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# Use of the American Doctrine of Piercing the Corporate Veil: An Argument in Danish Business Law

Professor Nis Clausen†

## INTRODUCTION

Piercing the corporate veil is a well-recognized doctrine in the United States. When shareholders use a corporate entity for illegitimate purposes, American courts attempt to do justice by ignoring the distinction between the shareholders and their corporation. A classic statement of the legal standard is “that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.”<sup>1</sup>

The doctrine of corporate veil piercing is hardly recognized in Denmark. However, there is reason to believe Danish courts will soon expand its use. Before creating a version suitable to their needs, they should consider the evolution of the doctrine in U.S. courts.

A veil-piercing doctrine is needed because recent economic changes in Denmark have brought about the development of new subsidiary financing techniques. Some corporations in Denmark now obtain financing from banks by creating a subsidiary corporation which holds most or all of its assets. The subsidiary takes out a loan from a bank, and the bank is its only creditor. This strategy, in effect, makes that bank the parent's preferred creditor, because the parent has stored its assets in the subsidiary where they are beyond the reach of the parent's other creditors.

The traditional means of attacking corporate fraud do not offer these creditors an effective means of combatting this new subsidiary financing technique. This Article argues that the creditors of the parent corporation should petition to the Danish courts to pierce the corporate veil, allowing them access to the assets in the subsidiary and forcing the bank to take its proper

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1. *United States v. Milwaukee Refrigerator Transportation Co.*, 142 F. 247, 255 (7th Cir. 1905).

share of the losses. Danish courts have the power to create a veil-piercing doctrine, which may be the only effective remedy for these creditors.

This Article first establishes the need to adopt the doctrine of piercing the corporate veil in Denmark by analyzing current financing practices and creditors' remedies in Denmark. Part II then discusses in both theoretical and practical terms how the U.S. courts have applied the doctrine to date. The case analysis focuses on problems germane to the Danish experience, for example: the parent/subsidiary relationship, adequacy of capitalization, commingling of assets, self-dealing, control of the corporation and the need to show fraud. Finally, in Part III, the Article explores the way in which Danish courts may apply the veil-piercing doctrine.

## I

### OBTAINING FINANCING THROUGH A NEWLY-FORMED SUBSIDIARY IN DENMARK

#### A. *Economic Background*

An economic crisis in the 1970's changed the financing practices of Danish corporations. Before then, they used their equity, real estate, equipment and personal guarantees from stockholders and other sources as the basis for obtaining necessary business loans. However, the economic crisis caused Danish corporations to start obtaining more of their capital from outside institutions, such as banks. At the same time, they are using fewer hard assets to secure these loans. Three economic changes in particular have shaped Danish corporate finance:

- a) Corporate equity has diminished as existing corporations have been forced to cut prices to keep their market shares. Newly formed corporations, which have started up during the economic crisis, generally have less equity and fewer hard assets than well-established firms.
- b) Suppliers of goods, particularly foreign suppliers, have tightened credit terms, basing the credit they extend on the corporation's net worth or on letters of credit.
- c) It has become necessary to sell products on credit to retain market shares or enter new markets.<sup>2</sup>

Along with the decrease in equity, other traditional sources of financing have dried up or become less attractive. Real estate used primarily for business purposes no longer keeps its value over time.<sup>3</sup> Technological development has resulted in lower resale value for equipment and for some older buildings. Accordingly, instead of buying real estate and equipment on credit, corporations often enter into complex leasing arrangements.<sup>4</sup> These

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2. STATISTISKE MEDDELELSER, 1971-1983 (Danmarks Statistik).

3. *Id.*

4. Furthermore, it should be noted that this development has been accelerated through changes in Danish tax law. Through the use of different tax reduction systems, individuals not doing business, such as insurance companies, and pension funds have been encouraged to contribute new capital to develop financial leasing.

assets are therefore no longer available to secure the loans needed for working capital.

Inventory and its proceeds, such as accounts receivable, chattel paper, and other debt instruments, have replaced land and equipment as a firm's most valuable assets, and, therefore, currently play a very important role in financing Danish business enterprises.

A corporation's demand for credit will fluctuate greatly over a period of time. It may be important for the corporation to use devices which permit the amount of the indebtedness to vary. Financing through inventory and its proceeds gives the corporation this needed flexibility.

### *B. Legal Framework*

The Danish legal system has not adjusted itself well to the fact that the use of inventory and chattel paper as collateral is now often the best means of obtaining capital. Current regulations make these means of securing loans for corporations inefficient and prohibitively expensive.

Under Danish law, a security interest in inventory can only be perfected by possession or filing.<sup>5</sup> Perfection by possession does not require that the secured party personally take possession of the inventory. The inventory may be placed with an independent bailee. The crucial point is that perfection by possession of inventory deprives the debtor of the productive use of the inventory.

Perfection by filing, on the other hand, requires that the filing documents describe in detail each item covered by the security interest.<sup>6</sup> If the description in the documents is ambiguous or inaccurate, the interest in the collateral is not perfected. The debtor's other secured creditors who have perfected their interests will then have priority over this secured party's claim. Furthermore, a security interest in inventory does not automatically continue in the proceeds. A new and independent perfection by possession, filing or notification is required in order to perfect a security interest in the proceeds.<sup>7</sup> Creditors are thus reluctant to extend credit secured by inventory alone.

Perfection of a security interest in chattel paper, accounts receivable, and other kinds of intangible debt requires notification to each of the original creditor's debtors.<sup>8</sup> Such notice must clearly identify the secured party and the account transferred. It is necessary to give notice after each new addition

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5. Lov nr. 464 af 14.9.1976 §§ 43-47 (Den.)

6. Lov nr. 464 af 14.9.1976 §§ 43.4, 10.1.

7. Financing in the seller-buyer situation is also possible under a so called "retention of ownership until payment is made" arrangement. However, although the seller under certain conditions can take possession of the goods if a party defaults, the seller's right is not transferred to the proceeds of the items sold. Therefore such an arrangement is not suitable for raw materials and inventory. See lov nr. 275 af 6.9.1982 §§ 17-31.

8. Lov nr. 146 af 13.4.1938 § 31.1.

to the account and the notice must indicate whom the debtor is to pay. Finally, the secured party must control the arrangement.<sup>9</sup>

Filing, notification or possession of each item of collateral is required. The filing or notification is not sufficient if it identifies the current and after-acquired collateral generally but not specifically. Hence, describing the collateral in a security agreement or financing statement as "all accounts receivable," "after-acquired accounts,"<sup>10</sup> all items of a certain kind or all assets of a corporation,<sup>11</sup> is not sufficient for perfection and may not even be sufficient for attachment of the security interest.

In practice, it is expensive,<sup>12</sup> if not impossible, to obtain financing for certain kinds of corporate assets by creating a security interest in accounts receivable and inventory. This is especially true when the value of each item of collateral is small and when inventory is sold very quickly or the accounts receivable fluctuate greatly.

### *C. Subsidiary Formation as a Financing Mechanism*

There is a great need to create a radically new system in which perfection of a security interest in collateral, especially inventory and its proceeds, is less costly. Danish corporations have developed a new financing mechanism: a subsidiary created solely to obtain financing that uses the accounts receivable and inventory of the parent as assets. The total business enterprise is split into at least two corporations, a parent and a wholly-owned subsidiary. The parent normally transfers its accounts receivable and other liquid nonoperating assets to the subsidiary. The parent retains all of its other assets, although it is also possible for it to transfer the goods it has manufactured and use the subsidiary as a sales corporation.

A bank can make floating loans to the subsidiary, which then uses the money to pay for the assets that the parent transfers to it. In most cases, the loan from the bank is 80 percent of the gross value of the transferred assets. Through provisions in the subsidiary's bylaws or by an agreement between the subsidiary and the bank, the business activities of the subsidiary are limited to transactions necessary for this financing device. In a typical arrangement, the parent agrees to subordinate its claims against the subsidiary to the claims of the bank. This means that if the parent becomes insolvent, the bank in reality will be the only creditor to be paid. It will obtain full payment through the assets transferred by the parent to the subsidiary.

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9. For illustrations, see Judgment of June 25, 1975, Vestre Landsrettsdomme, Den., 1975 Ugeskrift for Retsvæsen [UfR] 975; Judgment of June 14, 1977, Højesteretsdomme, Den., 1977 UfR 636.

10. Lov nr. 146 af 13.4.1938 §§ 22, 31.

11. Lov nr. 464 af 14.9.1976 §§ 47a-47b.

12. Expenses include not only the paperwork costs but also a stamp duty which is generally between 0.3 and 1.5 percent of the value of the collateral. See lov nr. 375 af 8.7.1981.

There are important advantages to financing by subsidiary formation instead of by traditional financing through the perfection of a security interest. Because the assets on which the loan agreement is based are sold to the subsidiary, such a transfer is generally less costly and involves fewer legal requirements than does the perfection of a security interest. Pursuant to Danish law, a buyer of goods (here, the subsidiary if it is a sales corporation) that has claims in conflict with those of the seller's (here, the parent) creditors acquires rights to the chattels sold at the time of the agreement, or, in the case of the purchase of fungible goods, the buyer's right attaches when the goods are separated from similar goods belonging to the seller. Further steps, such as possession or filing, are not required. If chattel paper is transferred to the subsidiary, the legal requirements are the same as when perfecting a security interest, i.e., notification,<sup>13</sup> but this is generally less costly and cumbersome than filing and possession.

The cost of transferring the assets from the parent to the subsidiary are borne by the corporation and not by the bank. In contrast, the bank would bear the costs of creating a security interest. Finally, the bank does not need to exert direct control over the corporation's notification procedures. The accountant of the corporation handles this and is required to make periodic statements to the bank.

Banks prefer "subsidiary formation" financing arrangements. First, in case of insolvency, the bank is the only creditor of the subsidiary. Second, in undertaking the credit arrangement, the bank can separate the assets, identifying those with which it is most familiar and believes are most suitable for financing purposes. Other assets remain in the parent. Third, costs and documentation are streamlined. The bank need not directly control the transfer of assets.

From the corporations' point of view, this method may be the cheapest or in many situations the only way of obtaining financing. The amount of the loan is greater and the credit terms are better than in traditional financing arrangements such as factoring. These lower rates reflect the greater ease and lower costs that accompany this security device. Furthermore, the corporations are generally in a better position to minimize their own administrative costs than the banks and other finance companies are to reduce the costs incurred in controlling the financing arrangements and complying with the notification procedures.

#### *D. Legal Problems of Insolvency in Denmark*

If the parent corporation becomes insolvent, creditors of corporations have four ways of attacking the subsidiary formation finance arrangement.

First, transactions may be set aside because they do not, for example, fulfill the formal legal requirements for transfer of ownership, mortgage or

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13. Lov nr. 146 af 13.4.1938 § 31.1, 31.2.

perfection of security interest. Grounds for setting aside the transfer of assets to the subsidiary include commingling of assets, incorrect description of collateral in the filing documents, and insufficient notification when perfecting security interests in accounts receivable.<sup>14</sup>

Second, pursuant to the Danish Corporate Act, the directors, shareholders or others acting on behalf of the corporation can, under certain circumstances, be held personally liable for the corporation's debts.<sup>15</sup> Such personal liability requires proof that the person has intentionally or negligently caused injury to the corporation or its creditors.<sup>16</sup> The Danish courts, like the U.S. courts, rarely question the business judgment of those acting on behalf of a corporation where there has been no self-dealing or misrepresentation.<sup>17</sup>

Typical cases finding liability under the Danish Corporate Act involve the use of misleading or false financial statements to obtain credit,<sup>18</sup> self-dealing transactions such as transfer of goods at less than cost, nonbusiness-related increases in personal or family members' salaries on the eve of bankruptcy,<sup>19</sup> or the making of loans to insiders.<sup>20</sup> Such loans are unlawful under the Danish Corporate Act.<sup>21</sup> Insiders have also been held liable to creditors for obtaining unsecured credit at a time when it is obvious that the business is insolvent.<sup>22</sup> However, a 1977 Supreme Court decision seems to indicate that even in this situation insiders may be blameless.<sup>23</sup> In that case, the Court declined to hold the insiders liable even though the credit was obtained a few hours before bankruptcy was declared. The Court stressed that negotiations to restructure the corporation's debt continued until the very last minute.

The third and fourth means for setting aside a subsidiary formation finance arrangement can be found in the Danish Bankruptcy Act of 1977.<sup>24</sup>

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14. For a description of the legal requirements for perfecting a security interest, see *supra* notes 5 through 7 and accompanying text.

15. Aktieselskabsloven, lov nr. 483 af 15.11.1985 as amended by lov nr. 324 af 4.6.1986 §§ 140-146; Anpartsselskabsloven, lov nr. 484 af 15.11.1985 as amended by lov nr. 324 af 4.6.1986 §§ 110-16.

16. Aktieselskabsloven, *supra* note 15 at § 140.

17. This may explain why relatively few litigated cases result in liability under the corporate statute. On the other hand, clear cases of improper conduct probably do not go to trial.

18. Judgment of May 18, 1982, Højesteretsdom, Den., 1982 UfR 595.

19. Judgment of Nov. 14, 1928, Østre Landsrets Dom, Den., 1928 UfR 183.

20. Judgment of May 8, 1979, Vestre Landsrets Dom, Den., 1979 UfR 777.

21. Lov nr. 483 af 15.11.1985 §§ 115-115a and lov nr. 484 af 15.11.1985 §§ 84-84a.

22. Judgment of Apr. 18, 1961, Højesteretsdom, Den., 1961 UfR 515; Judgment of June 22, 1966, Sjø- og Handelsretsdom, Den., 1966 UfR 732.

23. Judgment of Feb. 16, 1977, Højesteretsdomme, Den., 1977 UfR 274.

24. Konkursloven, lov nr. 444 af 28.8.1984 as amended by lov nr. 320 af 4.6.1986 [hereinafter Bankruptcy Act]. The Bankruptcy Act of 1977 is better suited to the needs of creditors than its predecessor. Previous law permitted creditors to pursue assets already transferred out of an insolvent corporation only upon a showing that a transfer was made in bad faith, with the object of avoiding creditors. The creditor had the burden of showing that the debtor was insolvent at the time of the transfer, and that the transferee knew or should have known of the upcoming bankruptcy. These two requirements made it difficult to predict whether certain transactions

This Act divided the provisions for the avoidance of transfers during bankruptcy proceedings into two categories: one using an objective standard, and one based on a subjective standard.

The objective provisions allow certain types of transfers to be avoided if they occurred less than three months before the registration of insolvency<sup>25</sup> and allow certain transfers between affiliated persons and corporations<sup>26</sup> to be avoided if they occurred within two years of registration.<sup>27</sup> The provisions covering transfers between nonaffiliated persons and corporations can be used even though the corporation was not insolvent at the time of the transaction and even though the party to it did not have any knowledge of the economic problems the corporation faced. The characteristic features of the transfers specified in the objective provisions are that they are unusual and are soon followed by bankruptcy. The primary kinds of transactions covered by the objective avoidance provisions are:

- 1) gifts<sup>28</sup> which include transfers to insiders or their families or the affiliated corporations at less than market price and without any business-related purpose;
- 2) certain kinds of unusual payments,<sup>29</sup> including payment through the transfer of goods instead of cash payments or payment before maturity or payment of huge sums; and
- 3) securing of already existing unsecured loans.<sup>30</sup>

In addition to these objective provisions, Danish bankruptcy law's subjective provision allows a creditor to invalidate any transaction which has certain characteristics.<sup>31</sup> An example of such a transaction is one where a creditor has been unduly favored at the expense of other creditors and the debtor is insolvent at the time of the transaction. The creditor using this provision must show that the favored creditor knew or should have known of the insolvency and the wrongful favoritism involved in the transaction. This provision contains no time limits. In practice, courts may be reluctant to use it because of difficulties in proving the subjective elements.

These four ways to set aside transactions in financial arrangements are of limited utility in attacking the new financing arrangements. First, the transfer of assets from the parent to the subsidiary is unaffected by bankruptcy if the transfer fulfills the formal legal requirements. Second, personal liability under the Danish Corporate Act will normally not attach to those involved in such financing arrangements. Third, the avoidance provisions under the

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might be set aside under a later bankruptcy procedure, and the outcome of most cases would be determined by this burden of proof.

25. For determination of the time of registration of insolvency, see Bankruptcy Act, *supra* note 24 at § 1.

26. For definitions of affiliated persons and corporations, see *id.* § 2.

27. See *id.* §§ 64(1-2), 67(2), and 70(2).

28. *Id.* § 64.

29. *Id.* § 67.

30. *Id.* § 70.

31. *Id.* § 74.



Danish Bankruptcy Act generally can be used only under the limited circumstances discussed above.

In sum, because of these limitations, the creditors of a parent corporation should seek to set aside the whole corporate structure by use of the veil-piercing doctrine. It is not sufficient for the creditors to take over the parent's shares in the subsidiary, because they will have little value and because normally very few assets remain after the bank's claims against the subsidiary have been satisfied. By piercing the corporate veil, the creditors can directly reach the parent's assets held by the subsidiary and may be able to force the subsidiary's finance company or bank to bear a greater share of the losses. Although the doctrine of piercing the corporate veil is an effective remedy and may be within the power of the Danish courts to apply, no Danish court has yet addressed the corporate veil-piercing issue in cases involving subsidiary financing. There have been only a few attempts to discuss the issue in other contexts.<sup>32</sup> If future Danish courts consider piercing the corporate veil, they should look to the doctrine as applied in the United States, where courts and commentators have dealt with the problem for years. Though Danish corporate law is very different from the law in the United States, the two countries' economic and business environments are similar. Thus, an analysis of the reasons for piercing the corporate veil in the United States may help the Danish courts establish a basis for applying this remedy to inequitable subsidiary financing arrangements.

## II

### THE DOCTRINE OF CORPORATE VEIL PIERCING IN THE UNITED STATES

To encourage investment, the United States has long permitted the creation of corporations whose liability is normally limited to the corporate assets.<sup>33</sup> The creation of a legal entity with limited liability has been described as the most important development in American law of the nineteenth century.<sup>34</sup>

As early as 1905, the courts acknowledged that in isolated situations it is appropriate to look behind the separate legal entity and hold the corporation's shareholders liable for its debts.<sup>35</sup> The courts and commentators have used a variety of expressions to describe the phenomenon in which the shareholders, directors, or other corporations are held liable for the obligations of a

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32. For a discussion of the court's power to consider veil piercing, see Part IV.

33. A non-controversial exception to this rule occurs where the insiders personally guarantee the obligations of the corporation.

34. See generally, Dodd, *The Evolution of Limited Liability in American Industry*. 61 HARV. L. REV., 1351, 1378 (1948).

35. *United States v. Milwaukee Refrigerator Transportation Co.*, 142 F. 247, 255 (7th Cir. 1905).

corporation; the most common expressions are "piercing the corporate veil", "alter ego", and "instrumentality".<sup>36</sup>

### A. *The Theoretical Approaches*

U.S. courts employ two theories to determine whether the veil should be pierced: the equitable and the enterprise theories.

#### 1. *The equitable theory*

According to the equitable theory, the decision to pierce the veil depends on whether it is fair and equitable to treat the corporation as an entity separate from another corporation and from its shareholders and directors. The decisive factor is whether recognition of two separate entities would work an injustice.<sup>37</sup> In resolving this question, courts employing this approach have investigated how insiders behaved in relation to outsiders, especially creditors;<sup>38</sup> whether insiders represented the corporation to outsiders as financially sound when it was undercapitalized; whether funds were withdrawn from the corporation contrary to its economic interest;<sup>39</sup> and whether insiders used the corporate entity to commit fraud or injustice.<sup>40</sup>

While not requiring actual fraud,<sup>41</sup> courts using the equitable theory have required proof of some kind of misbehavior. In *Marr v. Postal Union Life Ins. Co.*, a California appellate court observed, "[B]ad faith in one form or another must be shown before the court may disregard the fiction of separate corporate existence."<sup>42</sup> The Oregon Supreme Court in *Schlecht v. Equitable Builders* noted, "Authorities from other jurisdictions agree that some form of moral culpability on the part of the parent corporation is required before the parent will be held liable for a debt of its subsidiary."<sup>43</sup>

Because the traditional equitable theory stresses subjective notions of equity and fairness, it is difficult for the courts to lay down principles guiding the application of the doctrine. Rather, as Professor Latty has described it,

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36. For a list of 37 terms which courts have used to refer to the doctrine of veil piercing, see H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* § 146 note 2 (2d ed. 1970).

37. In *Angelo Tomasso, Inc. v. Armor Construction and Paving, Inc.*, 187 Conn. 544, 555, 447 A.2d 406 (1982), the Supreme Court of Connecticut enunciated the identity rule as follows: "If plaintiff can show that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise." Note, however, that the court ultimately pierced the corporate veil under a formulation of the instrumentality rule that contained elements of both the equitable and the enterprise theories.

38. *Bartle v. Home Owners Co-operative*, 309 N.Y.103, 127 N.E.2d 832 (1955).

39. *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir 1976).

40. *Texas Industries, Inc. v. Duppy & Duppy Developers*, 227 So. 2d 265 (La. Ct. App. 1969).

41. See *infra* Part II.B.6.

42. *Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 681, 105 P.2d 649, 654 (1940).

43. *Schlecht v. Equitable Builders*, 272 Or. 92, 98, 535 P.2d 86, 88 (1975).

the courts make ad hoc decisions on whether to pierce the veil.<sup>44</sup> As a result, the equitable approach has made it difficult to predict whether the veil will be pierced in a given case. In many cases the decisive factors are whether the plaintiff can prove that the defendants acted in bad faith, and whether these acts caused the creditors' loss.<sup>45</sup>

In contrast to the traditional view, Professor Clark has attempted to set up more precise guidelines for applying the equitable theory.<sup>46</sup> He states that this theory has the same rationale as that of fraudulent conveyance law, namely the moral obligation of a debtor to its creditors.<sup>47</sup> Clark stresses that "objective" facts may indicate bad faith. His approach makes it possible to disregard the corporate entity, even though direct proof of misbehavior is impossible. Instead of focusing on how the directors and shareholders have acted in a particular situation, as Latty does, Clark takes a broader view of the causation problem. He looks at the general business practice. For him, self-dealing, commingling of assets, and the failure to keep books and observe formalities may suggest bad faith and may indicate that fraudulent transfers have taken place. This is sufficient to pierce the veil. Thus, it is easier to predict whether the veil will be pierced under Clark's approach than under the traditional view.

## 2. *The enterprise theory*

Under the enterprise theory, a court's decision to veil pierce is justified when a single corporation has allowed itself to be treated as a mere department of an enterprise, a group of corporations acting in common. This occurs when the single corporation has served the goals of the whole enterprise rather than maintained an independent business profile and interests.<sup>48</sup> Advocates of the enterprise theory propose that if a single corporation has been

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44. E. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS*, 191 (1936), "[M]any of the tests laid down by the courts for guidance are for the most part illusory and give no intelligible principle" and "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." For an early example of a court employing the equitable theory, see *In re Clarke's Will*, 204 Minn. 574, 578-79, 284 N.W. 876, 878 (1939).

45. *See*, *Continental Bankers Life Ins. Co. of the South v. Bank of Alamo*, 578 S.W.2d 625 (Tenn. 1979).

46. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, (1977).

47. Clark concludes: "All of the latter kinds of 'indicia' of agency—the inattention to formalities and the mingling of affairs and assets—are, upon analysis, singularly lacking in *direct* relevance to the question of the existence, and the amount of harm caused the outside creditor by the misbehavior of the controlling shareholder. Yet these indicia do at least *suggest* that fraudulent transfers may have taken place, or that creditors justifiably relied on the creditworthiness of the dominant stockholder or an affiliated corporation, and when sufficiently suffused with intimations and evidence of some actual self-dealing, may create the appearance of a justification for going beyond the limits imposed by doctrine which would require atomistic analysis and a precise remedy." *Id.* at 553.

48. Professor Berle, in *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 342 (1947), expressed the enterprise theory in the following manner: "If it be shown that the enterprise is not

used to reach the best economic and commercial result for the whole enterprise, then the whole enterprise should be liable for the obligations incurred by that corporation. Professor Powell identified eleven factors courts should consider when using the enterprise theory approach.<sup>49</sup>

Proponents of the equitable theory focus on how the corporation and insiders have acted towards outsiders. In contrast, the enterprise theory emphasizes the internal organization of the corporation's business affairs and looks at whether the legal separation is reflected in the actual management of the business. The enterprise theory focuses on the corporate management as a whole, whereas the equitable theory stresses the actors' behavior in connection with individual transactions, particularly those that occurred on the eve of insolvency.

In practice, these two theoretical approaches have been applied in a variety of ways. For example, the instrumentality rule focuses on the nature of the defendant's actions and on whether he has used the corporation for his own purposes.<sup>50</sup> As in the equitable theory, the crucial point is whether the

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reflected and comprehended by the corporate papers, books and operation, the court may reconstruct the actual enterprise, giving entity to it, based on the economic facts. Thus one corporation may be shown to be in fact only an instrumentality of a larger enterprise, or to be so intermingled with the operation of such larger enterprise as to have lost its own identity. On such reconstruction of the true entity, the court may assign the liabilities of the paper fragment to the economic whole." The U.S. Supreme Court took note of Berle's approach in *NLRB v. Deena Artware, Inc.*, 361 U.S. 398, 404 (1960).

For an approach in support of the enterprise theory based solely on economic arguments, see Lander, *A Unified Approach to Parent, Subsidiary, and Affiliated Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) [hereinafter Lander, *A Unified Approach*]. See also, Posner, *Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); Lander, *Another Word on Parent, Subsidiary, and Affiliated Bankruptcy*, 43 U. CHI. L. REV. 527 (1976).

49. These factors were:

- (a) The parent corporation owns all or most of the capital stock of the subsidiary.
- (b) The parent and subsidiary corporations have common directors or officers.
- (c) The parent corporation finances the subsidiary.
- (d) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
- (e) The subsidiary has grossly inadequate capital.
- (f) The parent corporation pays the salaries and other expenses or losses of the subsidiary.
- (g) The subsidiary has substantially no business except with the parent corporation, or no assets except those conveyed to it by the parent corporation.
- (h) In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.
- (i) The parent corporation uses the property of the subsidiary as its own.
- (j) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary, but take their orders from the parent corporation in the latter's interest.
- (k) The formal legal requirements of the subsidiary are not observed.

F. POWELL, *PARENT AND SUBSIDIARY CORPORATIONS*, § 5-6 (1931). Cited with approval in *Jackson v. General Electric Co.*, 514 P.2d 1170, 1173 (Alaska 1973). The court pointed out that it is not necessary that all eleven of these factors be found in order to pierce the corporate veil.

50. See *Angelo Tomasso, Inc. v. Armor Construction & Paving, Inc.*, 187 Conn. 544, 553-54, 447 A.2d 406, 410 (1982).

enterprises behaved wrongfully and thereby caused the losses at issue.<sup>51</sup> On the other hand, the identity rule, like the enterprise theory, employs a more objective standard, and focuses on the way business is done and on which entities receive economic benefits and losses.<sup>52</sup>

*B. Piercing the Veil Between Parent and Subsidiaries*

*1. The purpose of forming subsidiaries*

Commercial, managerial, tax and legal considerations can motivate a corporation to create a subsidiary into which it transfers assets. In addition, corporations that possess valuable assets have a strong motivation to form subsidiaries in order to shield some of their assets from creditors. The courts do not seem to regard the desire to shield assets per se as a prohibited purpose.<sup>53</sup> But if the sole purpose of the corporation is to shield assets, and owners use the corporate form to gain the benefits of limited liability without accepting the obligation of financial responsibility, the courts may disregard the corporate entity.

The relationship between the rationale for forming subsidiaries and actual business practices is seldom stressed in court decisions. However, two cases from the Supreme Court of Alabama have dealt with the issue.

In *Ex parte Baker*,<sup>54</sup> the issue was whether the veil should be pierced between the parent corporation, a wholly owned subsidiary and a partly owned management corporation.<sup>55</sup> The parent was a holding company that controlled the above two subsidiaries as well as many others, all of which did business in the health sector. The wholly owned subsidiary managed a local hospital. The management corporation provided management consulting services for hospitals, including some of the parent's subsidiaries, but not for the wholly owned subsidiary. There was some overlapping of personnel between the three entities and the parent's other subsidiaries, but a local administrator and board of trustees ran the day-to-day management of each subsidiary's hospital. The parent handled some administrative matters which were common to all the subsidiaries.<sup>56</sup>

The plaintiff asserted that the parent's control over the subsidiaries was not limited to stockholder control, but that it extended to general management control. The plaintiff pointed to a booklet the parent used for marketing purposes as evidence of the parent's control.

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51. See e.g., *Amfac Foods, Inc. v. Intern Systems Etc.*, 294 Or. 94, 654 P.2d 1092 (1982) ("inadequate capitalization", "milking", and a violation of statute were deemed decisive under an equitable theory approach).

52. See *Angelo Tomasso*, 187 Conn. at 554, 447 A.2d at 411.

53. See generally, *Lander, A Unified Approach*, *supra* note 48.

54. 432 So. 2d 1281 (Ala. 1983).

55. *Id.* at 1284.

56. These included centralized payroll and financial reporting to the New York Stock Exchange, neither of which were central to the plaintiff's complaint alleging medical malpractice. *Id.* at 1282-83.

The court, however, upheld the trial court's findings that the affairs of the corporations were conducted in a way which was "appropriate to their separate purposes and functions," and refused to pierce the veil.<sup>57</sup> The court found that the structure of the multiple enterprises was based on legitimate functional considerations. The court found further that this separation was reflected among the personnel and in the day-to-day business and management. Centralized reporting did not affect the result because such a practice reduced costs.

In *Woods v. Commercial Contractors*, a parent corporation owned all the stock of several subsidiaries engaged in construction.<sup>58</sup> Some of the subsidiaries obtained options to purchase land, others developed land, and one was the general contractor. Apparently, the parent presented no rationale for dividing the functions in this manner.

The plaintiff provided architectural services for one of the subsidiaries that purchased land, Commercial Properties, Inc. [hereinafter CPI]. CPI defaulted, and plaintiff asserted that the veil between CPI, the parent and some of the other subsidiaries should be pierced. The court agreed, because CPI had purchased and transferred the land to other affiliated corporations at cost. The subsidiary itself had no financial interest in the transaction; the other corporations reaped the benefits of the purchase and development. The court took this as an indication that the legal separation did not reflect the actual business practices, and the court did not find any legitimate considerations supporting the structural separation.

The above two cases indicate that courts applying the enterprise theory will look for managerial and economic considerations reflected, for example, in the purpose clause,<sup>59</sup> that justify the legal separation between a parent and its subsidiary.

## 2. *Observation of Formalities and Interlocking Directorates*

Disregard of legal formalities and the use of interlocking directorates among corporate entities are the factors most frequently raised in veil piercing cases.<sup>60</sup> Although courts rarely explain why these factors are important, the underlying rationale here is that the lack of formalities may indicate that

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57. *Id.* at 1284.

58. *Woods v. Commercial Contractors, Inc.*, 384 So.2d 1076 (Ala. 1980).

59. *See, e.g., Gentry v. Credit Plan Corp. of Houston*, 528 S.W.2d 571, 573 (Tex. 1975) where the veil was pierced because, among other things, the corporations "were engaged in the same business, their charters containing the same or similar purpose clause."

60. Some commentators have criticized the courts' emphasis on these factors. *See, Hamilton, The Corporate Entity*, 49 TEX. L. REV., 979, 990-91 (1971) ("There seems to be little reason to punish errant shareholders unless the actions are directed towards defrauding another party."). *Cf. Gelb, Piercing the Corporate Veil — The Undercapitalization Factor*, 59 CHI.-KENT L. REV. 1, 8 (1982), "It is obviously not a justification for treating defendants in piercing cases differently simply because their respective corporations are more or less attentive to formalities." Gelb further notes that courts ignore the nonobservance of formalities if the creditor was not thereby prejudiced. *Id.* at 8 n.35.

there have been fraudulent transfers between the entities. A disregard of formalities may also indicate that the corporations' affairs have not, in practice, been separated. Courts require that the shareholders and directors observe legal formalities and treat their corporation as a separate entity if they wish to maintain the corporation's status as an independent legal entity and the resulting protection of limited liability.

*Chatterley v. Omnico*,<sup>61</sup> illustrates how the disregard of formalities may indicate that two nominally separate corporations actually act as one. Omnico acquired eighty percent of the shares of Interface Computer, increased the number of Interface directors from four to seven, and elected six of its own directors. Omnico never complied with the statutory requirement of filing an amendment with the Secretary of State. The Supreme Court of Utah held that the mere failure to file the amendment could not alone invalidate the election of the board so long as the board was "otherwise properly constituted and functioning."<sup>62</sup>

The board meetings of Omnico also served as board meetings of Interface, which never held its own meetings. At these common meetings, no distinction was drawn between Omnico and Interface affairs. Only one meeting was ever formally called as a combined meeting, but no Interface business was discussed at it. Although only six members of Omnico's board members served on Interface's board, all fifteen members of the Omnico board participated and voted whenever Interface business was on the agenda. The court concluded that "it was Omnico and its board of directors who were actually operating the business of Interface."<sup>63</sup> The court pierced the corporate veil of Interface and upheld judgment against the parent Omnico.

Courts have not regarded the holding of common board meetings to be a conclusive reason for disregarding the separate legal existence of a corporation. It seems, however, that the more corporations depart from standard business procedure, e.g., holding separate meetings, the more strictly they must comply with formalities such as keeping each corporation's affairs separate in minutes, notices of meetings, and business documents. Among other important formalities are issuance of stock,<sup>64</sup> registration in different states,<sup>65</sup> shareholder meetings that are separate from board meetings, separate places of business,<sup>66</sup> and independent letterheads.<sup>67</sup> The courts do not require dissimilar corporate names as evidence of corporate entity separation. In *McKibben v. Mohawk Oil Co.*, the Alaska Supreme Court held that the similarity

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61. *Chatterley v. Omnico*, 26 Utah 2d 88, 485 P.2d 667 (Utah 1971).

62. *Id.* at 90, 485 P.2d at 669.

63. *Id.* at 91, 485 P.2d at 669.

64. *Automotriz del Golfo de California S.A. de C.V. v. Resnick*, 47 Cal.2d 792, 796, 306 P.2d 1, 4 (1957).

65. *Volkswagenwerk, AG v. Klippen GmbH*, 611 P.2d 498, 506 (Alaska 1980).

66. *Continental Bankers Life Ins. Co. v. Bank of Alamo*, 578 S.W.2d 625, 636 (Tenn. 1979).

67. *McKibben v. Mohawk Oil Co.*, 667 P.2d 1223, 1230 (Alaska 1983).

between the corporate names "Mohawk Oil and Gas, Inc." and "Mohawk Oil Company, Ltd." was not in itself a sufficient basis to pierce the veil between a parent and a wholly-owned subsidiary.<sup>68</sup>

Under both the equitable and the enterprise theories, it is considered important that corporate formalities be observed. According to the equitable theory, a corporation might disregard formalities in order to delude a creditor into believing that he is dealing with some other entity. It is also more difficult for a corporation to conceal fraudulent transactions if it is forced to observe formalities. Under the enterprise theory, the disregard of formalities may indicate that the subsidiary is treated as a department of the parent, rather than as an independent corporation.

The courts will not pierce the corporate veil solely because officers, directors or employees overlap,<sup>69</sup> or because the parent, as shareholder of the subsidiary, elects the members of the board. However, when these factors are weighed with others, they may indicate that the two corporations' activities overlap. Since directors of a corporation have a fiduciary duty to serve the interest of that particular corporation and not their personal interests or those of another corporation, the fact that the boards of several supposedly independent corporations have the same members often indicates that these interests are in conflict.

### 3. *Inadequate capitalization*

Inadequate capitalization is another factor which courts frequently discuss in veil piercing cases. The concept of inadequate capitalization assumes that, in the normal course of business, a corporation incurs obligations and presents certain risks to society for which it ought to be financially responsible. In return for the protection of limited liability, a corporation should have, at the time of incorporation, capital and economic resources that are reasonably sufficient in light of its foreseeable obligations and risks. If a court finds that a corporation's capital is grossly inadequate relative to its foreseeable obligations and risks, then veil piercing is prescribed as the appropriate sanction for the corporation's abuse of the privilege of limited liability.<sup>70</sup>

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68. *Id.* at 1225.

69. *Gentry v. Credit Plan Corp. of Houston*, 528 S.W.2d 571, 573 (Tex. 1975).

70. In deciding whether inadequate capitalization alone is sufficient to pierce the corporate veil, the courts must determine what is meant by inadequate or undercapitalization. Traditionally, the courts look at the circumstances which existed when the corporation was incorporated to determine whether the capital is reasonable, taking into account the foreseeable obligations and risks involved in the business. Some commentators suggest that it is more practical to look at the circumstances at the time the obligation arose while others and some courts appear to consider the circumstances after incorporation. *See, e.g., DeWitt Truck Brokers v. W. Ray Fleming Fruit*, 540 F.2d 681, 686 (4th Cir. 1976) ("The obligation to provide adequate capital begins with incorporation and is a continuing obligation, thereafter . . . during the corporation's operations.") (Quoting Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D.L. REV. 363, 377-78 (1969)).

Most courts, however, still refer to the time of incorporation in determining whether a corporation is under-capitalized. *See Pierson v. Jones*, 102 Idaho 82, 84, 625 P.2d 1085, 1087



Under the equitable theory, inadequate capitalization has traditionally been regarded as a clear indication of misusing the corporate form to delude creditors and favor insiders. Professor Ballantine notes,

If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts . . . . If the capital is illusory or trifling compared with the business to be done and risks of loss, this is a ground for denying the separate entity privilege.<sup>71</sup>

Two leading cases, *Walkovsky v. Carlton*,<sup>72</sup> and *Minton v. Cavaney*,<sup>73</sup> dealt with the issue of whether the veil may be pierced merely because the corporation has inadequate capital. In each case, the plaintiff was a tort judgment creditor, and the particular issue concerned piercing the veil between a corporation and its individual shareholders.

In *Walkovsky* the plaintiff was struck by a cab and brought a personal injury action against the corporation which owned the cab. The corporation's only assets were two cabs, and the minimum insurance coverage required by statute, \$10,000. These assets were insufficient to satisfy the plaintiff's claim, so he sued Carlton, the sole stockholder of the corporation and the owner of nine other cab corporations with similar assets and levels of insurance coverage. Plaintiff asked the court to pierce the veil between the corporation and Carlton, and asserted that Carlton had intentionally set up a multiple corporate structure in an attempt to defraud those who might be

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(Idaho 1981) ("Financial inadequacy is measured by the nature and magnitude of the corporate undertaking or the reasonableness of the cushion for creditors at the time of the inception of the corporation."). The majority rule is based upon the rationale that a corporation is a legal entity separate from its shareholders. As a consequence, corporate liability is limited to the amount of capital put into the corporation by the shareholders.

Generally, the courts have been very reluctant to set up guidelines for determining what precisely constitutes inadequate capitalization. Courts often decide whether capitalization is adequate by considering only a few salient numbers. See, e.g., *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958) (\$6,000 of capital was held to be inadequate for a business having net sales of \$390,000 a year). When the situation is not clear, courts look at incorporation costs, start-up costs, and the foreseeable obligations and risks involved in the business of the corporation. Also, courts will be tipped off if a corporation becomes insolvent soon after incorporating. See, e.g., *Iron City Sand and Gravel Div. v. West Fork Towing Corp.*, 298 F. Supp. 1091 (N.D.W.Va. 1969), *rev'd on other grounds*, 440 F.2d 958 (4th Cir. 1970) (the corporation was insolvent from its inception). In practice, courts look at the capitalization of other corporations in the same or similar businesses, and rely to some degree on statements of experts. They are unwilling to place heavy reliance on expert testimony, however, especially if it involves highly technical accounting or economic data and principles that may be accessible only to specialists. This is because the standards courts use for determining when the veil should be pierced, like "grossly inadequate capital", or "an obvious inadequacy of capital", consider legal, rather than technical, criteria.

71. H. BALLANTINE, BALLANTINE ON CORPORATIONS, § 12 (1946).

72. *Walkovsky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966)[hereinafter, *Walkovsky*].

73. *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

injured by one of his cabs.<sup>74</sup> The court held that the corporate entity could not be disregarded solely because the corporate assets and the statutorily sufficient amount of insurance coverage were insufficient to satisfy the claim against the insured.<sup>75</sup>

The result in *Walkovsky* may have been influenced by the fact that the applicable statute required a minimum of only \$10,000 insurance coverage. The court felt that if \$10,000 was insufficient to cover the risk of running a cab, the legislature, not the courts, should change the situation.<sup>76</sup> Although the *Walkovsky* case was unusual in that the legislature had prescribed the minimum amount of cab insurance required to conduct business, it is still reasonable to conclude that in New York, inadequate capitalization alone is not a sufficient reason for piercing the corporate veil.<sup>77</sup>

In *Minton v. Cavaney*, the plaintiffs had an unsatisfied judgment of \$10,000 against the corporate manager of a swimming pool for the drowning death of their daughter.<sup>78</sup> The corporation evidently had no substantial assets. The pool was leased from one of the insiders. There were also indications that formalities, such as the issuance of stock, had been ignored and that the corporation had never been treated as a separate entity by the insiders.<sup>79</sup>

The court pierced the veil and stated that stockholders are personally liable for the debts of the corporation, "when they treat the assets of the corporation as their own or withdraw capital from the corporation at will, when they hold themselves out as being personally liable for the debts of the corporation, or when they provide inadequate capitalization and actively participate in the conduct of corporate affairs [citations omitted]."<sup>80</sup>

The implication in *Minton* that inadequate capitalization can be a sufficient justification for piercing the corporate veil is very unusual, and the case is distinguishable from *Walkovsky* since the corporation in *Minton* had no assets, and had never issued any stock. Furthermore, it is doubtful that this interpretation of *Minton* prevails even in California. In *Associated Vendors v.*

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74. *Walkovsky I*, 18 N.Y.2d at 416, 223 N.E.2d at 7, 276 N.Y.S.2d at 587.

75. An amended complaint against Carlton was held to state a cause of action on the theory that "he and the other individual defendants were conducting the business of the taxi cab fleet in their individual capacities." *Walkovsky v. Carlton*, 29 A.D.2d 763, 287 N.Y.S.2d 546, 547 (1968), *aff'd* 23 N.Y.2d 714, 244 N.E.2d 55, 296 N.Y.S.2d 362 (1968).

76. *Walkovsky I*, 18 N.Y.2d at 420, 223 N.E.2d at 9-10, 276 N.Y.S.2d at 590.

77. See *Gartner v. Snyder*, 607 F.2d 582, 588 (2d Cir. 1979) ("We know of no New York authority that disregards corporate form solely because of inadequate capitalization.").

78. *Minton*, 56 Cal. 2d 576, 578, 364 P.2d 473, 474, 15 Cal. Rptr. 641, 643.

79. *Id.*, at 580, 364 P.2d at 475, 15 Cal. Rptr. at 643.

80. *Id.*, at 579-80, 364 P.2d at 475, 15 Cal. Rptr. at 643. Although the court may have pierced the corporate veil in *Minton* because of factors other than inadequate capitalization, (e.g., disregard of legal formalities), the California Supreme Court's use of the word "or" may indicate that inadequate capitalization is enough to pierce the veil where the insiders actively participate in the conduct of corporate affairs.

*Oakland Meat Co.*, a California Court of Appeal stated that inadequate capitalization is an important factor but is not in itself a sufficient reason for piercing the corporate veil.<sup>81</sup>

The decision to pierce a corporate veil for inadequate capitalization may also depend on whether the court is disregarding a subsidiary in order to reach its parent or affiliated corporations, or disregarding a corporation in order to reach its shareholders. The court in *Walkovsky* indicated that if a corporation is part of a larger entity that is actually running the business, the court can attach liability to the larger entity. Whether the court should hold the individual stockholders personally liable, however, is a separate issue. The plaintiff must show that the larger entity is itself undercapitalized, and that the individual stockholders were actually carrying on the business themselves.<sup>82</sup>

Finally, management behavior may influence a court's decision to pierce the veil because of undercapitalization. In *Bartle v. Home Owners Cooperative*,<sup>83</sup> for example, the court decided not to pierce the corporate veil, pointing out that the parent corporation had contributed more than \$25,000 above its original capital contribution to the subsidiary when the subsidiary faced economic problems. On the other hand, management's withdrawal of funds from the corporation when the latter faces economic problems may convince the court to pierce the veil. In *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, the court imposed liability on the defendant corporation's president because he had completely disregarded corporate formalities and had withdrawn funds when the corporation was undercapitalized, and because the corporation functioned exclusively for his benefit.<sup>84</sup>

#### 4. *Commingling of assets and self-dealing*

Commingling of assets and self-dealing are both factors which suggest that the economic affairs of two corporations have not been separated. Commingling describes a situation where the formal registration of assets bears no relation to the actual location of the assets, especially where it is difficult to determine which corporation owns which assets. Self-dealing refers to transactions where a person with a fiduciary duty to a corporation seeks to consummate a deal in which this duty is in conflict with his personal interests.

##### a. *Commingling*

Commingling of corporate assets can be a decisive factor in determining whether to veil pierce. Commingling leads creditors to believe that they have

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81. *Associated Vendors v. Oakland Meat Co.*, 210 Cal. App. 2d 825, 841, 26 Cal. Rptr. 806, 816 (1962).

82. *Walkovsky I*, 18 N.Y.2d at 418-20, 223 N.E.2d at 8-10, 276 N.Y.S.2d at 588-90.

83. *Bartle v. Home Owners Cooperative*, 309 N.Y. 103, 127 N.E.2d 832, 833 (1955).

84. *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 688 (4th Cir. 1976).

been dealing with a larger corporate entity, and may also indicate that fraudulent transfers have taken place. The enterprise theory begins with the assumption that in normal business practice the assets of each entity are kept separate. If corporate assets are commingled, the corporations have not been treated as separate entities, but rather as branches or departments of a larger enterprise. Courts feel that piercing the veil is justified when, for example, one corporation pays for property acquired by another<sup>85</sup> or when one pays the expenses of another.<sup>86</sup>

The courts will not disregard the separate entity solely because a parent-subsidary structure has integrated financial reports and accounting systems. In *Ex parte Baker*, the Alabama Supreme Court recognized the subsidiary as a separate entity even though the parent corporation and its multiple subsidiaries used a centralized payroll system and common financial reporting.<sup>87</sup>

Courts may veil pierce, though, if corporations do more than keep books in common. For example, a court may justifiably veil pierce when entries in the separate accounts of related corporations do not record the actual business transacted between the corporations, or when it can be shown that the corporations indiscriminately transferred funds between them.<sup>88</sup>

#### b. *Self-dealing*

When considering self-dealing, courts usually look first at what proportion of a corporation's transactions were internal.<sup>89</sup> When using the enterprise theory, the courts find that a subsidiary is not a separate entity when it does business only with affiliated corporations. Under these circumstances, the courts treat the subsidiary as a department or branch of a larger enterprise rather than as a separate enterprise.<sup>90</sup> Consequently, defendants may argue that the veil should not be pierced because the corporation has not done business exclusively with affiliated corporations but has also conducted business with independent third parties.<sup>91</sup>

Even where only a few self-dealing transactions occur, a court may be persuaded to disregard the corporate entity if they are of a large magnitude. Examples of such transactions are huge unsecured loans between a parent

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85. See *Woods v. Commercial Contractors*, 384 So.2d 1076, 1080 (Ala. 1980) (the veil between two subsidiaries was pierced because one subsidiary acquired title to certain real estate and the other paid the purchase price).

86. See *Neese v. Fireman's Fund Insurance Co.*, 53 Tenn. App. 710, 719, 386 S.W.2d 918, 922 (1964) (court stressed that employees of both corporations were paid by one of the corporations).

87. *Ex parte Baker*, 432 So.2d 1281 (Ala. 1983).

88. *Neese*, 53 Tenn. App. at 719, 386 S.W.2d at 922 (1964).

89. *Jackson v. General Electric Co.*, 514 P.2d 1170, 1173-74 (Alaska 1973).

90. *Woods v. Commercial Contractors, Inc.*, 384 So.2d 1076, 1079 (Ala. 1980).

91. *Jackson v. General Electric Co.*, 514 P.2d 1170, 1172-73 (Alaska 1973). The court found the subsidiary was not underfinanced and that it maintained independent accounting and separate property. The court also stated that the financing agreement between the two and "an agreement by which [the subsidiary] obtains management consultant services from GE appear to establish rights and obligations as between separate corporate entities." *Id.* at 1174.

and a subsidiary, non-interest bearing loans and loans without a payback clause or period, transfers at cost or less, or the sale of goods furnished by the insider at extraordinarily high prices to the corporation.<sup>92</sup> Therefore, the more uncertain the terms of the self-dealing transaction or the more the terms deviate from those of an external arms-length transaction, the more often the courts will veil pierce.

A court's evaluation of external transactions makes it possible to analyze the fairness of the terms of internal transactions and determine whether self-dealing has taken place. The external transactions may serve as a yardstick for determining the fairness of the internal transactions because the external transactions are conducted at arm's length and are an opportunity for the corporation to maximize its profits.

Some corporations never make a profit on their internal transactions. It is unclear whether a court will disregard a corporate entity because provisions in the corporate by-laws or in contracts with the parent or affiliated corporations make it impossible for the corporation to make a profit.<sup>93</sup> The issue was raised by the dissent in *Bartle v. Home Owners Cooperative*.<sup>94</sup> In that case, the parent formed a wholly owned subsidiary for the sole purpose of securing a contractor to construct houses that the parent would then sell at cost to its shareholders.<sup>95</sup> The subsidiary soon experienced financial difficulties, and the parent gave it additional capital.<sup>96</sup> Even though the same persons served on the board of the two corporations, and the parent had some control over the management and business of the subsidiary, the New York Court of Appeals refused to pierce the veil. Using the equitable theory, the court emphasized that the creditors were not misled.<sup>97</sup>

Judge Van Voorhis' dissent in *Bartle* argued that the veil should be pierced because the subsidiary would never be able to make any profit due to its agreement to sell its houses at cost.<sup>98</sup> Using the enterprise theory, Judge Van Voorhis observed that the subsidiary's object was to benefit the parent's stockholders by enabling them to obtain their houses at cost.<sup>99</sup>

The courts will not tolerate the formation of subsidiaries that have no possibility of making a profit when there is a concomitant commingling of assets. In *Woods v. Commercial Contractors*,<sup>100</sup> the court pierced the veil between a parent and a subsidiary in a building construction concern. Not

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92. See, e.g., *McKibben v. Mohawk Oil Co.*, 667 P.2d 1223, 1230 (Alaska 1983).

93. The issue of lack of profitability is an important one for the Danish courts because Danish subsidiaries formed for financing purposes do not have a profit-making goal. See *supra* Part I.D.

94. *Bartle v. Home Owners Cooperative*, 309 N.Y. 103, 107, 127 N.E.2d 832, 833 (1955).

95. *Id.* at 105-06, 127 N.E.2d at 833.

96. *Id.* at 106, 127 N.E.2d at 833.

97. *Id.* The facts did not indicate any misbehavior or misuse of the corporate form by the parent.

98. *Id.* at 107, 127 N.E.2d at 834.

99. See also, *Zaist v. Olson*, 154 Conn. 563, 573, 227 A.2d 552, 558 (1967).

100. 384 So.2d at 1076.

only did the subsidiary assign options to purchase real estate at cost to other affiliated corporations, but unlike the corporations involved in *Bartle*, the affiliated corporations commingled funds and the subsidiary used the letterhead of another corporation.<sup>101</sup>

##### 5. *Control over the affairs of the corporation.*

As discussed earlier, the enterprise theory focuses on whether a subsidiary has conducted business as an independent entity or has been treated as a department or branch of the parent corporation.<sup>102</sup> Control is particularly germane to the enterprise theory because of the issue of corporate independence. Control may also play a role under the equitable theory, but here the extent of the domination is not as important as its misuse.<sup>103</sup>

The actual behavior of the controlling party, rather than his formal status as owner, may justify piercing the veil.<sup>104</sup> A showing that a party owns 100 percent of the stock of a corporation is not per se sufficient justification for a court to pierce the veil. This follows from the fundamental difference between the status and power of the stockholders and that of the management and board members. To a great extent, a shareholder can vote and act for his own benefit. In contrast, management and members of the board must act independently of individual shareholders' interests and in the best interests of the corporation as a whole.<sup>105</sup>

Thus, the decisive factor is how the parent's board of directors actually supervises the affairs of the subsidiary. The fact that a parent and its subsidiary have board members in common is not a sufficient reason for piercing the veil between the two.<sup>106</sup> As a stockholder of its subsidiary, a parent is free to cast its votes for the members of its subsidiary's board of directors, even if it results in the election of some or all of the parent corporation's directors to the subsidiary's board.

The methodology the courts use to determine when control has gone so far that the legal separation must be disregarded is illustrated in *Neese v. Fireman's Fund Insurance*.<sup>107</sup> There the court pierced the veil between First Trust Company (FTC) and Real Estate Management, Inc. (REMCO), two corporations having the same majority stockholder, president, treasurer, and nearly the same board of directors. A close look at the way the corporations

101. *Id.* at 1078-80.

102. *See supra* Part II.A.2.

103. *See generally*, Clark, *supra* note 46.

104. *Gentry v. Credit Plan Corp. of Houston*, 528 S.W.2d 571, 573 (1975).

105. "That when voting as a stockholder he may have the legal right to vote with a view of his own benefits and to represent himself only; but that when he votes as a director he represents all the stockholders in the capacity of a trustee for them and cannot use his office as a director for his personal benefit at the expense of the stockholders." *Zahn v. Transamerica Corp.*, 162 F.2d 36, 45 (3d Cir. 1947).

106. *State Dept. of Environmental Protection v. Ventron Corp.*, 94 N.J. 473, 501, 468 A.2d 150, 165 (1983).

107. *Neese*, 53 Tenn. App. 710, 386 S.W.2d 918.

conducted business revealed that the corporations disregarded formalities by using the same phone number, address and office space, having the same employees, commingling assets, and indulging in self-dealing transactions. In addition to that, FTC was by far the largest creditor of REMCO. These practices demonstrated that the control FTC exercised over REMCO went far beyond that normally exercised by a corporation's stockholders. FTC entirely dominated the finances, policies and practices of REMCO. The court concluded that neither corporation "had any mind, will or existence of its own".<sup>108</sup>

The crucial point here is whether the affairs of a subsidiary are decided by its own board of directors or by its parent's directors. If the decisions are made by the subsidiary's own board, a court must decide if those decisions advance the interests of the subsidiary rather than those of the parent or the whole enterprise. This is not to say that the directors of a subsidiary may never respond to the goals of the parent or the whole enterprise. But the more the subsidiary is motivated by the interests of the parent, not only in its own overall strategic planning, but also in the tactics and operations of its day-to-day business, the more likely it is that the courts will veil pierce.

6. *Is fraud an independent requirement for piercing the corporate veil?*

Must plaintiff prove, in addition to the elements discussed above, that the defendant used the corporate entity to commit fraud or defeat public policy? Courts that apply the equitable theory often mention fraud in their opinions, particularly in the older cases, but they are in fact usually concerned with bad faith.<sup>109</sup>

The importance of demonstrating fraud as an independent requirement for veil piercing has declined. In some jurisdictions, fraud may be a necessary element in contract cases but not in tort cases.<sup>110</sup> Upon close examination, however, most cases reveal that fraud is not an independent requirement for piercing the corporate veil, but is an apt description of all the circumstances which lead a court to pierce the corporate veil.<sup>111</sup>

### III THEORETICAL AND PRACTICAL USE OF THE DOCTRINE OF PIERCING THE CORPORATE VEIL IN THE DANISH COURTS

Danish courts may set aside subsidiary financing schemes by means of their power to interpret the meaning and scope of statutes. They can decide,

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108. *Id.* at 922.

109. *See supra* notes 42-43 and accompanying text.

110. *Cf.* *Bell Oil & Gas Co. v. Allied Chemical Corp.*, 431 S.W.2d 336 (Tex. 1968); *Gentry v. Credit Plan Corp.*, 528 S.W.2d 571 (Tex. 1975) (Fraud does not seem to be an absolute requirement in Texas contract actions, and it is definitely not an element of tort recovery).

111. *See supra* Part III.B.1 through III.B.5.

for example, whether the statutory requirements for obtaining ownership, or the perfection of a security interest have been fulfilled. The courts may also determine whether persons acting on behalf of a corporation shall be held personally liable for its debts. Under a formal bankruptcy proceeding, the courts have additional power to invoke the special avoidance provisions included in the Danish Bankruptcy Act.<sup>112</sup>

The Danish courts also possess some equity power that may allow them to set aside subsidiary financing schemes. For example, prior to the enactment of the Danish Tort Act<sup>113</sup> in 1984 the courts decided tort cases by virtue of their equity powers. Even since then, the courts have decided many issues in tort cases without reference to or express reliance on statutory regulations.<sup>114</sup> In addition, in the area of creditor protection, the courts have equity power to set aside transactions<sup>115</sup> and impose personal liability.<sup>116</sup>

Thus, in theory, Danish courts have the authority to apply a doctrine like veil piercing. Should they choose to do so, the question becomes to what extent the Danish courts will find it reasonable to veil pierce and which factors the courts will consider important in the application of the doctrine.

As previously noted,<sup>117</sup> the legal requirements in Danish statutes do not completely regulate subsidiary financing devices. These statutes cover some aspects of corporate transactions, but not all aspects of subsidiary financing schemes that may need to be regulated. In general, when transactions fall within statutorily defined areas, the courts may regard such regulations as exhaustive and be reluctant to use their additional equity powers. However, the statutory provisions are meant to apply to independent legal entities, and do not question the corporate structure of the subsidiary financing devices. Therefore, the use of the courts' equity powers would be an appropriate way to decide the subsidiary financing cases.

Danish courts have acknowledged the need for the doctrine of veil piercing in a few cases. The Supreme Court pierced the corporate veil in the Inka-Print case.<sup>118</sup> In that case, a corporation called A/S Inka-Print ("I-P"), doing business in the textile industry, experienced severe economic problems, and arranged a reorganization plan with one of its most important creditors, the finance company Balfour, Williamson & Co. ("F"). This plan involved

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112. See *supra* Part I.D.

113. Lov nr. 228 af 23.5.1984 (Den.).

114. The Danish Tort Act mainly consists of provisions concerning who is entitled to compensation and the amount to be awarded. Even in these areas, the Tort Act is only a codification of older case law. A Danish court may determine, for example, whether negligence or absolute liability applies in a given case without reference to the Danish Tort Act.

115. See, e.g., the court's use of "Actio Pauliana" in Judgment of June 28, 1977, Højesteretsdom, Den., 1977 UfR 686 and the annotation in 1977B UfR 369.

116. See, e.g., Judgment of Oct. 27, 1913, Højesteretsdom, Den., 1914 UfR 11 (a person was held liable to the bankrupt estate because he had actively participated in an illegal preference).

117. See *supra* Part I.B, I.D.

118. Judgment of Oct. 4, 1978, Højesteretsdom, Den., 1978 UfR 880. For further discussion of piercing or similar issues in specific relations see Judgment of Oct. 17, 1968, Højesteretsdom, Den., 1968 UfR 766 (payments originated from the parent corporation and not, as alleged, from



the creation of a new corporation, Inka-Print International A/S ("I-PI"), wholly owned by F. The financing device was set up in the following manner: I-PI would buy raw materials with financing from F and sell ready-made clothes. In turn, I-P was to do the needle work on contract and be paid through I-PI's accounts receivable. As a further condition, I-P was to subordinate its claim to the accounts receivable to F. I-P declared bankruptcy and the question arose whether the court should pierce the veil between I-P and I-PI. If it did so, raw materials, ready-made clothes, and accounts receivable in possession of I-P could not be given back to I-PI in order to secure loans that F had advanced to I-PI.

The Danish Supreme Court decided to pierce the veil between I-P and I-PI because it determined that this financing device was only established to secure F's original account against I-P and that I-P never did business through the sale and purchase of goods. Even though it was alleged that I-PI was the seller of the ready-made clothes, I-P did the actual selling and carried the business risks. Therefore, the actual business practice did not correspond to the legal separation between I-P and I-PI. The Danish Supreme Court's reasoning was similar to that employed by U.S. courts using the enterprise theory in veil piercing cases.

There are several reasons why the Danish courts are less likely to use the American equitable theory of veil piercing. The equitable theory focuses on subjective behavior, and in the last few decades Danish statutes<sup>119</sup> and case law have tended to use more objective standards because such standards can minimize difficult questions of proof. Use of the equitable theory would constitute a departure from this trend. Moreover, in many of the cases where the U.S. courts used the equitable theory to veil pierce, the Danish Courts would reach the same result under the personal liability provisions of the Danish Corporate Act.<sup>120</sup> Finally, the enterprise theory looks to a subsidiary's lack of a profit-making goal as an indication that the subsidiary lacks an independent business purpose.<sup>121</sup>

Therefore, if courts find that the reasoning of the enterprise theory is in accordance with Danish public policy, they will choose this approach. Many of the factors that have been deemed decisive by U.S. courts which use the enterprise theory should also apply in Danish cases. This is because the business environment and public policy considerations supporting corporate law

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the subsidiary); Judgment of May 14, 1980, Vestre Landsrets Dom, Den., 1980 UfR 806 (employees of the subsidiaries could raise wage claims against the parent corporation upon bankruptcy of the companies); Judgment of Mar. 19, 1982, Sjø-og Handelsretsdøm, Den., 1983 UfR 267 (third party requested set-off of amount owed to it by parent corporation against debt it owed subsidiary). See also Judgment of May 25, 1977, Højesteretsdøm, Den., 1977 UfR 526.

119. See, e.g., the above-mentioned changes in the avoidance provision of the Danish Bankruptcy Act of 1977. A more objective standard was also added to Danish Contract Law in 1975. See Lov om aftaler og andre retshandler på formuerettens område, lov nr. 242 af 8.5.1917 as amended by lov nr. 250 af 12.6.1975, § 36 (Den.).

120. See *supra* notes 15-16 and accompanying text.

121. See *supra* notes 98-101 and accompanying text.

are very similar to those in the United States. A Danish court will take into account many of the same economic and managerial reasons for splitting an enterprise into a parent and subsidiary. The courts will also consider whether these reasons are reflected by the enterprises' formal structure, such as purpose clauses, and more crucially, whether the reasons are reflected by its actual business practices.

On the other hand, differences between the two legal systems may be decisive in a judicial determination of whether to pierce the corporate veil. For example, because most legal relations in Denmark are based on statutes, Danish courts will look more critically than do the U.S. courts at corporations which do not fit into existing regulatory schemes. For this reason, Danish courts may be more likely to pierce the veils of such corporations than would American courts.

Undercapitalization, however, is likely to be a less significant consideration in Denmark than it is under the enterprise theory as applied by U.S. courts. Incorporation pursuant to the Danish Corporate Act requires the corporation to have a minimum of approximately \$11,300<sup>122</sup> or \$43,000<sup>123</sup> worth of capital, depending on the type of corporation. By requiring such a high amount of minimum capital compared to incorporation statutes in the United States, the legislature may have implied that this level of capital is sufficient to run an ordinary business.

The element of unfairness as used by the U.S. courts is also not likely to be as relevant a consideration in Denmark. Unfair self-dealing transactions can be set aside in Denmark through established legal doctrines such as imposing personal liability pursuant to the Danish Corporate Act or avoiding transfers under the Danish Bankruptcy Act.

In sum, a doctrine of piercing the corporate veil is within the reach of the Danish courts. If they apply the doctrine, the Danish courts, like their American counterparts, will take into account all the circumstances in each case. Adapting the enterprise theory to their own legal framework, the Danish courts will weigh these circumstances somewhat differently, but in the end they will veil pierce when encouraged to do so by public policy.

#### CONCLUSION

Changes in Danish corporate financing practices have made it more difficult for corporations to obtain loans for start up capital. In search of a new financing mechanism, Danish corporations have turned to subsidiary formation as a cheaper and more flexible means of securing financing. This practice

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122. Anpartsselskabsloven, lov nr. 484 af 15.11.1985 as amended by lov nr. 324 af 4.6.1986, § 1.3 (Den.) regarding incorporation of an Anpartsselskab. (Minimum capital in Danish Kroner 80,000.)

123. Aktieselskabsloven, lov nr. 483 af 15.11.1985 as amended by lov nr. 324 af 4.6.1986, § 1.3 (Den.) regarding incorporation of an Aktieselskab. (Minimum capital in Danish Kroner 300,000.)

may harm the parent corporation's creditors because the bulk of the assets have been transferred to the subsidiaries where they are beyond the creditors' reach.

Thus, if a Danish corporation declares bankruptcy, the existing alternatives available to creditors for reaching the corporate assets may be of limited utility. This gap in Danish law demonstrates the need for a corporate veil-piercing doctrine in Denmark. Because the Danish courts already exercise some limited powers in equity to satisfy creditors, it should be feasible for them to adopt and adapt the U.S. veil-piercing remedy as applied under the enterprise version of the doctrine. The Supreme Court of Denmark has already acknowledged the need and reason for piercing the corporate veil in a few cases. Thus, it is quite likely that the Danish courts will turn to the doctrine of veil piercing as an equitable remedy for creditors of corporations.

When developing its veil-piercing doctrine, the Danish courts would be wise to conduct a comparative legal study of the American doctrine. As this Article has shown, a comparative study can be quite relevant when a legal doctrine rarely used in one country is already well-developed in another. An adapted version of the American veil piercing doctrine will not completely solve the problem of subsidiary financing in Denmark, but will provide a significant start.