporate entity would thus determine whether the statute protects corporate borrowers. Hence, this type of challenge is quite different from the more typical case where a successful challenge would impose shareholder liability.

9. See infra notes 70—116 and accompanying text.

10. See infra notes 70—116 and accompanying text.

11. See infra notes 70—116 and accompanying text.

12. See infra notes 70—116 and accompanying text. Other unusual challenges to the corporate form are:

   a. Personal jurisdictional purposes. Courts have used alter ego analysis to determine whether a parent corporation was subject to personal jurisdiction because of the activities of its subsidiary. E.g., Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925). Essentially, the Court in Cannon read the alter ego doctrine into state long-arm statutes as a jurisdictional test. Id. at 337. Recent lower court decisions, however, have indicated that the alter ego doctrine is not a jurisdictional test. For example, in Energy Reserves Group, Inc. v. Superior Oil Co., 460 F. Supp. 483 (D. Kan. 1978), the court specifically stated that alter ego analysis was not the proper method of determining whether the state had personal jurisdiction over a parent corporation. The court held that mere formal separation of corporate identities does not raise a constitutional barrier to the exercise of jurisdiction over a non-resident whose affiliated corporation has a substantial nexus with the forum. The intercorporate relationship between the parents and subsidiaries was found to be a sufficient contact with the forum so that jurisdiction over the corporation would not offend traditional notions of fair play and substantial justice.

   b. Diversity jurisdiction. In Lavin v. Lavin, 182 F.2d 870, 871 (2d Cir. 1950), the
rate entity fiction.\textsuperscript{13} First, it will analyze the economic policies underlying the separate entity concept\textsuperscript{14} and the justification for imposing shareholder liability in typical alter ego cases.\textsuperscript{15} Second, this Comment will review cases in which the corporate entity is challenged for alternative purposes and demonstrate how the usual alter ego analysis fails in these cases.\textsuperscript{16} Finally, this Comment proposes a three-stage analysis for examining alternative challenges to the separate entity fiction.\textsuperscript{17} The proposal would require courts to analyze the facts of the cases, identify the policies underlying the challenge, and balance the economic and non-economic policies that would be either furthered or frustrated by disregarding the separate corporate entity concept.\textsuperscript{18} This Comment will then demonstrate the utility of this framework by showing how the analysis would work in cases involving alternative challenges.\textsuperscript{19}

I. Typical Alter Ego Case

One of the main reasons for incorporation is limiting the owners' liability.\textsuperscript{20} As a result, two categories of conflicting policies emerge: those supporting the entity concept,\textsuperscript{21} and those justifying the imposition of personal liability on shareholders.\textsuperscript{22}
A. Policies Supporting the Separate Entity Concept

Originally, corporations were grants from the English Crown authorizing individuals to unite and form enterprises. These early corporations were municipalities that constructed roads and irrigation systems for the common benefit. Later, corporations developed into business entities. In the United States, legislatures acknowledged the evolution of the corporate form by enacting business codes authorizing corporate existence. Today, corporations derive from these codes their authority to carry on activities as separate entities. Limited liability is an adjunct to regarding the corporation as a separate entity.

The primary reason for treating the corporation as a separate entity is to encourage the efficient operation of a free enterprise system. Efficiency is achieved by reducing transaction costs, streamlining business operations, and encouraging the aggregation of large amounts of capital. The separate entity status furthers these goals by providing a convenient and efficient form for transacting business. The limited liability rule serves to diversify investor risks and to subsidize the corporate entities by allocating risks to tort creditors of insolvent corporations.

1. Convenience and Efficiency

The states' business corporation acts accord to corporations

---

24. Id.
26. Cf. H. Henn, supra note 3, at 30 ("At the state level are the basic laws governing the formulation of business associations.").
27. Limited liability was not the general rule until the middle of the 19th century. This attribute may have been given to corporations more because of legislative concern with lagging industrial production than with judicial concern with the separate entity concept of the corporation. E. M. Dodd, American Business Corporations Until 1860, at 380—84 (1954). Courts do not always consider the limited liability attribute inviolate and have imposed liability on shareholders to punish those who have used the separate entity privilege in bad faith. See infra notes 53—63 and accompanying text.
30. See infra notes 32—41 and accompanying text.
31. See infra notes 42—52 and accompanying text.
32. This Comment will use the Model Business Corp. Act (1979) as the example of a state statute which creates the corporate form. The Model Act was the basis
For the corporation statutes in Alabama (adopted in 1959), Alaska (adopted in 1957),
Arizona (adopted in 1975), Arkansas (adopted in 1965), California (adopted in 1977),
Colorado (adopted in 1958), Connecticut (modified and adopted in 1959), Georgia
(adopted in 1969), Iowa (adopted in 1959), Maryland (modified and adopted in 1951),
Massachusetts (modified and adopted in 1965), Mississippi (adopted in 1962), Ne-
braska (adopted in 1963), New Jersey (modified and adopted in 1968), New Mexico
(adopted in 1967), New York (modified and adopted in 1963), North Carolina (modi-
fied and adopted in 1955), North Dakota (adopted in 1957), Oregon (adopted in
1953), Rhode Island (adopted in 1969), South Carolina (modified and adopted in
1962), South Dakota (adopted in 1965), Tennessee (adopted in 1968), Texas (adopted
in 1955), Virginia (adopted in 1956), Washington (adopted in 1965), West Virginia
(adopted in 1953), and Wisconsin (adopted in 1951). See generally Model Business
Corporation Act (1978). The Model Business Corporation Act has been adopted in substance

transaction costs by obviating the need for each owner to meet and make every deci-
sion concerning the corporation. Instead, the shareholders/investors vote for the
persons they believe will operate the corporation most effectively. Id. § 36. Of course,
investors must bear the risk of loss from such decisions as well as the profits.

34. Id. § 4(b).
35. Id. § 4(d), (e), (g).

A corporation's ability to hold and convey property avoids the difficulty of deter-
ing which owner should own and convey property, the inconvenience of having to
find all the owners to convey jointly-held property, and the complicated questions of
control and management that would arise if the property were held either jointly or
separately. Thus, the entity concept greatly decreases the transaction costs and diffi-
culties associated with property owned for business purposes.

36. Id. § 4(f), (h).

Since business codes allow a corporation to contract as an entity, the risk and
cost of non-performance is distributed among the corporation's owners.

37. Id. § 4(a).

Since corporate business can continue functioning beyond the death or departure
of the owners, third parties can depend on the business entity's indefinite existence; a
corporation does not have to reorganize, restructure, and rebuild every time its own-
ship changes.

38. Id. § 4(f), (h).

Because corporations can borrow money as entities, a lender need only examine
the credit history of the corporation and not that of its owner. As a result, transaction
costs are greatly decreased. State business codes also authorize corporations to exer-
cise all other necessary or convenient powers to achieve their purposes, giving them

separate entity attributes that makes a corporation a convenient
and cost efficient form by which to transact business. One such
attribute is separate, centralized management, which relieves in-
vestors of the duty of managing the business and lessens the trans-
action costs of the decision-making process.33 Another facilitating
aspect of corporate codes allows corporations to sue or be sued as
entities,34 thus avoiding the costs and difficulty of joining all a cor-
poration's owners as plaintiffs or defendants. In the interests of
convenience and efficiency, state statutes also permit corporations
to hold and convey property,35 contract as an entity,36 and con-
tinue operating beyond the death or departure of the owners.37
Corporations can borrow money and exercise all other necessary
or convenient powers to achieve their purposes as entities.38
In addition, a corporation is taxed separately from its owners and must file its own tax forms. A corporation may be a "debtor" under the bankruptcy laws and thus may take advantage of the relief afforded insolvent debtors notwithstanding the solvency of the corporation's owners. Court decisions according "personal" rights and privileges to corporations exemplify the reification of corporations through use of the separate entity concept.

These separate entity attributes make the corporate form a convenient and cost efficient medium for transacting business. The convenience aspect of corporate separateness, however, is not challenged in typical alter ego cases. Instead, the plaintiffs in typical alter ego cases attack the limited liability rule, which diversifies risk and subsidizes the corporate entity.

2. Risk Diversification

The limited liability aspect of corporate status encourages investment by allowing investors to diversify their risk, thus reducing the cost of amassing capital for productive enterprise. The limited liability aspect of corporations allows individuals to invest without fear of losing their personal assets.


41. For example, the Supreme Court has held that a corporation is a "person" under the due process clause of the fourteenth amendment. See Grosjean v. American Press Co., 297 U.S. 233, 244 (1936). See also Oklahoma Press Co. v. Walling, 327 U.S. 186, 208-09 (1946) (a corporation enjoys the right of the "people" to be secure against unreasonable searches and seizures); Diplomat Elec., Inc. v. Westinghouse Elec. Supply Co., 378 F.2d 377, 381 (5th Cir. 1967) (a corporation may sue for defamation); Radiant Burners, Inc. v. American Gas Ass'n, 320 F.2d 314, 322-23 (7th Cir.) (a corporation is a "client" and entitled to invoke the attorney-client privilege), cert. denied, 375 U.S. 929 (1963); Burnham, The Attorney-Client Privilege in the Corporate Arena, 24 BUS. LAW. 901, passim (1969) (citing Radiant Burners and other cases holding that a corporation may invoke the attorney-client privilege).


43. If individuals can invest fractions of their savings in various enterprises without risking debilitating losses when any one enterprise becomes insolvent, the cost of raising capital is reduced, and individual investment is stimulated.

Given a choice between investing in a risky enterprise with high returns and
Risk diversification and the aggregation of large amounts of capital are strong economic justifications for limited liability.\(^4\) These economic attributes are essential to the stimulation and development of industry in a free enterprise system.\(^4\) Therefore, the judiciary must have compelling reasons to ignore the limited liability rule in order to impose liability on shareholders.\(^4\)

3. Subsidizing the Corporate Entity

In some instances, the limited liability aspect of separate entity status acts as a subsidy to insolvent corporate tortfeasors.\(^4\) When an insolvent corporation commits a tort, innocent third parties—tort victims—must absorb the loss. Since the victims are unable to negotiate in advance to avoid the limited liability rule,\(^4\) essentially they become involuntary creditors\(^4\) and must absorb investing in a safe enterprise with lower returns, most individuals opt for the safer investment unless the promised return compensates them for taking the risk. This phenomenon is called risk aversion. In order to compensate individuals for taking large liability risks, corporations would have to promise a higher return on investment, which would increase the cost of amassing capital. As long as individuals believe that not all their capital is subject to liability, they will accept lower returns because they can diversify their risk by spreading their capital investment over various enterprises. See P. O'Donnell, Taking the Plunge: Many New Investors Have Modest Means But Large Ambitions, Wall St. J., Jan. 30, 1981, at 1, col. 5. O'Donnell describes new investors as younger and less risk averse than their predecessors. He concludes that because these investors were not in the market during 1973 and 1974, and did not remember "lean years" in the market, they tend to be less risk averse than their predecessors.

44. Limited liability is an aspect of corporateness because it was and still is a basic assumption of businessmen. It is not an "essential" characteristic of corporateness, but an attribute "which, for reasons of social expediency, seems desirable to attach to the modern corporation." The attributes of corporateness are determined by the economic and social environment of the time: "[W]hat laws propose, the underlying forces of economics dispose." A. Dewing, Financial Policy of Corporations 14—16 (5th ed. 1953). Cf. Deiser, The Juristic Person, 57 U. Pa. L. Rev. 131 (1908) (implicitly regards the immunity of shareholders as merely an incident of the corporation's holding of property, but not a necessary incident). Both Dewing and Deiser suggest that the two concepts are not logically, legally, or historically coextensive.

45. Cf. W. Klein, supra note 13, at 75—79 (discussing the problems of raising capital in the context of partnerships).

46. See infra notes 53—59 and accompanying text.

47. This is true for all tort creditors of insolvent corporations. In general, however, contractual creditors negotiate around the limited liability rule. See, e.g., Teller v. Clear Serv. Co., 9 Misc. 2d 495, 498—99, 173 N.Y.S.2d 183, 186 (N.Y. Sup. Ct. 1958). In Teller, the effect of carrying on the business of owning and operating taxicabs through multiple corporations was to limit the liability on a suit by the injured party.

48. Most entities and individuals contracting with financially weak corporations do so by requiring personal guarantees or charging a higher rate of interest. Cf. R. Posner & K. Scott, Economics of Corporation Law and Securities Regulation 269 (1980).

49. Professors Posner and Scott maintain that the limited liability aspect of incorporation does not externalize the risk of loss. Rather, the risk is paid for by the corpo-
their losses when the corporation is insolvent. Conven7;ience, risk diversification, and business subsidization are important reasons for maintaining the separate entity concept and for declining to impose corporate liability on shareholders. Courts should accord these policies different weights, however, depending on their importance. In any event, in order for shareholders to enjoy the privilege of limited liability courts generally require that they act in good faith.

B. Justification for Imposing Shareholder Liability

In every case in which courts impose shareholder liability, the shareholders arguably have acted in bad faith. Many of the metaphors used to justify imposing shareholder liability imply

ration because third parties either negotiate for more favorable terms to pay for the risk, or require guarantees or other provisions to reduce the risk. They conclude, however, that unlimited liability would discourage risk averse investors and that most individuals are risk averse. Id. at 269.

50. Id. at 268—70.

While this may encourage some entrepreneurs to form small business ventures, it may also promote undercapitalization. In Harris v. Curtis, 8 Cal. App. 3d 837, 841, 87 Cal. Rptr. 614, 617 (1970), the court defended the grossly undercapitalized corporation:

There is no question that the corporation was underfinanced, a condition not uncommon among new small businesses, including small corporations privately financed. It is common knowledge that many such corporations have been highly successful, that others have prospered but without legendary success, and that still others have failed in part, at least, because of inadequate capital. Such is the story of our American enterprise system.

"Thin" corporations can take advantage of the limited liability rule, using it in lieu of insurance as a shield from personal liability. See, e.g., Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966) (ownership of taxi fleet vested in many corporations, with each owning one or two cabs, thus allowing the corporations to operate with minimum capitalization and without insurance).

Although subsidization of small business ventures serves the valid economic policy of encouraging growth, it also frustrates the important tort policy of making tortfeasors pay for those losses that they caused. R. Posner & K. Scott, supra note 48, at 271. Because this economic consequence of the limited liability rule involves a fairly narrow category of cases and thwarts a strong tort policy, subsidization is not nearly as strong a reason as is the diversification of risk policy for retaining the separate entity status.

51. For instance, tort subsidization should not be weighed as heavily as either convenience or diversification because the latter two serve important economic goals and neither one has a countervailing undesirable effect.

52. See all cases cited in § 1.

53. Id. For example, when an attorney cheated his client by forming a sham corporation, the court asserted that his bad faith behavior justified piercing the corporate veil. Clark v. Millsap, 197 Cal. 765, 242 P. 918 (1926) (corporation was at all times the attorney's alter ego and was employed by him to perfect the scheme by which he cheated his client).
bad faith. The list of factors courts generally examine in deciding whether to pierce the corporate veil includes criteria that directly indicate bad faith behavior. Other factors imply bad faith more subtly. For instance, in traditional alter ego analysis, courts implicitly find bad faith when the officers or shareholders of a grossly undercapitalized corporation deceive third parties into believing that they are contracting with individuals rather than with a corporation. Requiring shareholders to act in good faith is justifiable because the policies served by the limited liability rule rest on an assumption of good faith behavior.

54. For example, "cloak," "creature," "sham," "shell," and "snare," etc. In discussing these metaphors, Professor Hamilton noted that:

[i]his language is inherently unsatisfactory since it merely states the conclusion and gives no guide to the considerations that lead a court to decide that a particular case should be considered an exception to the general principle of nonliability. A systematic analysis, moreover, is not readily discernible in the cases, and many courts continue to rely on metaphors to explain their results.


55. For example, either an intent to perpetrate a fraud, see, e.g., Design Assocs., Inc. v. Welch, 224 Cal. App. 2d 165, 36 Cal. Rptr. 341 (1964), or a corporation used "as a subterfuge of illegal transactions," see, e.g., Arnold v. Browne, 27 Cal. App. 3d 386, 395, 103 Cal. Rptr. 775, 782 (1972), constitute bad faith behavior.


57. Cf. Harris v. Curtis, 8 Cal. App. 3d 837, 843, 87 Cal. Rptr. 614, 619 (1970) (court refused to pierce the corporate veil despite undercapitalization because plaintiff was not deceived into believing that he was dealing with individuals rather than with a corporation); Carlesimo v. Schwebel, 87 Cal. App. 2d 167, 172 (1948) (court refused to pierce the corporate veil where it was clear to plaintiff that he was dealing with the officer of a corporation and not with an individual). If such implicit bad faith does not exist, undercapitalization by itself is not enough to justify piercing the corporate veil. As other factors in the traditional shopping list—such as whether the corporation had by-laws, or kept minutes—do not imply bad faith, courts have not imposed shareholder liability when only such innocuous factors existed. See, e.g., Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962) (bad faith is always an underlying consideration where the trial court was justified in disregarding the corporate entity); Luis v. Orcutt Town Water Co., 204 Cal. App. 2d 433, 22 Cal. Rptr. 389 (1948) (showing of bad faith is prerequisite for piercing corporate veil).

58. See supra notes 42—50 and accompanying text.

59. See supra notes 42—50' and accompanying text.
C. Overview

The alter ego doctrine has not developed into a cogent body of law. The tension between stare decisis and the judiciary's desire to do justice in every case has turned a fact-oriented examination of "bad faith" into a mechanical application of factors that have only limited usefulness as precedent. The traditional alter ego analysis, while often plagued with problems of mechanical and uneven application, is useful when the question before the court is whether to afford to the shareholders the benefits of limited liability. The crucial difference between typical alter ego cases and the types of alternative challenges which this Comment examines is that the alternative challenges are di-

60. Grossman, Alter Ego: A Perplexing Doctrine, 51 L.A.B.J. 233 (1975). See Montgomery, The Alter Ego Type Defenses Reconsidered, 13 FORUM 528 (1978), for a criticism of the use of the standard analysis and the phrase "alter ego" in fidelity bond cases. Montgomery maintains that it is actually the sole actor doctrine or sole representative theory which is advanced. The fidelity insurer seeks to impute knowledge of fraud or dishonesty to the corporate insured in order to support one or more special defenses.

61. Strictly speaking, stare decisis is not a rule of law, but a matter of judicial policy. Geohegan v. Union Elevated R. Co., 266 Ill. 482, 496—97, 107 N.E. 786, 792—93 (1915); Muller v. Nebraska Methodist Hospital, 160 Neb. 279, 282—83, 70 N.W.2d 86, 88—89 (1955), overruled on other grounds, Myers v. Drozda, 180 Neb. 183, 141 N.W.2d 852 (1966). It simply involves a court's reliance on a prior court's decision to guide it in rendering a decision in the case before it. Higher court decisions are binding on lower courts, and courts at the same level of the judicial branch should decide cases consistently.

62. The alter ego doctrine has been shaped by two basic policies of the law: "stare decisis" and "justice in each case." Because these policies are inconsistent, they push and pull at each other, forming the list of factors presently comprising the law of "piercing the corporate veil." The overriding goal of courts applying the alter ego doctrine is to secure a just and equitable result. This consideration is especially important in alter ego cases because of the equitable nature of the doctrine as well as the vague nature in which courts have identified the policies underlying it.

63. See, e.g., United Paperworkers Int'l Union v. PennTech Papers, Inc., 439 F. Supp. 610, 617—18 (D. Me. 1977) (some degree of moral culpability on the part of the parent corporation must be shown, even if a subsidiary is found to be an alter ego or instrumentality of the parent), aff'd, 583 F.2d 33 (1st Cir. 1978).

64. See supra note 6.

65. Summarizing the existing case law, Professor Latty states: "What the formula comes down to, once shorn of verbiage about control, instrumentality, agency, and corporate entity, is that liability is imposed to reach an equitable result." E. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 191 (1936). See also Claremont Press Publishing Co. v. Barksdale, 187 Cal. App. 2d 813, 817, 10 Cal. Rptr. 214, 217 (1960) (all that is required to disregard the corporate entity is that it would be unjust to recognize it as a corporate entity).

rected solely at the fiction of separateness. The key issue asks whether a court should recognize the entity fiction when the parties challenging it actually prefer that the court disregard the entity so that they may accomplish other objectives. In these cases, the factor analysis fails because courts consider neither the policies underlying the separate entity concept nor the other policies underlying the alternative challenge. When the corporate form is challenged for purposes other than imposing liability on shareholders, the policies underlying the challenge are not exactly the same as those underlying the alternative challenge to the limited liability rule. In alternative challenge cases, courts should examine other justifications for disregarding the separate entity concept.

II. ALTERNATIVE CHALLENGES TO THE SEPARATE ENTITY FICTION

Parties challenge the fiction that a corporation is separate and distinct from its shareholders in various situations. The cases can be divided into two broad categories: the challenge of one party to the separate entity status of another, and the shareholders' and/or corporation's challenge to its own corporate separateness.

A. One Party Challenges the Separate Entity Status of Another

In typical alter ego cases where the limited liability rule is challenged, the party raising the challenge attempts to show that the corporation should not be viewed as a separate entity. In contrast, certain alternative challenge cases utilize the same procedural posture but challenge a different aspect of the separate entity theory.

1. Setoff Cases

In order for a defendant to obtain a setoff against a plaintiff's claim, the debt must be mutual and must exist between both parties. Since a corporation is viewed as separate from its owners, the general rule is that obligations of shareholders or subsidiaries to a defendant may not be set off against the corporation's

67. See infra notes 70—117 and accompanying text.
68. See supra note 6.
69. Setoff "is defined as a remedy employed by a defendant to discharge or reduce plaintiff's demand by an opposite one arising from a transaction which is extrinsic to the plaintiff's cause of action." Edmonds v. Stratton, 457 S.W.2d 228, 232 (Mo. Ct. App. 1970). In some cases it may be replaced by the counterclaim. See, e.g., Fed. R. Civ. P. 13. "Of course, setoff is not permitted when it would impair stated capital or prejudice the rights of corporate creditors." H. HENN, supra note 3, at 267.
70. Cf. H. HENN, supra note 3, at 267.
claim against the defendant, and vice versa. In practice, this normally means that if a shareholder in his individual capacity sues a party who has a claim against the shareholder's corporation arising out of a collateral matter, the corporation's debt can not be set off against the shareholder's claim. This result is sound when large, publicly owned corporations are involved because of the complexity of their financial structure. The result also is consistent with the basic policies supporting diversification of investors' risk. In cases where the corporation is solely owned or where there are affiliated parent and subsidiary corporations, the rule against setoff frustrates the policies of efficiency and convenience that underly the separate entity fiction.

a. One-person corporations. Courts usually refuse to allow setoffs in controversies involving solely owned corporations. Two lawsuits often result when the dispute could have been settled in one. In cases where the owner and the corporation cannot be joined as defendants, the fiction of the separate entity serves little purpose and disregarding the fiction avoids an unnecessary second lawsuit. By raising a procedural obstacle to what could

71. See McLendon v. Galloway, 216 Ga. 261, 116 S.E.2d 208 (1960). McLendon involved a cross-complaint filed by the buyers of a corporation against the seller to have the seller's indebtedness to the corporation and damages resulting from the seller's alleged fraud in misrepresenting the corporate debt set off against the buyer's indebtedness to the seller for the unpaid balance of the purchase price. The Georgia Supreme Court held that the buyers were not entitled to setoff because the corporation was separate from the owners of the corporation's stock.


73. Schneider & Manko, Going Public—Practice, Procedure, and Consequences, 15 VILL. L. REV. 283, 289-90 (1970). Among many of the complexities of public corporation financing, the authors discuss the problems of determining the number of shares to be offered and their prospective price. The authors conclude that this is a matter of judgment. Factors to consider in determining the amount of public investment that can profitably be employed in the business are "the company's need for funds and the dilution in earnings per share to result from the additional issuance of stock." Id. at 290.

74. See supra notes 42-46 and accompanying text.

75. See infra notes 78—81 and accompanying text.

76. See infra notes 82—88 and accompanying text.

77. See supra notes 32—41 and accompanying text.

78. See, e.g., Gallagher v. Germania Brewing Co., 53 Minn. 214, 54 N.W. 1115 (1893).

79. If the claims against the owner and the corporation do not arise out of the same transaction or occurrence the two often cannot be joined. See Fed. R. Civ. P. 20(a).

80. See State Trust & Sav. Bank v. Hermosa Land & Cattle Co., 30 N.M. 566, 240 P. 469 (1925) (explained in Barber's Super Mkts. v. Stryker, 84 N.M. 181, 187, 500 P.2d 1304, 1310 (1972), as resting on agency principles). Indeed, in State Trust, had the court recognized the separate entity fiction, the defendant would have had to file a separate lawsuit to recover against the plaintiff for misrepresentation. There, Wigmore contracted with Hopewell, the president of Hermosa corporation, to buy a ranch, which was the corporation's sole asset. Instead of taking title to the ranch
be a neat settlement of all of the disputes between the parties in one lawsuit, the court frustrates the convenience policy underlying the separate entity concept. In sum, when a court decides one-shareholder corporation setoff disputes by rigid adherence to the fiction of the separate entity, the corporate form is an inconvenience.

b. Parent and subsidiary corporations. For a variety of reasons, owners of a business often choose to conduct the enterprise in two or more corporate entities rather than as a single entity. In cases where there are affiliated parent and subsidiary corporations, courts should allow a defendant to set off debts of a subsidiary corporation against the claim of the plaintiff parent corporation, and vice versa. When the parent and the subsidiary, although in form two or more separate entities, are actually one business, and one is obligated to indemnify the other for any loss, multiple lawsuits can be avoided by disregarding the separate entity concept and allowing setoff. The judges deciding these personally, Wigmore arranged to buy all of the stock in the corporation and then pay for the stock with notes of the corporation. Wigmore took corporate stock to limit his personal liability to Hopewell, and Hopewell made false representations about the ranch to induce Wigmore to buy it. After Wigmore refused further payment on the notes because of the misrepresentation, Hopewell sued the corporation on the notes and won at trial. After an exhaustive discussion of alter ego cases, the court held that if enforcing the fiction of the separate entity in the particular case would have inequitable results, the corporate veil should be pierced. Id. at 572—77. The court disregarded the corporate fiction to reveal the real nature of the transaction: Wigmore had purchased the ranch as an individual and was being sued for the balance of the purchase price. The court allowed Wigmore to set off the damages he suffered because of Hopewell's misrepresentation.


82. Professor Landers has suggested several reasons for conducting business with two corporate forms rather than one: “to separate functions for administrative ease, to control many businesses with a minimal capital investment, to comply with various legal requirements, to minimize liability, or to insulate certain assets from liability for other activities, and [to avoid taxes].” Landers, A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy, 42 U. CHI. L. REV. 589, 589 (1975).

83. See id. Landers suggests that the historical background indicates that limited liability was never intended to protect a parent corporation against liability for the debts of its subsidiary. Id. at 618. But see R. POSNER & K. SCOTT, supra note 48, at 271—84.

84. For detailed explorations of the problem, see I. M. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS (1927); Douglas & Shanks, Insulation from Liability through Subsidiary Corporations, 39 YALE L.J. 193 (1929); Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 CALIF. L. REV. 12 (1925).

parent/subsidiary cases often look to irrelevant factors and do not consider whether the policies supporting the concept of the corporation as a separate entity are served in such situations. By treating the businesses as one entity and consolidating two lawsuits into one, business risk still would be diversified with respect to investors and loss still would fall on the same shareholders, but the transaction costs would be reduced.

2. Conduits Through Which Other Defenses May Be Interposed

Some courts have disregarded the corporate entity to enable parties to raise otherwise untenable defenses. For example, in *Kahili, Inc. v. Yamamoto*, the plaintiff corporation lost its suit to

---


85. See generally Douglas & Shanks, supra note 84, and cases cited therein for examples of the often irrelevant factors examined by courts in parent/subsidiary alter ego cases. At one point the authors state:

The statement that the insulation will be broken down when the subsidiary is an "agency," "adjunct," "instrumentality," "alter ego," "tool," "corporate double," or "dummy" of the parent is not helpful. These concepts themselves need defining. At best they merely state results. And the results are significant only in light of the facts. The conclusion that the parent will be held liable only when the use of the subsidiary is a "cloak for fraud" or is "inequitable," "unjust," or "unconscionable" also falls short of describing the standard of conduct which the facts of most of the cases permit.

Id. at 195.

86. See, e.g., Ambridge Borough v. Philadelphia Co., 283 Pa. 5, 12, 129 A. 67, 69 (1925) (court found no "fraud or bad faith [or] unfair dealing" that would justify ignoring separate corporate identities and affirmed the lower court without discussing whether treating the parent and its subsidiaries as one corporation to secure the repair of streets would harm policies favoring the treatment of parent and subsidiary corporations as separate entities). For a discussion of the policies supporting the separate entity fiction, see supra notes 28—50 and accompanying text.

87. The business risk is diversified with respect to investors because there is only one "real" investor—the parent corporation. See W. Klein, supra note 13, at 153—58, for a discussion of the phenomenon of risk diversification.

88. The transaction costs are lower because defending one lawsuit is generally less costly than defending two, especially in light of attorney fees and the demands made by litigation on the defendant's time.

89. E.g., Wohlhuter v. St. Charles Lumber & Fuel Co., 25 Ill. App. 3d 812, 323 N.E.2d 134 (1975). In this case the two shareholders attempted to raise accommodation party defenses under Ill. Ann. Stat. ch. 26, § 3-606 (1963) (Illinois Uniform Commercial Code provision regarding impairment of recourse or collateral). The court held that since the shareholders were the only owners of the corporation, the loan was important to the interest of the corporation, and the note was signed in a personal and corporate capacity, the shareholders were principals on the note and could not raise the statutory defenses. The shareholders unsuccessfully attempted to use an alter ego type argument to assert that they were separate and distinct from the corporation and hence were accommodation parties.

enforce a contract because of the unreasonable conduct of its principal shareholders. The shareholders of Kahili, Lee and Lyum, had obtained an option on a sublease from Yamamoto and assigned the option to their corporation. A provision of the option contract provided that the seller, Yamamoto, was to obtain the consent of the tenants before the interest could be sold. If the tenants did not consent, Yamamoto was to refund the option price. When asked to consent, the tenants’ assignee, Bishop Trust Company, expressed concern that Kahili would not be able to fulfill its responsibilities as landlord since it was thinly capitalized. Bishop Trust Company asked Lee and Lyum to guarantee Kahili’s performance as landlord, but the shareholders refused. The Trust Company then refused to approve the sale of the sublease to Kahili. Based on Yamamoto’s failure to get Bishop Trust Company’s approval, Kahili sued for a refund of the option price. The court denied recovery, holding that the plaintiff’s acts had made the defendant’s performance impossible. The court recognized that it was not Kahili but rather Kahili’s shareholders who had made the performance impossible, yet the court treated Lee and Lyum as “alter egos” of Kahili. Thus, the alter ego doctrine enabled the seller to argue that when a party to a contract prevents the performance of a condition, the other party has a valid excuse for non-performance.

The court’s analysis of the challenge to the corporate entity, however, was not adequate. The court merely stated that “other courts have . . . under certain circumstances, disregarded the corporate entity.” Following this unilluminating explanation of precedent, the court cited a string of typical alter ego cases from other jurisdictions. In its cursory exploration of the facts in Kahili, the court emphasized the shareholders’ relationship to the corporation, noting that they continued to transact business in their individual capacities even after the assignment, but the court failed to explain the significance of the relationship beyond stating that Lee and Lyum had used Kahili as an “instrumentality.” In addition, the court noted that Kahili was capitalized with only $2,000 and found that Kahili’s undercapitalization, in combination with Lee and Lyum’s use of the corporation for their individual business affairs, justified Bishop Trust Company’s refusal to

Owners Coop., Inc., 309 N.Y. 103, 106, 127 N.E.2d 832, 833 (1955) (containing broad statements that under certain circumstances a court properly may disregard the corporate entity).

91. 54 Hawaii at 270, 506 P.2d at 11.
92. Id. at 271, 506 P.2d at 11.
93. Id.
94. Id. at 271, 506 P.2d at 12.
approve the sale of the sublease. The court concluded, without clarifying its reasoning, that recognizing the corporate fiction would bring about "injustice and inequity." 

This case exemplifies the courts' failure to recognize that the limited liability rule is not under challenge in these alter ego cases. Rather, the challenge is to the concept that the corporation is separate and distinct from its owners. The court in *Kahili* failed to consider whether the strong policies supporting the separateness of corporations would be compromised by its decision, and whether any other policy might justify disregarding the separate entity.

While setoffs and conduits for raising defenses procedurally resemble typical alter ego cases, neither of these situations compromises the economic policies of risk diversification or the subsidization of the corporate entity. In other situations where the separate entity concept is in dispute, both the challenge to the concept and the procedural context are unusual.

**B. Shareholders of Corporations Challenge Their Own Separateness**

Generally, judges seem to feel that people who choose to incorporate must live with that choice. In some situations, however, courts disregard the corporate entity.

1. Expectations of the Parties Cases

In some cases, parties at the time of contracting may have expectations that would be frustrated if the corporate form was later to be recognized. For example, in *Fontainbleau Hotel Corp. v. Crossman*, the issue was who was entitled to renew the lease for a store: a dissolved corporation, or its shareholder in possession of the premises. Mrs. Crossman, the shareholder, had exercised her option to renew the lease for a store in the name of her family corporation, Florence Lustig of New York, Inc. She took .

95. *Id.* at 270—71, 506 P.2d at 11—12.
96. *Id.* at 271, 506 P.2d at 12.
97. *See, e.g.*, Hair Indus. v. United States, 340 F.2d 510 (2d Cir.), *cert. denied*, 381 U.S. 950 (1965) (defendant had incorporated himself, and IRS subpoenaed records of the corporation; defendant then attempted unsuccessfully to invoke his personal fifth amendment privilege). *See also* Schenley Distillers Corp. v. United States, 326 U.S. 432 (1946) (corporate entities will not be disregarded when those in control have adopted the corporate form to secure its advantages); Glendale Fed. Sav. & Loan Ass'n v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101, 135 Cal. Rptr. 802 (1977) (defendants argued that they were alter ego of Marina View and entitled to the direct protection of *CAL. CIV. PROC. CODE § 580d* (West 1976), but the court was unpersuaded); Jonas v. Wisconsin, 19 Wis. 2d 638, 121 N.W.2d 235 (1963) (corporation is treated as separate from its stockholders under all normal circumstances).
98. 286 F.2d 926 (5th Cir. 1961).
possession of the premises, operated a dress shop, paid the rent, and otherwise followed the terms of the lease. The owner sued to evict Mrs. Crossman after the family corporation dissolved. The testimony and evidence indicated that the parties expected that the premises would be rented to the tenant occupying them. The owner argued, however, that Mrs. Crossman did not have an option to renew, that the defunct corporation had the option, and that Mrs. Crossman, as an individual, could not exercise it. The appellate court affirmed the district court's finding that Mrs. Crossman and Florence Lustig of New York, Inc., "were inseparable and interchangeable." Had the court recognized the separate entity, the expectations of the parties at the time of contracting would have been frustrated. The court's holding was sound because it furthered a legitimate objective of contract law.

The court's reasoning became muddled, however, in a later opinion in the same case, but on a different issue, when the court made a cursory reference to the alter ego doctrine and failed to articulate the contract policy underlying the transaction.

2. Usury Statute Cases

In many states, usury laws protect individual borrowers but not corporate borrowers. Lenders frequently try to circumvent the protection that these laws afford to individual borrowers by requiring them to incorporate. If a lender sues the corporation on a debt in these jurisdictions, the shareholder debtors often argue that the court should "pierce the corporate veil" and view the shareholder as the real debtor. Several courts have accepted

99. Id. at 929—30.
100. Fulfilling the expectations of the parties has for some time been considered a legitimate objective of contract law. In a classic article, Professors Fuller and Perdue analyze the various interests protected by contract law. See Fuller & Perdue, The Reliance Interest in Contract Damages (pts. 1, 2), 46 Yale L.J. 52, 373 (1936).
102. Id.
104. Lenders then extend credit to corporate entities at usurious rates of interest. See Note, Incorporation to Avoid the Usury Laws, 68 Colum. L. Rev. 1390, 1390 n.6 (1968) [hereinafter cited as Note, Incorporation]. The author maintains that it may be commercially reasonable to force a buyer to incorporate in order to earn a higher interest rate. See also, e.g., Jenkins v. Moyse, 254 N.Y. 315, 172 N.E. 521 (1930) (lender told borrower he would deal only with a corporation).
105. See infra notes 106—107.
this argument; others have not. The courts that disregarded the fiction of corporate separate-ness found bad faith in the lender's intent to defeat public policies. Those that recognized the separate corporate entity generally did not find any "inequity" because the individuals were aware of the consequences of incorporation. Both lines of cases, however, applied the typical alter ego analysis. These cases illustrate how the typical alter ego analysis often may lead to opposite results. This inconsistency results from courts' failure to articulate and balance two conflicting sets of policies: those supporting the separate entity concept, and those embodied in the legislative prohibition of usurious loans to individuals.

3. Tax Advantages

In tax cases, shareholders do not challenge the limited liability rule; instead, they assail the separate entity fiction in an effort to gain an otherwise unavailable tax benefit. A successful challenge may mean that the shareholder will be taxed once at an individual rate rather than twice (once as a corporation and again upon receipt of dividends). A successful challenge may also mean that the shareholders can treat corporate expenses as their own and deduct them.

---


109. See supra note 106.

110. See supra note 107.

111. See, e.g., cases cited supra notes 106—107.


113. Cf. Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962) (court refused to allow taxpayer to pierce his own corporation and deduct corporate expenses as his own; however, court implied that this rule applies only where taxpayer, rather than an
A court may disregard the corporate entity for income tax purposes if the shareholders can show that the corporation is their "alter ego" or "instrumentality" and that it has no substantial business purpose and no function as an independent business organization.\textsuperscript{114} When a court uses the usual alter ego metaphors in tax cases, the issues become confused and the results are unpredictable.\textsuperscript{115} This results from use of metaphors without examining which policies would be either furthered or frustrated by disregarding the corporate entity.

III. A Mode of Analysis

This Comment has described some of the the problems resulting from a mechanical application of the traditional alter ego criteria in cases of alternative challenges to the corporate entity. Perhaps because courts fail to recognize the difference between traditional and alternative challenges, they often examine many factors that are irrelevant to a particular case. Courts also inadequately consider the policies underlying the concept of the corporation and the specific policies at issue in the case before them.

A. Analysis

Another mode of analysis is needed when courts consider whether to disregard the corporate entity for purposes other than imposing liability on shareholders. This Comment suggests a three-step balancing approach which, if employed, would require courts to consider economic policies as well as other important social policies lurking beneath the challenge to the corporate

\textsuperscript{114} Cf. Dodd, 298 F.2d at 577 ("It is well established that if a taxpayer has voluntarily created a corporation to suit his or its own purposes, such taxpayer may not ignore and disregard the corporate entity when to do so would result in an otherwise unavailable tax benefit."). Compare Maine Aviation Corp. v. Johnson, 160 Me. 1, 5—6, 199 A.2d 748, 750 (1964), and Bonnar-Vawter, Inc. v. Johnson, 157 Me. 380, 387, 173 A.2d 141, 145 (1961) (attempts by corporations to disregard corporate form so that transactions between parent and subsidiary might escape Maine's use tax. The courts held that the veil sould not be pierced when to do so would give an unfair advantage or contravene public policy).

\textsuperscript{115} See, e.g., Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945) (real property held by a partnership was transferred to two corporations to hinder one of the party's creditors; the partners acted as if the property was still partnership property. The commissioner successfully taxed the corporation despite its contention that the corporate entity should be disregarded and the income treated as the partners' income.) Compare Paymer with Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), discussed infra note 117. See B. BITTKER & J. EUSTICE, supra note 112, ¶ 1.5, at 1-14 to -27, for a criticism of the uneven use of the separate entity concept and the confused use of metaphors.
1. A Factual Analysis

First, courts should determine why a party is seeking to disregard the corporate entity and which aspect of the entity is being challenged. This preliminary step would enable courts to find fact patterns with similar policies at issue.

2. A Policy Analysis

Next, courts should identify which policy concerns the case raises and determine whether those policies would be furthered or frustrated by disregarding the corporate entity. Specific policies would be more easily identified because of the prior factual analysis. Further, courts would more easily distinguish cases challenging the limited liability rule from those challenging other aspects of corporate separateness. Included in this policy analysis would be a consideration of whether the corporation and/or its shareholders acted in bad faith.

3. Balancing

Courts should weigh each policy according to its importance. While some economic policies are compelling, others are not at issue in cases where the limited liability rule is not challenged. Courts should consider and give great weight to legislative pronouncements on given issues. The parties' expectations also should be given great weight, except when those expectations

---

116. Courts identify and balance the "public interest" in many contexts. In weighing public policies with respect to the granting of a stay motion, the District of Columbia Circuit has stated:

The public interest may, of course, have many faces—favoring at once both the rapid expansion of utilities and the prevention of wasteful and repetitive proceedings at the taxpayers' or consumers' expense; both fostering competition and preserving the economic viability of existing public services; both expediting administrative or judicial action and preserving orderly procedure. We must determine, these many facets considered, how the court's action serves the public best.


117. For example, in the leading case of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court stated without discussion: "At [the] time [the tax was assessed, the corporation] was clearly not Thompson's alter ego and his exercise of control over [the corporation] was negligible." Id. at 440. Apart from that cursory statement, the Court failed to consider any tax policies at issue when determining if gains from the corporation's sales were income to the individual or to the corporation. Id. See also, e.g., Factor v. Commissioner, 281 F.2d 100 (9th Cir. 1960) (the sole shareholder was taxed on his corporation's income on an "agency" theory, but the court did not discuss any tax policies), cert. denied, 364 U.S. 933 (1961).

118. See supra § II.

119. See infra notes 134—140 and accompanying text.
do not comport with the policy underlying the law.\textsuperscript{120} Contract and tort policies are extremely important, yet they can be overridden if a party acts in bad faith.\textsuperscript{121}

This three-step balancing approach will give some guidance to otherwise undirected courts. The analysis can be used in all cases of alternative challenges to the separate entity and can help courts develop new policies, disregard out-dated metaphors, and make informed decisions.\textsuperscript{122}

B. Applying the proposed mode of analysis

Under the mode of analysis proposed above, each case must be examined in order to understand the facts and determine the policies involved. This Comment will demonstrate how the proposed analysis would work in those alternative challenge cases discussed above.

1. Setoff Cases

The factual analysis is similar in cases involving one-person corporations\textsuperscript{123} and those involving affiliated parent and subsidiary corporations.\textsuperscript{124} In both types of cases, the parties ask the court to disregard corporate separateness in order to reduce their prospective liability. Defendants have a valid claim against the sole shareholder, or the parent or subsidiary, of the plaintiff entity, but recognition of the fiction that the corporation is separate and distinct from its shareholders prevents them from setting off that obligation. In these cases, the obstacle to the setoff is procedural rather than substantive.

In situations involving one-person corporations where there is no true financial separateness,\textsuperscript{125} and in situations involving

\begin{itemize}
  \item \textsuperscript{120} For example, courts do not enforce: 1) contracts barred by the statute of limitations, \textit{Restatement (Second) of Contracts} \textsection{} 8 comment b (1981); 2) contracts barred by the statute of frauds, \textit{id.} \textsection{} 110; or 3) contracts which have unconscionable terms, \textit{id.} \textsection{} 208.
  \item \textsuperscript{121} See infra notes 128–139 and accompanying text.
  \item \textsuperscript{122} Courts should recognize that factors such as adequate capitalization, while relevant in the typical alter ego case, are irrelevant when the limited liability rule is not challenged. For example, in Kahili, Inc. v. Yamamoto, 54 Hawaii 267, 506 P.2d 9 (1973), the court's discussion of Kahili's capitalization was totally unnecessary in deciding whether to allow the contract defense. \textit{See supra} notes 90–96 and accompanying text.
  \item \textsuperscript{123} \textit{See supra} notes 78–81 and accompanying text.
  \item \textsuperscript{124} \textit{See supra} notes 82–88 and accompanying text.
  \item \textsuperscript{125} This occurs because creditors usually require personal guarantees before making the loan. \textit{See Wenban Estate, Inc. v. Hewlett}, 193 Cal. 675, 227 P. 723 (1924); \textit{Perkins v. Trinity Realty Co.}, 69 N.J. Eq. 723, 61 A. 167 (N.J. Ch. 1905), aff'd, 71 N.J. Eq. 304, 71 A. 1135 (N.J. 1906). In neither of these cases did the courts specifically refer to the financial unit of sole shareholder and corporation. Apparently, that was not important.
\end{itemize}
parent and subsidiary corporations where the parent corporation must indemnify the subsidiary, it would be more convenient to allow the setoff and settle the disputes in one lawsuit. It would also be less costly to settle all disputes in one lawsuit. Thus, another important policy, judicial economy, would be served. In these cases, diversification of risk is not at issue because the entire risk is already borne by one person in the sole shareholder case and by one business in the parent/subsidiary case. Thus, the effects of disregarding corporate separateness will not influence a potential investor's desire to invest. In sum, disregarding the corporate entity in these cases serves to further the policies of convenience and judicial economy without frustrating other important economic policies.

2. Conduits Through Which Other Defenses May Be Interposed

In cases like *Kahili, Inc. v. Yamamoto*, where the shareholders use the separate entity fiction to shield themselves from responsibility for their acts, courts should disregard the corporate entity. In those cases, the shareholders do not use the separate entity concept to diversify risk or as a convenient method by which to transact business. In addition, the contract law policy at issue is very strong. Since no economic policies are compromised and an important contract policy is at stake in these cases, courts should disregard the corporate entity. If the shareholders in *Kahili* were regarded as separate from and independent of the corporation (the buyer), the sellers would have been deprived of a legitimate contract defense.

3. Expectations of the Parties Cases

In cases like *Fontainbleau Hotel Corp. v. Crossman*, where

---

126. This occurs because of contractual guarantees. See authorities cited supra note 84. See also, e.g., Joseph R. Foard Co. v. Maryland, 219 F. 827 (4th Cir. 1914) (the subsidiary was required to pay its parent a management fee which equaled the former's net earnings). But see Bartle v. Home Owners Coop., Inc., 309 N.Y. 103, 127 N.E. 2d 832 (1955) (parent corporation not held liable on contract debts of bankrupt subsidiary even though subsidiary was not permitted to earn a profit during its normal operations prior to bankruptcy).


128. The policy issue is whether one can use the defense of the other party's prevention of the occurrence of a condition as an excuse for non-performance. See S. Williston, A TREATISE ON THE LAW OF CONTRACTS § 677 (3d ed. 1961) ("It is a principle of fundamental justice that if a promisor is himself the cause of the failure of performance . . . he cannot take advantage of the failure.").

129. See id.

130. 273 F.2d 720 (5th Cir. 1959), aff'd, 286 F.2d 926 (5th Cir. 1961). See supra text accompanying notes 98—102.
shareholders seek to disregard the corporate entity for their own benefit, the analysis should proceed as follows. First, the court should determine which aspect of the separate entity is being challenged. If this analysis had been applied in Crossman, the court would have found that the defendant was seeking to disregard the fiction of the separate corporate entity in order to avoid eviction. Second, the court should examine the policies involved in the case. In Crossman, the court would have found that the diversification of risk policy was not affected because the transaction did not place any shareholders at risk. The convenience policy would have been frustrated, however, if the separate entity were recognized. This would occur because the separate corporate form hinders the smooth operation of business by allowing a party to defeat contractual expectations for its own benefit. The contract policy of fulfilling the expectations of the parties and must be weighted heavily. In cases like Crossman, then, the corporate entity should be disregarded because the policies favoring recognition of the entity are not affected.

4. Usury Cases

In the typical usury case, a debtor challenges the separate entity concept to plead the defense of usury. In these cases, the lender has tried to avoid complying with legislative intent to exempt individual borrowers from extremely high interest rates by requiring a prospective borrower to incorporate. The lender then makes the loan to the newly formed “corporation” at a usurious rate of interest. If a court were to disregard the corporate entity in these cases, none of the policies supporting the separate entity concept would be adversely affected. Here, the corporation is no different from a sole proprietorship. As no corporate investment occurred, diversification of risk is not a policy consideration in these cases. Convenience is not affected because the corporation was not

131. See id. In Crossman, the landlord sued the tenant for violating a provision of her lease by assigning it to her solely-owned corporation. That transaction involved no fraud or misrepresentation. The same parties would reside on the premises and, because an assignment ordinarily does not relieve the assignor of its duties, the pool of money from which the landlord could collect the rent would be the same.


133. See also Epstein v. Fabrikraft Corp., 67 N.Y.S.2d 730 (1947) (court found no substantial violation of lease where tenant corporation subleased portion of premises to corporation; same person owned stock of both lessee and sublessee, was president of both corporations; and sublease did not cause any detriment, loss, or injury to landlord).

functioning freely in the free enterprise system. In fact, the borrower was coerced into becoming a corporate entity.

Arguably, the lender acted in bad faith by attempting to circumvent the usury laws' protection of individual borrowers. This behavior should be taken into account. The courts that have disregarded the separate entity have looked to the strong legislative policy against usury. Those courts that have recognized the entity have failed to note such a policy. They reason that the usury laws have not been evaded, but instead have been followed in order to accomplish what the laws do not forbid. Such an argument, though technically correct, fails to consider that the statute was enacted to prevent lenders from charging usurious rates to individual borrowers. Thus, the legislative intent is circumvented by lenders who require borrowers to incorporate.

Another policy for courts to consider is that of fulfilling the expectations of contracting parties. The shareholders generally enter into the transaction with their eyes open, knowing the significance of incorporation. Thus, the expectations of the contracting parties would be fulfilled by the courts' recognizing the corporate entity. Frequently, however, courts are unwilling to uphold the expectations of parties when those expectations do not comport with legislative policy. In these cases, courts usually decide that the policies against enforcing such agreements outweigh the policy of fulfilling the parties' expectations. Since none of the strong policies for retaining the separate form are affected, and the parties' expectations violate a strong legislative policy against usury, the separate entity should be disregarded.

5. Tax Advantages

The tax cases present a complicated problem. The facts usually disclose that taxpayers are trying to reduce their tax liability by characterizing themselves as corporations. The Internal Revenue Service seeks to maximize the parties' taxes either by taxing the entities separately or by separating non-deductible personal expenses from deductible corporate expenses. This di-

135. See supra note 106.
136. See supra note 107.
137. Cf. note 103 and accompanying text.
138. See supra note 107.
139. See supra note 106.
140. See supra note 106.
141. See supra notes 111—113 and accompanying text.
142. In various places, the tax code neatly handles this characterization problem with a mechanical test. For example, I.R.C. § 1239(a) (Supp. IV 1980) states that gain between "related persons" will be recognized as ordinary income. "Related persons" are defined as either an individual or a corporation, 80% of which is owned directly or indirectly by or for such individual, id. § 1239(b)(2) (Supp. IV 1980), or two or more
chotomy of purpose is an example of the tension between a case-by-case analysis and a hard and fast rule. A rigid rule would reduce the cost of litigation to determine the status of the entities, but would ignore distinctions between different forms of business entities. 143

Furthermore, the loopholes and counterlegislations written into the law make it difficult to identify tax policies. As a result, it is not clear which policies would be affected by ignoring the general rule of separate taxation. 144 Also, the tax code is not ideal because it penalizes the most efficient corporations most heavily. 145

Of all the reasons for recognizing the separate entity, the convenience policy is the only one clearly jeopardized when the separate entity is disregarded. Separate taxation is convenient because computation is easy. Since the other policies underlying the tax code are vague and the convenience policy would be served, the balance seems to weigh in favor of consistently recognizing the corporate form. This would occur at the behest of either the individual taxpayer or the Internal Revenue Service.

CONCLUSION

Courts faced with alternative challenges to the fiction of the separate entity have used traditional alter ego analysis. The traditional alter ego analysis, however, is not appropriate in these cases. The courts merely repeat a broad metaphoric rule and then mechanically evaluate a list of factors. In addition, the courts have failed to articulate the basic policies underlying each individual challenge and often consider irrelevant factors in their inquiry.

This Comment has proposed a mode of analysis which provides a framework for solving the problem of alternative chal-
challenges to the corporate form. This mode of analysis considers the economic policies underlying the separate entities concept and the social policies underlying each alternative challenge. Society considers some social policies important enough to outweigh various economic policies. Thus, both categories of policies must be balanced when a court considers whether to disregard the corporate entity.

The proposed mode of analysis requires the court to evaluate the facts and to determine which aspect of the separate entity concept is challenged. It then requires identification of all relevant policies which either would be furthered or frustrated by disregarding the separateness of the corporate entity. Finally, the court must balance all relevant economic and non-economic policies. This analysis forces courts to articulate the rationale for their decisions and should help courts develop a cogent body of law for alternative challenges to the corporate fiction.

**ANTOINETTE SEDILLO LÓPEZ**

---

* The author would like to thank Professors Stephen Yeazell and Alison Anderson, and her editors, Julie Heldman and "Buzz" Gibson. Their thoughtful guidance far exceeded mere aid in the completion of this Comment. Also, the author wishes to express her appreciation to her parents, Perla O. Sedillo and the late Frank A. Sedillo, for their unfailing support. *Mil gracias por todo.*