COMMENTS

CORPORATIONS: DISREGARD OF THE CORPORATE ENTITY FOR THE BENEFIT OF SHAREHOLDERS

Unlike the corporate creditor, the shareholder who attempts to persuade a court to disregard the corporation's status as a separate legal entity will find few black-letter rules by which he can evaluate his chances of success. An analysis of the cases in which these attempts have been made may help to fill the gap left by the failure of the courts to articulate generally applicable rules.

PROTECTION OF THE SHAREHOLDER

Three situations will be discussed here in which disregard of the corporate entity for the benefit of the shareholder has been found necessary by the courts to properly adjust the equities between the parties to a suit. The factual contexts involved are widely divergent. The entity has been disregarded to prevent avoidance of contractual obligations by the shareholder's adversary. In other cases, the corporate form has been ignored by the court on policy grounds to extend to a shareholder the protection afforded by a particular state statute. On a few occasions, courts have disregarded the corporate entity to enable the shareholder to avoid federal income taxes.

Contractual Obligations

The law of contracts attempts to insure realization of the reasonable expectations which have been induced by the making of a promise. In order to prevent a party from manipulating the corporate form to his own advantage in violation of this basic prin-

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2 A few courts have held, or at least implied, that the corporate entity may never be disregarded to benefit a shareholder. See Montana Power Co. v. FPC, 185 F.2d 491 (D.C. Cir. 1950); In re Sun Cab Co., 67 F. Supp. 137 (D.C. Cir. 1946); Eastwood Model Mkt. v. State, 359 S.W.2d 294 (Tex. Civ. App. 1962); Barium Steel Corp. v. Wiley, 379 Pa. 38, 108 A.2d 336 (1954) (dissent).
3 See 1 CORBIN, CONTRACTS § 1 (1950).
principle of the law, courts have been willing to disregard the corporate entity.\(^4\) Epstein v. Fabricraft\(^5\) represents a line of cases involving disregard for that purpose at the request and for the benefit of a shareholder.\(^6\)

In the Epstein case a landlord attempted to expel his tenant on the grounds that the tenant had violated the lease contract by subletting the premises to an affiliated corporation. The court, however, disregarded the separate entity of the subtenant, holding that since all of the stock of both tenant and subtenant was owned by one person, the premises were in fact still occupied by the same party.\(^7\) There had therefore been no violation of the lease and the landlord could not prevail.

The approach demonstrated by the Epstein case does not unfairly prejudice lessors. A subleasing arrangement does not relieve the original tenant of liability for failure to perform any of the covenants in the lease, including the usual promise to pay rent.\(^8\) Further, the tenant in some jurisdictions is liable to the landlord for any waste committed by his subtenant.\(^9\) Even if under local law such liability will not be imposed, and the subtenant is judgment-proof, the court can again deny the subtenant’s status as a separate legal entity to impose liability on the controlling shareholder.\(^10\) In short, that pool of assets originally available to a landlord under a lease contract will still be available after the sublease. This being the case, the shareholder’s expectation of successfully transferring possession of the leased premises to the corporate sub-


\(^{5}\) 67 N.Y.S.2d 730 (Sup. Ct. 1947).


\(^{7}\) 67 N.Y.S.2d at 731.


\(^{10}\) Perhaps on grounds of inadequate capitalization. See Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473 (1961); Wallace v. Tulsa Yellow Cab Taxi & Baggage Co., 178 Okla. 15, 61 P.2d 645 (1936). At any rate there had been no waste in the Epstein case and none was threatened. The court noted that there had been no change in the type or amount of equipment located on the premises, and that there had been no increase in the number of employees using the premises. 67 N.Y.S.2d at 730.
tenant is not unreasonable. The courts will effectuate that expectation by disregarding the entity for the shareholder's benefit. A contrary result would permit the landlord to avoid a contractual obligation on a mere technicality.

Usury Statutes

In sharp contrast to the cases discussed above is a line of authority permitting disregard of the corporate entity to benefit the shareholder even though that procedure actually defeats the expectations of the parties to a contract. In some states the protection afforded by the local usury statute is not extended to corporate borrowers. Frequently, a lender will attempt to circumvent the usury laws as they relate to individual borrowers by requiring prospective debtors to incorporate and then making the loan to the corporation at an usurious rate of interest. If a suit is subsequently brought on the debt, the individual shareholder will defend, of course, on the ground that the court should look behind the corporation and view the shareholder as the real debtor. Several courts have accepted this argument and have allowed the shareholder to raise the defense of usury where they were convinced that the loan was in fact made to the individual, and that the corporation was formed and used

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1 For other decisions in which courts have disregarded the corporate entity for the benefit of a shareholder in order to enforce a contract in the light of the reasonable expectations of the parties, see Grossman v. Fontanbleau Hotel Corp., 273 F.2d 720 (5th Cir. 1959); Barium Steel Corp. v. Wiley, 379 Pa. 38, 108 A.2d 336 (1954) (3-3 decision); Tinkoff v. Foddin, 337 Ill. App. 384, 85 N.E.2d 855 (1949); Earp v. Schmidt, 334 Ill. App. 382, 79 N.E.2d 697 (1948); Montgomery v. Central Nat'l Bank & Trust Co., 267 Mich. 142, 225 N.W.2d 274 (1973). But see, White v. Evans, 117 N.J. Eq. 1, 174 Atl. 731, reversing, 115 N.J. Eq. 177, 169 Atl. 812 (1934). In the White case, defendant Evans had insured his farm against loss by fire, and subsequently conveyed the premises to the “W.C. Evans Co.,” his wholly owned corporation, to defeat his wife's right of dower. The property was destroyed by fire and the insurance company was permitted to escape liability under a clause in the policy providing that “this entire policy . . . shall be void . . . if any change . . . takes place in the interest, title or possession of the subject of the insurance . . . .” 115 N.J. Eq. at 2, 174 Atl. at 732. The New Jersey Supreme Court refused to disregard the corporate entity for stockholder Evans' benefit. Id. The lower court in deciding for Evans had stressed that insofar as the fire hazard was concerned, the insurance company had not been subjected to any greater risk of loss as a result of the change in title. 115 N.J. Eq. at 183, 169 Atl. at 815.

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solely for the purpose of avoiding the local usury statute. These courts apparently have been motivated by what they view as a strong local policy adverse to usury. Thus, in Lesser v. Strubbe, a New Jersey court recently asserted that, “the mere use of the corporate form cannot be permitted to obscure the true facts and sanction the exaction of usury . . . in disregard of our public policy against it.”

The expectations of the creditor derived from the loan contract are regarded as subordinate to that policy.

Early New York decisions generally granted the shareholder relief where it was shown that the lender was manipulating corporate entities to exact usurious rates of interest. However, since the decision in Jenkins v. Moyse in 1930 the New York courts have consistently held that the defense of usury may not be pleaded even though the lender compelled the formation of the corporation for


14 56 N.J. Super. 274, 152 A.2d 409 (Ch. 1959).

15 Policy considerations implicit in other types of legislation have caused courts in some cases to refuse to disregard the entity for the benefit of the shareholder. In point are cases which arose during the severe postwar housing shortage under statutes and regulations restricting the right of a landlord to evict his tenant at the expiration of the lease. Viewing these acts as the products of a public emergency, the courts construed their provisions strictly, holding (1) that a corporate landlord was ineligible to bring suit under the statutes to remove its tenant and (2) that the corporate entity would not be disregarded at the behest of a shareholder in a corporate landlord where the effect would be to sanction an eviction. For example, one requirement of these statutes was that the landlord have full legal title to the premises in question; where petitioner had paid the price of the building and had operated it, he was denied relief when the court discovered that he had recorded legal title to the premises in the name of his wholly owned corporation. The court expressly refused to disregard the corporate entity. Nathan Straus-Duparquet, Inc. v. Moglen, 185 Misc. 657, 57 N.Y.S.2d 393 (N.Y.C. Munic. Ct.), aff’d per curiam, 185 Misc. 831, 58 N.Y.S.2d 714 (Sup. Ct. 1945). Accord, Goldberg v. Friedman, 186 Misc. 983, 61 N.Y.S.2d 222 (N.Y.C. Munic. Ct. 1946); Dimas Homes, Inc. v. Logerfo, 188 Misc. 286, 67 N.Y.S.2d 414 (N.Y.C. Munic. Ct. 1946). Reconstruction Syndicate v. Sharpe, 186 Misc. 897, 61 N.Y.S.2d 176 (N.Y.C. Munic. Ct. 1946).


the express purpose of avoiding the usury statute. These courts point out that the shareholder has generally entered into the transaction with his eyes open, knowing the significance of incorporation. Further, while conceding that the corporate entity may be disregarded in order to prevent the evasion of statutory restrictions, the New York courts find, in the conduct of the lender, full compliance with the law. *Jenkins v. Moyse* was explicit on this point:

Here the corporate entity has been created because the statute permits a corporate entity to make a contract which would be illegal if made by an individual. The law has not been evaded but followed meticulously in order to accomplish a result which all parties desired and which the law does not forbid.

In fact, however, the *Jenkins* doctrine relieves all but the unsophisticated creditor from the ambit of New York usury prohibitions, and effectively strips from the typically hard-pressed borrower the protection the statutes are designed to provide.

**Taxation**

Despite an overwhelming volume of adverse precedent, shareholders have persisted in attempts to have the corporate entity disregarded in order to gain an otherwise unavailable tax benefit. Under the doctrine of *Moline Properties v. Commissioner*, the individual stockholder can persuade the court to disregard the corporate entity for income tax purposes only if he can show that it was

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20 254 N.Y. at 324, 172 N.E. at 522.

21 The New York legislature, apparently recognizing that *Jenkins* had opened the door to "unjust, unfair . . . and uneconomic practices . . . by money lenders using the corporate device to accomplish the exaction of oppressive and usurious rates of interest" (N.Y. Sess. Laws 1957, ch. 968, §1), restored the defense of usury "to a corporation, the principal asset of which shall be the ownership of a one or two family dwelling" where the corporation was created within the six month period preceding execution of the loan in question. N.Y. GEN. BUS. LAW § 374.2.

22 E.g., Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962); Hagist Ranch, Inc. v. Commissioner, 295 F.2d 351 (7th Cir. 1961); Commissioner v. State-Admas Corp., 283 F.2d 585 (2d Cir. 1960); Nelson v. Commissioner, 281 F.2d 1 (6th Cir. 1960); Wartley v. Commissioner, 275 F.2d 461 (2d Cir. 1960); Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957). See generally 7 MERTENS, FEDERAL INCOME TAXATION §§ 38.07-.15 (rev. ed. 1956).

23 319 U.S. 436 (1943).
created for no substantial business purpose, and in fact did not function as an independent business organization. Paymer v. Commissioner illustrates the practical difficulty in making such a showing. In this case the court found that one of two corporations formed by the taxpayers had been completely passive, having no business purpose and in fact engaging in no business activity. It was held that the income derived from property held by this corporation was taxable only to the shareholders. However, the shareholders had accepted and secured a loan in the name of the other corporation. That single corporate act was held sufficient business activity to justify a holding that the income in question was taxable to that corporation. In general, the necessary lack of business activity and purpose has been found only where the corporation has merely held legal title to property transferred to it, the shareholders retaining in fact and in form all incidents of ownership.

24 "Whether the purpose be to gain some advantage under the law of the state . . . or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Id. at 438-39.

25 150 F.2d 334 (2d Cir. 1945). Real property held by a partnership was transferred to two corporations to hinder one of the partner's creditors; the partners continued to treat the property as partnership property. The Commissioner attempted to tax the corporations on the income from the property over the contention of the partners that the corporate entities should be disregarded and the income treated from its inception as the partner's income. Id. at 335-36.

26 150 F.2d at 337.

27 Id. at 336-37. Accord, Sheldon Bldg. Corp. v. Commissioner, 118 F.2d 835 (7th Cir. 1941). Other courts have agreed that very slight business activity will be sufficient to require the corporation to be sustained as a separate taxable entity. In Commissioner v. State-Adams Corp., 283 F.2d 395 (2d Cir. 1960), a corporation formed for the purpose of holding title to trust property and avoiding anticipated difficulties on the death of the sole trustee and income beneficiary was sustained as a separate entity. The corporation had merely taken an assignment of a lease on the property and executed a note to the trustee at an interest rate equal to the rental value of the property. The court in Gray Holding Corp. v. Clauson, 95 F. Supp. 928 (S.D. Me. 1951) upheld the entity where there had been no business activity, but where the corporation had the privilege under its charter of engaging in business. "[P]laintiff's broad though unexercised, corporate powers are alone sufficient to subject plaintiff to the corporate income tax . . . ." Id. at 935.

28 Jackson v. Commissioner, 233 F.2d 289 (2d Cir. 1956); United States v. Brager Bldg. & Land Corp., 124 F.2d 349 (4th Cir. 1941); North Jersey Title Ins. Co. v. Commissioner, 84 F.2d 898 (3d Cir. 1936); 112 W. 59th St. Corp. v. Helvering, 68 F.2d 397 (D.C. Cir. 1933). One author argues that failure to discover any business activity has been equated with the existence of an agency relationship between the shareholder and the corporation; the income is then taxed only to the shareholder on the grounds that income collected by an agent for his principal in the scope of his agency belongs to the principal. BITTKER, FEDERAL INCOME TAXATION OF COR-
Courts have indicated a similar reluctance to disregard the corporate entity in other types of tax litigation. Attempts to avoid state sales taxes assessed on transfers between a parent corporation and its closely held subsidiary, on the ground that the subsidiary was really only a department or agent of the parent, have almost uniformly been frustrated. There has also been a general refusal to disregard the corporate entity to allow the shareholder to escape state levies for unemployment compensation. In all the above cases the courts have been unwilling to disregard the entity where the shareholder has utilized the corporation's status as a separate entity for a substantial period and has enjoyed the economic advantages that result from conducting business in the corporate form.

The shareholder cannot reasonably complain that the courts have taken an unduly rigid view of the corporate entity in imposing tax liability. While the average businessman may be unable to anticipate many of the legal ramifications of the separate corporate entity, certainly the tax burdens are notorious and foreseeable. His voluntary creation and use of the corporation has been deemed, in effect, acceptance by him of these burdens as a cost of doing business in the corporate form. The shareholder has been denied only what he had no right to expect: the benefits of the corporate form without its burdens.

**PROTECTION OF THIRD PARTIES**

Though the shareholder has convinced the court that as between himself and his adversary there is no barrier to disregarding the corporate entity, nevertheless third party interests may intervene and induce the court to insist that the entity be maintained. As the discussion below indicates, courts have been most sensitive to threats to third party interests in cases involving shareholder attempts to make personal use of corporate assets.


Shareholder Recovery on a Corporate Cause of Action

A shareholder may not successfully assert a corporate cause of action in a suit brought in his own name and for his exclusive benefit. In refusing to disregard the entity and to recognize a personal cause of action, the courts have insured that recovery will be sought by the corporation itself or by the shareholders in a derivative capacity. Either of these latter two methods of asserting corporate claims protects innocent shareholders and corporate creditors since the recovery inures to the corporate treasury.

However, under special circumstances a few courts have bypassed the corporate treasury and divided the recovery in a derivative action pro rata among selected shareholders of the corporation. For instance, in Perlman v. Feldmann, where the derivative action was based on alleged breach of fiduciary duty by corporate management and majority shareholders, the court allowed minority shareholders to recover individually. It was emphasized that recovery by the corporation would have restored the funds recovered to the control of the wrongdoers. Similarly, in Chounes v. Laing, another case involving alleged breach of fiduciary duty, the court awarded pro rata recovery to limit recovery to innocent shareholders. As in the Perlman case, corporate recovery was not needed to protect corporate creditors, and the court was unwilling to benefit shareholders who had acquiesced in the alleged wrongs. Thus courts have indicated a willingness to grant an extraordinary remedy where

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22 See E. M. Fleischmann Lumber Corp. v. Resources Corp. Int'l, 105 F. Supp. 681 (D. Del. 1952); London v. Bruskas, 64 N.M. 73, 324 F.2d 424 (1958); Massachusetts v. Davis, 140 Tex. 396, 168 S.W.2d 216 (1942), cert. denied, 320 U.S. 210 (1943). Courts have also sought to avoid the "multiplicity of suits" which would result if each shareholder had a cause of action for each single wrong suffered by his corporation. Waller v. Waller, 187 Md. 185, 49 A.2d 449 (1946). See BALLANTINE, CORPORATIONS 43 (rev. ed. 1946). Further, recovery by the corporation may also be necessary to insure payment of the corporation's tax liabilities. See Licken v. Shaffer, 64 F. Supp. 432, 411 (N.D. Iowa 1946).


25 125 W. Va. 275, 23 S.E.2d 628 (1942).

the third party interests normally thought to bar individual recovery either do not exist or are not worthy of protection. 37

**Debt Set-Offs**

Fear of injury to third parties has resulted in refusal to disregard the corporate entity for the benefit of shareholders in suits involving attempted debt set-offs. Plaintiffs, in *Dennis v. Smith*, 38 held stock in a corporation which had a deposit in an insolvent bank. Suit was brought to compel the receiver of the bank to apply the corporation's deposit against the shareholder's personal liability to the bank. Generally, one claim will not offset another unless each is owned by a party to the suit. 39 To overcome this hurdle the shareholder urged that the separate entity of the corporation should be ignored so that they could be viewed as creditors of the bank. The court refused on the grounds that the set-off would amount to an improper use of corporate assets; such assets, the court noted, are properly used to carry on corporate business to benefit all shareholders and to secure corporate creditors. 40

Other courts in dealing with attempted set-offs against insolvent banks have refused to disregard the entity on the grounds that the set-off would be prejudicial to creditors of the bank. 41 Such set-offs would amount to a preference in favor of the particular depositor, and, to whatever degree the set-off satisfied the shareholder's obligation to the bank, the pool of assets available to meet the claims of other depositors would be reduced.

There is a similar line of cases involving suits instituted by a solvent plaintiff against a defendant who happens to hold stock in a corporation to which plaintiff is in debt. Here too the courts have refused to reduce the shareholder's liability by allowing him to set-off the corporation's claim where such set-off might prejudice credi-

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 tors of his corporation. However, where no corporate creditors were threatened, set-off has been allowed.

From the shareholder's point of view, the refusal to sanction set-off here is not as serious as it was where the plaintiff was insolvent; the shareholder can institute a new suit in the name of the corporation, and, since the plaintiff is solvent, recover the debt. However, in this context the refusal to disregard the entity is open to the objection that it promotes circuity of action. In addition, in an occasional case, the shareholder might find that the statute of limitations had run on the corporation's claim. These considerations make it important that the court ascertain that, in fact, third party interests would be prejudiced by the set-off before refusing to disregard the entity.

Testamentary Dispositions of Corporate Property

Courts have been willing under some circumstances to allow nominally corporate property to pass under a shareholder's will. The cases in which the devise has been upheld have involved close corporations created by the testator solely for the convenience of holding title to his property, the testator during his life having treated the property in question as though it were his own. Generally these corporations have had no creditors at the testator's death. Where that was not the case, the devise was upheld on a showing that the corporation had sufficient assets to satisfy the claims of its creditors over and above the corporate assets bequeathed. Here again the courts have disregarded the corporate entity at the


behest of the shareholder where no prejudice would result to third parties.47

CONCLUSION

A court may be induced to disregard the corporate entity by a shareholder who can establish that no one would be unfairly prejudiced by the relief he seeks. Initially the shareholder must show that it is necessary to disregard the corporate entity to properly adjust the equities between himself and his adversary. Courts have been satisfied on this point with a showing that the shareholder’s opponent has manipulated a corporate entity to avoid a contractual obligation or a statutory restriction. Further, since interests not represented or protected by parties to the suit may be adversely affected where the entity is disregarded, courts have also required the shareholder to establish that no third parties would be prejudiced. If refusal would seriously prejudice the shareholder, the court should examine the facts closely to determine that there would be actual injury to third party interests before refusing on that ground to disregard the entity for the benefit of the shareholder. Even where such interests are actually threatened, the courts might, as one commentator has suggested, disregard the entity while protecting those interests with other available procedures.48

47 The fact that a legatee may be injured by the disregard has not caused the courts to refuse to pierce the veil. In the Matter of Barries’ Estate, 25 Misc. 2d 890, 203 N.Y.S.2d 12 (Surr. Ct. 1960) where testator bequeathed all of the stock of his corporation to named legatees subject to a $300 per month payment to his widow, payable from the rental income from property held by the corporation, the fact that the payment diminished the value of the stock did not prevent disregard of the entity. See Fidelity Trust Co. v. Service Laundry, 160 Tenn. 57, 22 S.W.2d 6 (1929).

48 Berger suggests that a court of equity could allow the shareholders to recover on the conditions that they accept liability for the claims of such third parties; or, the court might abate the judgment until creditors have been notified and given a chance to file claims with the court. Berger, “Disregarding the Corporate Entity” for Stockholders’ Benefit, 55 COLUM. L. REV. 808, 823 (1955). He also suggests that a class action by the shareholders for their own benefit would avoid the “multiplicity of suits” problem. Id. at 822.