

1982

Corporations—Disregarding the Corporate Entity—Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509 (Minn. 1979)

Follow this and additional works at: <http://open.mitchellhamline.edu/wmlr>

Recommended Citation

(1982) "Corporations—Disregarding the Corporate Entity—Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509 (Minn. 1979)," *William Mitchell Law Review*: Vol. 8: Iss. 1, Article 6.

Available at: <http://open.mitchellhamline.edu/wmlr/vol8/iss1/6>

This Note is brought to you for free and open access by the Law Reviews and Journals at Mitchell Hamline Open Access. It has been accepted for inclusion in William Mitchell Law Review by an authorized administrator of Mitchell Hamline Open Access. For more information, please contact sean.felhofer@mitchellhamline.edu.

© Mitchell Hamline School of Law

The majority's confusion with the use of a temporary custody order can be traced to a lack of clarity in the UCCJA itself.⁴³ A strict reading of the UCCJA does not allow a state to assert jurisdiction and temporarily enjoin enforcement of a custody order.⁴⁴ Nevertheless, since the UCCJA's adoption, it has become evident that courts are often asked to enforce orders which are not based on complete records and which are not in the child's best interest.⁴⁵ In response to this problem the suggestion has been made that the present emergency provision of the UCCJA be replaced by one that would expressly allow a court to issue a temporary order pending litigation in the proper forum.⁴⁶ Such a provision would allow a state to insure that custody is based on an informed decision without sacrificing the UCCJA's goal of eliminating concurrent jurisdiction.⁴⁷ Though the *Mullins* court extended the UCCJA beyond previous interpretations, it did serve the best interest of the child by insuring that the custody of Carl Otis Mullins was based on an informed decision.⁴⁸

Corporations—DISREGARDING THE CORPORATE ENTITY—*Victoria Elevator Co. v. Meriden Grain Co.*, 283 N.W.2d 509 (Minn. 1979).

The corporation is the cornerstone of the American economic structure.¹ Through incorporation, investors can combine capital and reap the profits that derive from economies of scale.² Because of its integral

emergency constituted an implicit challenge to the California custody decree. 298 N.W.2d at 62.

43. *See supra* note 33.

44. *Id.*

45. *See, e.g.*, *Fry v. Ball*, 190 Colo. 128, 544 P.2d 402 (1975).

46. *See Note, supra* note 11, at 616-20.

47. *Id.*

48. The court ordered evidentiary hearing in Minnesota resulted in the Krolick's continued custody of the child with visitation rights afforded to the father. *Minneapolis Tribune*, Sept. 13, 1981, at 113.

1. *See Congdon v. Congdon*, 160 Minn. 343, 373, 200 N.W. 76, 87 (1924) (corporations are of "utmost importance" to industrial world and "essential to the welfare of business interests"); H. BALENTINE, *THE LAW OF CORPORATIONS* § 1 (rev. ed. 1946); Note, *Disregard of the Corporate Entity*, 4 WM. MITCHELL L. REV. 333, 334-36 (1978) (acceptance of corporate device by American business has resulted in phenomenal industrial growth). One leading commentator has stated that "[b]ecause of its size, power, and import, the modern business corporation is a key institution in contemporary society and in the American free enterprise profit system—somewhat analogous to the feudal system of old." H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 1, at 4 (2d ed. 1970).

2. *See generally* H. HENN, *supra* note 1, § 1, at 4. For a general discussion of the history and effect of incorporation, see 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 1-5 (rev. perm. ed. 1974) and H. BALENTINE, *supra* note 1, §§ 118-119.

role in business and industry, the corporation has attained a favored status in the law.³ The law surrounding the creation and legal status of a corporation has two essential characteristics. First, liability of shareholders is limited to their capital investment.⁴ Second, a corporation is treated as a separate legal entity, distinct from its shareholders.⁵

Exceptions to the principles of limited liability and separate corporate existence evolved in the early part of the twentieth century.⁶ The equita-

3. A corporation is generally regarded as a "person" unless the relevant constitutional or statutory provision is limited in application to natural persons. Thus, for example, under the United States Constitution a corporation enjoys the right of the "people" to be secure against unreasonable searches and seizures, U.S. CONST. amend. IV, the right not to be deprived of liberty or property without due process, U.S. CONST. amend. V, and the right to equal protection of the laws, U.S. CONST. amend. XIV. This status is accompanied by a corresponding responsibility to act in the public interest; thus a corporation's acts are governed by public policy, as are any other person's. See *Villainen v. American Finnish Workers Soc'y*, 236 Minn. 412, 416, 53 N.W.2d 112, 115 (1952). See generally Note, *supra* note 1.

4. Limited liability of shareholders, an important feature of modern corporations, has not always been a corporate attribute. See Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351-53 (1948). For a history of the concept of limited liability in Minnesota, see Note, *supra* note 1, at 334-35 n.5. Today, however, limited liability is the fundamental rule of corporate law. See *Anderson v. Abbott*, 321 U.S. 349, 361-63 (1944).

The feature of limited liability for corporate shareholders has been both responsible and necessary for attracting the large amounts of capital required to establish many corporations. Without limited liability modern business would not have experienced the vast growth that it enjoyed in the last century. See generally I. WORMERS, *DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS* 2-3 (1927); Ballantine, *Stockholders' Liability in Minnesota*, 7 MINN. L. REV. 79-80 (1923).

5. See, e.g., *J.J. McCaskill Co. v. United States*, 216 U.S. 504, 514-15 (1910); *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819); *United States v. Martin*, 337 F.2d 171, 175 (8th Cir. 1964); *Milwaukee Motor Transp. Co. v. Commissioner of Taxation*, 292 Minn. 66, 71, 193 N.W.2d 605, 608 (1971); *Gallagher v. Germania Brewing Co.*, 53 Minn. 214, 219-20, 54 N.W. 1115, 1116-17 (1893).

In the last 150 years, courts have agreed that a corporation is an entity separate from its shareholders, but they have been unable to agree on the exact nature of a corporation. In *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819), the Court perceived the corporation as an "artificial being, invisible, intangible, and existing only in the contemplation of the law." *Id.* at 303 (4 Wheat. at 636). Since then, courts have generally considered a corporation to be either a legal entity or a legal fiction. The Minnesota Supreme Court has not been consistent in characterizing the nature of the corporate structure. Compare *In re Clarke's Will*, 204 Minn. 154, 157-58, 284 N.W. 876, 878 (1939) (legal entity) with *Prudential Ins. Co. v. A. Enkema Holding Co.*, 196 Minn. 154, 157-58, 264 N.W. 576, 578 (1936) (legal fiction). See generally 1 W. FLETCHER, *supra* note 2, §§ 1, 5; Note, *Shareholder Liability—Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc.—A Single-Factor Test?*, 3 J. CORP. L. 219 (1977); Comment, *Disregard the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441 (1967); Note, *supra* note 1, at 334.

6. As the law of corporations developed and the principle of limited liability became firmly entrenched, abuses of the corporate form created a need for disregarding the separate nature of the corporation. See *Anderson v. Abbott*, 321 U.S. 349, 362-63 (1944); *New Colonial Ice Co. v. Heuvering*, 292 U.S. 435, 442 (1934); *Chicago, M. & St. P. Ry. v. Minneapolis Civic & Commerce Ass'n*, 247 U.S. 490, 501 (1918); *J.J. McCaskill Co. v.*

ble remedy of disregarding the corporate entity and imposing personal liability on individual shareholders was judicially created to redress injustices perpetrated through the corporate form.⁷ Originally, the corporate entity was disregarded only in instances of fraud.⁸ However, under capitalization,⁹ failure to observe corporate formalities,¹⁰ and identity of

United States, 216 U.S. 504, 514-15 (1910). These cases generally disregarded the corporate entity when there was an overriding public policy at stake, such as the need to pay corporate creditors or to compensate victims of tortious conduct. *See generally* Dobbyn, *A Practical Approach to Consistency in Veil-Piercing Cases*, 19 U. KAN. L. REV. 185, 185-86 (1971).

7. *See* H. BALANTINE, *supra* note 1, § 122. The remedy of corporate disregard is not limited to situations where corporate assets fail to satisfy creditors. *See* Note, *supra* note 1, at 365-69 (discussing application of disregard doctrine to cases involving probate administration, attempted evasion of statutes, and disputes among shareholders). In *Reopke v. Western Nat'l Mut. Ins. Co.*, 302 N.W.2d 350 (Minn. 1981), a recent no-fault stacking case, the Minnesota Supreme Court used a "reverse pierce" of the corporate entity theory in holding that a decedent, who was president and sole shareholder of a corporation, was an insured under six no-fault policies that covered vehicles owned by the corporation. The theory allowed the decedent and corporation to be treated as a single entity. *Id.* at 353.

8. This is particularly true in Minnesota. *See* *Ahlm v. Rooney*, 274 Minn. 259, 264, 143 N.W.2d 65, 69 (1966) (mere dominance of corporation by single shareholder not enough to hold shareholder personally liable for debts); *Whitney v. Leighton*, 225 Minn. 1, 8, 30 N.W.2d 329, 333 (1947) (fraud only basis to disregard corporate entity), *aff'd on rehearing*, 225 Minn. 12, 30 N.W.2d 335 (1948); *Fewell v. Tappen*, 223 Minn. 483, 495, 27 N.W.2d 648, 655 (1947) (corporate entity not a veil for fraud); *Central Motors & Supply Co. v. Brown*, 219 Minn. 467, 469-70, 18 N.W.2d 236, 237 (1945) (existence of fraud justified liability); *Lake Park Dev. Co. v. Paul Steenberg Constr. Co.*, 201 Minn. 396, 400-01, 276 N.W. 651, 654 (1937) (appropriation by officer of corporate assets not a basis of liability, the assets being taken pursuant to officers authority); *Prudential Ins. Co. v. A. Enkema Holding Co.*, 196 Minn. 154, 157-58, 264 N.W. 576, 578 (1936) (fraud or strong equitable claim only basis to disregard separate entity nature of the corporation). *But see* *Manufacturers Bldg., Inc. v. Heller*, 306 Minn. 180, 183, 235 N.W.2d 825, 827 (1975) (corporate entity disregarded despite absence of fraud), *noted in* 3 WM. MITCHELL L. REV. 293 (1977); *In re Clarke's Will*, 204 Minn. 574, 579, 284 N.W. 876, 879 (1939) (disregard concept "serves no purpose"). *See generally* Note, *supra* note 1, at 338-39.

9. *See* *Anderson v. Abbott*, 321 U.S. 349 (1944); *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); *Erickson v. Minnesota & Ontario Power Co.*, 134 Minn. 209, 158 N.W. 979 (1916). In *Erickson* liability was imposed on a parent corporation because a subsidiary corporation was inadequately capitalized. Although the court's rationale was based on agency principles rather than corporate disregard law, *id.* at 214, 158 N.W. at 981, the subsidiary corporation's undercapitalization was a result of the parent company's actions. Some observers suggest that courts are more likely to disregard the corporate entity in cases where liability will be imposed on a corporate, rather than individual, shareholder. *See* H. HENN, *supra* note 1, §§ 147-148, E. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 194-95 (1936); Note, *supra* note 1, at 342.

10. Corporate disregard principles based on failure to observe corporate formalities are often called the "Massachusetts" rule. Dobbyn, *supra* note 6, at 186, 189. Jurisdictions following the Massachusetts rule emphasize the formal barriers that segregate the corporation from the shareholders. *Id.* at 186; *see, e.g., My Bread Baking Co. v. Cumberland Farms, Inc.*, 353 Mass. 614, 233 N.E.2d 748 (1968). *See generally* W. FLETCHER, *supra* note 2, § 41-42; Note, *supra* note 1, at 339-40.

interest between shareholders and the corporation¹¹ have also served as justification for imposing personal liability on individual shareholders. Corporate disregard law balances two competing interests: the limitation of the corporate shareholders' liability and the satisfaction of the corporation's creditors.¹² The equitable nature of corporate disregard law lends itself to decisions based on standards of fairness and justice rather than on a structured method of analysis.¹³

In *Victoria Elevator Co. v. Meriden Grain Co.*¹⁴ the Minnesota Supreme Court recognized the "instrumentality" or "alter ego" theory of corporate disregard law.¹⁵ Under this theory, eight factors are considered in determining whether to disregard the corporate entity.¹⁶ The *Victoria Elevator* court applied the eight-factor test and held that fraud was not necessary to disregard the corporate entity.¹⁷ The court also held that the failure to treat the corporation as a separate legal entity, when coupled with the element of fundamental unfairness or injustice, provides sufficient basis to impose personal liability on shareholders.¹⁸

Defendant Harold D. Schroeder and his wife were the sole shareholders of the Meriden Grain Company.¹⁹ The Schroeders owned most of

11. The emphasis in this approach is on the similarity between the financial interests of the controlling shareholder and those of the corporation. California and New York have similar approaches in that both states look to whether the relationship between the shareholder and the corporation is one of complete control or unity of financial benefit. See *Dobbyn*, *supra* note 6, at 186-87; *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962); *Rosen v. E.C. Losch Co.*, 234 Cal. App. 2d 324, 44 Cal. Rptr. 377 (1965); *Zaist v. Olson*, 154 Conn. 563, 227 A.2d 552 (1967); *Walkovszky v. Carlton*, 24 A.D.2d 582, 262 N.Y.S.2d 334 (1965); *Lowendahl v. Baltimore & O.R.R.*, 247 A.D. 144, 287 N.Y.S. 62 (1936).

12. *Dobbyn*, *supra* note 6, at 186-87.

13. See *Dobbyn*, *supra* note 6, at 185-86. One court stated that "it is well nigh impossible in the present state of the law to enunciate a clear cut rule." *Hazeltine Corp. v. General Elec. Co.*, 19 F. Supp. 898, 902 (D. Md. 1937). There is no general formula for all cases. Doctrinal concepts are of limited value; each case must be decided upon its own peculiar facts. See H. BALLANTINE, *supra* note 1, § 122.

14. 283 N.W.2d 509 (Minn. 1979).

15. *Id.* at 512. The *Victoria Elevator* court did not distinguish between the instrumentality theory and the alter ego theory. *Id.*; see also *White v. Jorgenson*, 322 N.W.2d 607 (Minn. 1982). The theory adopted in *Victoria Elevator*, however, has broader application than the alter ego theory developed by the California and New York courts, which emphasizes the unity of financial interest between a shareholder and the corporation. See *supra* note 11.

16. See *infra* note 31 and accompanying text. The source of the eight-factor test was *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686-87 (4th Cir. 1976). The Minnesota Supreme Court's reliance on a Fourth Circuit decision was probably due to the lack of similar precedent in Minnesota corporate disregard law.

17. 283 N.W.2d at 512.

18. *Id.*

19. *Id.* at 510-11. Defendant Schroeder was a farmer until 1959, when he went into business selling feed, seed, and other farm-related products under the name of "Schroeder's Cashway." In 1969, defendant and two others entered into an agreement to form a corporation called Meriden Grain Company, Inc. Under the agreement, Schroeder was to

the property used by the corporation in conducting its business.²⁰ Schroeder never charged, and the corporation never paid, any rent for the use of the land and equipment.²¹ The property, however, was listed as an asset of the corporation on Meriden's tax returns and financial statements.²² The corporation took deductions for depreciation, taxes, and insurance on this property on its 1971 and 1972 tax returns.²³

The action arose after the Victoria Elevator Company had entered into a series of fourteen contracts with the Meriden Grain Company. Meriden was to deliver corn to the Victoria Elevator Company²⁴ and had partially performed only one of the fourteen contracts when Victoria sued Meriden for breach of the unperformed contracts.²⁵ By the time Victoria recovered a default judgment, Meriden had already ceased doing business. Shortly after the default judgment was entered, all of Victoria's corporate assets were transferred to defendant Schroeder and his wife.²⁶ Although no evidence was presented showing that the corporation had been dissolved, no corporate assets remained from which to satisfy Victoria's judgment.²⁷ Victoria therefore obtained a subsequent judgment holding Schroeder personally liable for the default judgment entered against Meriden.²⁸ The sole issue on appeal was whether, absent

transfer assets held by Schroeder's Cashway to the new corporation in return for shares. In 1970, defendant and his wife were issued shares of the corporation, ostensibly in return for cash and inventory. Although corporate records did reflect cash contributions, there was no evidence of machinery or equipment transfers to the corporation. The other two parties to the agreement never made a capital contribution to the corporation or received stock. *Id.*

20. The only property ever owned by Meriden was one bin and one grain leg. *Id.* at 511.

21. *Id.*

22. *Id.*

23. *Id.* This "error" was corrected on the corporation's 1973 tax return. Schroeder testified that the corporation never paid any taxes on the property. *Id.*

24. *Id.* The contracts called for delivery of the corn between May and November 1973.

25. In the fall of 1973, before plaintiff filed suit, a dispute arose between plaintiff and defendant regarding the failure to perform. Two meetings were held at which Schroeder, on behalf of the corporation, promised to deliver the remaining grain, and plaintiff tendered payment of the \$28,000 it had been holding because of delays in performance. The contracts, however, were not completed. *Id.*

26. *Id.* The assets consisted of a grain leg and storage bin. These transfers were approved at special meetings of the stockholders and board of directors. Schroeder and his wife were the sole members of each of these bodies.

27. *Id.* Prior to the default judgment, Schroeder withdrew money from the corporation, allegedly as wages, in spite of Meriden's financial difficulties. *Id.* at 512-13. Schroeder withdrew \$39,997 from the corporate checking account on May 31, 1973. The check was recorded as payment of wages, with interest, for October 1970 through July 1, 1973. The amount was not listed on Schroeder's 1973 individual income tax returns as wages received or on Meriden's 1973 corporate income tax returns as salary paid out. *Id.* at 513 n.7.

28. *Id.* at 510. The judgment against Schroeder individually was in favor of Victoria

a showing of fraud, plaintiff could recover from defendant Schroeder in his individual capacity. The Minnesota Supreme Court affirmed the trial court's order and held Schroeder personally liable.²⁹

In *Victoria Elevator* the Minnesota Supreme Court approved the instrumentality theory of corporate disregard law as the first prong of a two-prong test for determining whether to disregard the corporate entity.³⁰ The eight factors considered significant in corporate disregard cases under the instrumentality theory are insufficient capitalization, failure to observe corporate formalities, nonpayment of dividends, insolvency of the debtor corporation at the time of the transaction in question, siphoning of corporate funds by the dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and use of the corporation as a facade for individual dealings.³¹ The *Victoria Elevator* court held that not only must "a number of these factors be present,"³² but an element of injustice or unfairness, the second prong, is also necessary to impose personal liability on shareholders.³³

The eight factors provide evidentiary guidelines for courts and litigants in applying the instrumentality theory. In *Victoria Elevator*, for example, the evidence showed that Schroeder "failed to make formal distinctions between corporate and individual property,"³⁴ with the result that Meriden was deemed to have operated as a mere facade for Schroeder's individual dealings.³⁵ No corporate records of transfers of personal cash and property to the corporation were kept.³⁶ Schroeder was the sole management force of the corporation, and voting at the

Grain Company. *Victoria Elevator Company* was dissolved in July, 1974, and the causes of action against Meriden and Schroeder were assigned to its successor, *Victoria Grain Company*. The court referred to these two companies collectively as "plaintiff." *Id.* at 510 n.1.

29. *Id.* at 510.

30. See *supra* note 15 and accompanying text; see also *White v. Jorgenson*, 322 N.W.2d 607, 608 (Minn. 1982).

31. 283 N.W.2d at 512. Other courts have also found these factors to be significant. See *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686-87 (4th Cir. 1976); *Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc.* 519 F.2d 634 (8th Cir. 1975) (absence of corporate records); *G.M. Leasing Corp. v. United States*, 514 F.2d 935 (10th Cir. 1975) (using the corporation as mere facade), *cert. denied*, 435 U.S. 923 (1978); *TSS Sportswear, Ltd. v. Swank Shop, Inc.*, 380 F.2d 512 (9th Cir. 1967) (same); *Financial Counsellors, Inc. v. SEC*, 339 F.2d 196 (2d Cir. 1965) (nonfunctioning of other officers or directors); *Schoenberg v. Benner*, 251 Cal. App. 2d 154, 59 Cal. Rptr. 395 (1967) (non-payment of dividends); *Chatterley v. Omnico, Inc.*, 26 Utah 2d 88, 485 P.2d 667 (1971) (subsidiary corporation actually operated by parent).

32. 283 N.W.2d at 512.

33. *Id.* In *White v. Jorgenson*, 322 N.W.2d 607, 608 (Minn. 1982), the Minnesota Supreme Court made it clear that a two-prong test had been adopted in *Victoria Elevator*.

34. *Id.* at 513.

35. *Id.*

36. *Id.*

meetings by Schroeder and his wife was a mere formality.³⁷ Therefore, the inference was raised that Schroeder's wife was a non-functioning director.³⁸ The court also noted that the corporation paid no dividends.³⁹ These facts led the court to conclude that "[i]t is clear from the evidence in this case that defendant did not treat the corporation as a separate entity."⁴⁰

The court did not indicate the relative weight to be given each of the eight factors. It may have purposely left the significance of each factor ambiguous to preserve case-by-case consideration of corporate disregard cases. *Victoria Elevator* does, however, establish the narrow proposition that, in the absence of undercapitalization and fraud, the corporate entity may be disregarded if corporate formalities are not followed or if the corporation serves primarily as a front for the dealings of shareholders.⁴¹ The court's adoption of the eight-factor test provides a helpful framework for the analysis of corporate disregard. Prior to *Victoria Elevator*, the Minnesota Supreme Court had not developed useful standards for applying the disregard doctrine.⁴² *Victoria Elevator's* significance rests in the court's succinct statement of evidentiary rules seemingly applicable to all corporate disregard cases.

The eight factors enumerated in *Victoria Elevator* are derived from three separate theories of corporate disregard law. Throughout its struggle with corporate disregard law, the Minnesota Supreme court has drawn on the themes of undercapitalization,⁴³ corporate formalities,⁴⁴ and fraud.⁴⁵ The guidelines embodied in the eight-factor test should be viewed as a synthesis of these three theories.

Undercapitalization has been recognized for many years in other jurisdictions as an important factor in deciding whether to disregard the corporate entity.⁴⁶ Undercapitalization is defined as "an obvious

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* at 512.

42. Note, *supra* note 1, at 336. The Minnesota Court's varied approach to corporate disregard law is bewildering. Compare *In re Clarke's Will*, 204 Minn. 154, 158, 284 N.W. 876, 879 (1939) (alter ego theory utilized based on identity of interest) with *Whitney v. Leighton*, 225 Minn. 1, 8, 30 N.W.2d 329, 333 (1947), *aff'd on rehearing*, 225 Minn. 12, 30 N.W.2d 339 (1948) (corporate entity disregarded only in instances of fraud) and *General Underwriters, Inc. v. Kline*, 223 Minn. 345, 46 N.W.2d 794 (1951) (corporate entity disregarded because of failure to follow corporate formalities).

43. See *infra* notes 46-52 and accompanying text.

44. See *infra* notes 53-58 and accompanying text.

45. See *infra* notes 59-68 and accompanying text.

46. See *Anderson v. Abbott*, 321 U.S. 349, 362 (1944); *Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc.*, 519 F.2d 634, 638 (8th Cir. 1975); *Gordon v. SS Vedalin*, 346 F. Supp. 1178, 1181 (D. Md. 1972); *Arnold v. Browne*, 27 Cal. App. 3d 386, 395-97, 103 Cal. Rptr. 775, 781-83 (1972); *Harris v. Curtis*, 8 Cal. App. 3d 837, 841-

inadequacy of capital, measured by the nature and magnitude of the corporate undertaking."⁴⁷ The *Victoria Elevator* court expressly stated that insufficient capitalization is a factor to be considered in corporate disregard cases.⁴⁸ It is not clear, however, whether insufficient capitalization alone will be sufficient to impose personal liability on shareholders. In *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*,⁴⁹ upon which the *Victoria Elevator* court relied, the Fourth Circuit Court of Appeals suggested that in a case involving a closely-held corporation, undercapitalization would be a controlling factor.⁵⁰ Undercapitalization also ought

43, 87 Cal. Rptr. 614, 617-19 (1970); *Minton v. Cavaney*, 56 Cal. App. 2d 576, 579-80, 364 P.2d 473, 475, 15 Cal. Rptr. 641, 643 (1961); *Loy v. Booth*, 16 Ill. App. 3d 1077, 1081, 307 N.E.2d 414, 417 (1974).

In *Anderson v. Abbott* the United States Supreme Court cited to cases in jurisdictions that had recognized inadequate capitalization as a basis for denying shareholders the protection of limited liability. The Court included *Erickson v. Ontario & Minnesota Power Co.*, 134 Minn. 209, 158 N.W. 979 (1916). In *Erickson*, however, the Minnesota Supreme Court ostensibly relied on agency principles to hold the defendant parent corporation liable for damage its subsidiary caused to plaintiff's property. *Id.* at 214, 158 N.W. at 981. Although the Minnesota court recognized that the corporations were separate legal entities, it maintained that one corporation can be an agent for another, and that in this case the subsidiary was an agent for its parent corporation. *Id.* Therefore, agency principles would dictate visiting liability on the principal/parent corporation for the wrongful conduct of the agent/subsidiary. The court failed to indicate how the agency relationship was created. The decision, however, did contain an extended discussion of the financial relationship of the corporations that may have been the basis for inclusion of the case in *Anderson*. The *Erickson* court noted that "[b]y the terms of the contract defendant [parent corporation] agreed to pay, and has paid [to its subsidiary], annually the sum of \$4,000 to maintain the expense of the dam [and reserve to itself exclusive use of the dam and related property.] No rent or other charge was paid for this exclusive use, and no revenue is derived therefrom." *Id.* Thus raising the implication that the terms of the agreement created an undercapitalized subsidiary corporation because it could meet no liabilities beyond its operating expenses.

Because the *Erickson* court purported to impose shareholder liability on agency principles rather than by disregarding the corporate entity of the subsidiary, the case has raised more questions than it has settled with respect to the proper role that undercapitalization should play in relation to corporate disregard law. See Note, *supra* note 1, at 340-41.

47. *Anderson v. Abbott*, 321 U.S. 349, 362 (1944). Determining what constitutes undercapitalization presents some difficult problems of measurement. Inadequate capitalization for purposes of economic decisions such as entry into business, extension of credit, or taxation may not be the same as that for holding a shareholder personally liable. There is also the danger that hindsight will be used in making this determination. Comment, *supra* note 5, at 459. Inability to satisfy a judgment is not always indicative of inadequate capitalization.

48. 283 N.W.2d at 512.

49. 540 F.2d 681 (4th Cir. 1976).

50. *Id.* at 685. The weight of authority clearly holds that undercapitalization alone is not sufficient to invoke the remedy of disregard. See, e.g., *In re County Green Ltd.*, 604 F.2d 289, 292 (4th Cir. 1979) (per curiam) (noting that single factor will rarely be sufficient to justify drastic remedy of disregarding the corporate entity); *Harris v. Curtis*, 8 Cal. App. 3d 837, 841-43, 87 Cal. Rptr. 614, 617-19 (1970); *Bartle v. Home Owners Coop., Inc.*, 309 N.Y. 103, 106-07, 127 N.E.2d 832, 883 (1955).

to be determinative in disregard cases involving tort creditors. Unlike a party to a breached contract, a tort victim has no opportunity to investigate the financial soundness of a tortfeasor corporation before the commission of the tort.⁵¹ A contract creditor failing to investigate the financial soundness of a corporation assumes the risk of doing business with an undercapitalized corporation.⁵²

The corporate formalities theory of disregard law stresses the pragmatic concern of preserving the separate legal characteristics of a corporation.⁵³ The Minnesota Supreme Court recognized the importance of following corporate formalities in *Gallagher v. Germania Brewing Co.*⁵⁴ *Gallagher* was an action for the price of goods sold and delivered to the defendant corporation. The dominant shareholders of the corporation intervened and claimed a previously unsatisfied personal judgment against the assignor of the initial action as a set-off.⁵⁵ The court emphasized the nature of a corporation⁵⁶ and held that to allow a set-off would ignore the principle that a corporation “is an entity separate and distinct from the body of its shareholders.”⁵⁷ In dictum, the court stressed the need to adhere to corporate formalities to keep title to corporate property free from “complication and uncertainty.”⁵⁸

The most consistently applied theory of Minnesota corporate disregard law has been based on fraudulent shareholder conduct.⁵⁹ In *Matchan v.*

51. Compare Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 B.U.L. REV. 123, 138-42 (1968) and Note, *supra* note 1, at 356-58 with Comment, *supra* note 5, at 459 and Note, *supra* note 1, at 358.

52. Note, *supra* note 1, at 356-58. It is reasonable to expect that the financial soundness of a party to a contract will be investigated prior to entering into the contractual relationship. See *G.G.C. Co. v. First Nat'l Bank*, 287 N.W.2d 378, 384 (Minn. 1979) (“The Bank was a consensual and sophisticated creditor of the corporation and should, therefore, be generally regarded as being able to look out for itself. . . .”) (citing and quoting Note, *supra* note 1).

53. See *Gallagher v. Germania Brewing Co.*, 53 Minn. 214, 219, 54 N.W. 1115, 1116 (1893); see also Note, *supra* note 1, at 339-40.

54. 53 Minn. 214, 54 N.W. 1115 (1893).

55. *Id.* at 215, 54 N.W. at 1116.

56. *Id.* at 219, 54 N.W. at 1116.

57. *Id.*

58. *Id.* In a 1951 decision the Minnesota Supreme Court had intimated that failure to observe formalities was an important consideration in corporate disregard law. See *General Underwriters, Inc. v. Kline*, 233 Minn. 345, 46 N.W.2d 794 (1951) (disregard of corporate entity based, in part, on corporation's failure to keep books of account, corporate minutes, or separate corporate offices). But see *Whitney v. Leighton*, 225 Minn. 1, 30 N.W.2d 329 (1947), *aff'd on rehearing*, 225 Minn. 12, 30 N.W.2d 335 (1948) (separateness of corporate entity recognized where failure to observe corporate formalities does not amount to fraud).

59. See *Ahlm v. Rooney*, 274 Minn. 259, 143 N.W.2d 65 (1966); *Whitney v. Leighton*, 225 Minn. 1, 30 N.W.2d 329 (1947), *aff'd on rehearing*, 225 Minn. 12, 30 N.W.2d 335 (1948); *Fewell v. Tappan*, 223 Minn. 483, 27 N.W.2d 648 (1947); *Lake Park Dev. Co. v. Paul Steenberg Constr. Co.*, 201 Minn. 396, 276 N.W. 651 (1937); *Prudential Ins. Co. v. A. Enkema Holding Co.*, 196 Minn. 154, 264 N.W. 576 (1936); *Matchan v. Phoenix Land*

*Phoenix Land Investment Co.*⁶⁰ the Minnesota Supreme Court established the rule that shareholders may not use the corporate attribute of limited liability to avoid responsibility for fraudulent acts.⁶¹ In *Matchan* the dominant shareholder used a corporation to perpetrate a land fraud scheme. The court disregarded the corporate entity and held that the shareholder's fraud was attributable to the corporation.⁶²

Since *Matchan*, fraud has been the dominant factor in deciding whether to disregard the corporate entity.⁶³ In *Whitney v. Leighton*⁶⁴ the Minnesota court expressly held that proof of fraud was necessary to disregard the corporate entity⁶⁵ and that "in the absence of fraud the corporation must be treated as a legal entity separate and apart from its stockholders."⁶⁶ Whether the *Victoria Elevator* court impliedly overruled *Whitney* or simply overlooked it is not clear. In any event, *Victoria Elevator* is the first case since *Whitney* to impose personal liability on shareholders in favor of corporate creditors in the absence of fraud.⁶⁷ *Victoria Elevator* and its progeny have made it clear that although strict common-law fraud will remain an important factor, it is not an essential element in a decision to disregard the corporate entity.⁶⁸

Inv. Co., 159 Minn. 132, 198 N.W. 417 (1924); *Moe v. Harris*, 142 Minn. 442, 172 N.W. 494 (1919). *But see* *Manufacturers Bldg., Inc. v. Heller*, 306 Minn. 180, 235 N.W.2d 825 (1975), noted in 3 WM. MITCHELL L. REV. 293 (1977); *In re Clarke's Will*, 204 Minn. 574, 284 N.W.2d 876 (1939). *See generally* Note, *supra* note 1.

60. 159 Minn. 132, 198 N.W. 417 (1924).

61. *Id.* at 138, 198 N.W. at 420.

62. *Id.*

63. *See* cases cited *supra* note 59.

64. 225 Minn. 1, 30 N.W.2d 329 (1947).

65. *Id.* at 8, 30 N.W.2d at 333.

66. *Id.*

67. A recent case, *Manufacturers Bldg., Inc. v. Heller*, 306 Minn. 180, 235 N.W.2d 825 (1975), noted in 3 WM. MITCHELL L. REV. 293 (1977), allowed disregard without a finding of fraud. *Heller*, however, involved a dispute among shareholders of a close corporation and did not involve corporate creditors. This distinction provided the justification for the Minnesota court's withdrawal from the fraud basis of earlier decisions. *See* 3 WM. MITCHELL L. REV. 293, 295 (1977). The only other instance in which the Minnesota court disregarded the corporate entity in the absence of fraud was *Walsh v. Mankato Oil Co.*, 201 Minn. 58, 275 N.W. 377 (1937), a pre-*Whitney* decision.

68. *See* 283 N.W.2d at 512 n.5. The Minnesota Supreme Court has addressed the issue of disregarding a corporate entity four times since its decision in *Victoria Elevator* adopting of the two-prong test. *See* *White v. Jorgenson*, 322 N.W.2d 607 (Minn. 1981); *Snyder Elec. Co. v. Fleming*, 305 N.W.2d 863 (Minn. 1981); *G.G.C. Co. v. First Nat'l Bank of St. Paul*, 287 N.W.2d 378 (Minn. 1979). The court cited *Victoria Elevator* and in fact relied on the two-prong test in determining whether to disregard the corporate entity in *White*, *West Concord*, and *Snyder Electric*. In *G.G.C.*, which was decided three weeks after *Victoria Elevator*, the court alluded to the continued significance of fraud in corporate disregard cases by stating that "[d]isregard of the corporate entity theories is equitable in nature, and generally is not available, absent fraud." 287 N.W.2d at 384 (citing *Matchan v. Phoenix Land Inv. Co.*, 159 Minn. 32, 198 N.W. 417 (1924)). The court attempted to explain its holding in *G.G.C.*, which would appear to be contradictory to its earlier decision in *Victoria Elevator*, by noting in *West Concord* that in *G.G.C.*

The instrumentality theory and the eight-factor test adopted in *Victoria Elevator* integrate the disparate theories of corporate disregard law that have been applied in earlier Minnesota cases. Emphasis is placed on how the corporation operated and on the defendant shareholder's relationship to that operation.⁶⁹ Because the eight-factor test encompasses so many facets of corporate behavior, courts should be extremely careful in scrutinizing the conduct and shareholder relationships of small closely-held,⁷⁰ often family-owned, corporations. In applying the analysis, these corporations should not be compared to highly structured large publicly-held corporations. Features that are inherent to small closely-held corporations should not be the basis for disregarding the corporate entity, absent substantial evidence that a dominant shareholder is abusing the privilege of limited liability.⁷¹ Due recognition must be given to the typical characteristics of close corporations⁷² to allow them the limited shareholder liability that is a legitimate and often primary reason for incorporating.⁷³

this court stated that disregard of the corporate entity is equitable in nature, and generally not available, absent fraud. However, proof of strict common law fraud is not required, but, rather, evidence that the corporate entity has operated as a constructive fraud or in an unjust manner must be presented.

306 N.W.2d at 898 n.3 (citation omitted). The *West Concord* court, however, did not indicate why it failed to cite or rely on *Victoria Elevator* in *G.G.C.*

69. 283 N.W.2d at 512. The *Victoria Elevator* court stated that in applying the instrumentality theory "courts are concerned with reality and not form, with how the corporation operated and the individual defendant's relationship to that operation." *Id.* (quoting *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 541 F.2d 681, 685 (4th Cir. 1976)).

70. In a closely-held corporation shares of the corporation are held by a single shareholder or by a closely-knit group of shareholders. Unlike the publicly-held corporation, there is no public issue or trading of voting shares. Most close corporations are small business enterprises whose members desire certain corporate advantages, such as limited liability, while at the same time preserving many attributes of a sole proprietorship or partnership. Shareholders in a close corporation are usually active in the conduct and management of the business. Procedures tend to be simplified and informal. H. HENN, *supra* note 1, at 506-07. Because the procedure is less formal and, therefore, subject to abuse, courts are more likely to disregard the corporate entity in cases involving close corporations than in those involving publicly-held corporations. See Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D.L. REV. 363, 378 (1969). See generally F. O'NEIL, *CLOSE CORPORATION LAW AND PRACTICE* § 1.09(a) (2d ed. 1971 & Supp. 1977).

71. Gillespie, *supra* note 70, at 378 & n.61.

72. Closely held corporations typically do not observe strict corporate procedures because their communications and recordkeeping systems do not require it. Close corporations generally are not expertly managed and do not have the substantial financial foundation of public corporations. Also, the corporateness of close corporations should not be more readily disregarded because they are organizationally similar to partnerships, which do not enjoy the attribute of limited liability. *Id.*

73. *Anderson v. Abbott*, 321 U.S. 349, 362 (1944).