California Law Review

Published Quarterly throughout the Year by Students of the
School of Jurisprudence of the University of California, Berkeley,
California. Indexed in Index to Legal Periodicals, Public
Affairs Information Service and Current Legal Thought.

Subscription Price, \$3.50

Current Single Copies, 90 Cents

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Comment

CORPORATIONS: "DISREGARDING THE CORPORATE ENTITY" AS A REGULATORY PROCESS

The franchise of being a corporation and of doing business as a separate legal unit with limited liability is a statutory privilege. As such it must be confined to legitimate uses. The courts have assumed wide discretionary power to impose limitations or regulations on the use of the entity privilege to prevent abuse and injustice.¹

The California courts frequently speak about situations where "adherence to the fiction of separate existence"² would produce inequitable results. But as Judge Sanborn has well stated, "A corporation, as expressive of legal rights and powers, is no more fictitious or intangible than a man's right to his own home or his own liberty."³ To describe this regulatory process in the customary verbiage as "disregarding the corporate fiction" has been vigorously criticised and rejected as unrealistic by the Minnesota court.⁴ Such verbiage serves no purpose and obscures a clear understanding of what the courts are doing and what is the basis of doing it.

It has been clearly recognized in numerous California cases that

¹ *Grotheer v. Meyer Rosenberg, Inc.* (1936) 11 Cal. App. (2d) 268, 53 P. (2d) 996, 998; *BALLANTINE, CORPORATIONS* (1927) §26, pp. 26, 27; Fuller, *The Incorporated Individual* (1938) 51 HARV. L. REV. 1373; Note (1932) 45 HARV. L. REV. 1084, 1087.

² *Stark v. Coker* (1942) 20 Cal. (2d) 839, 846, 129 P. (2d) 390, 394.

³ *United States v. Milwaukee Refrigerator Transit Co.* (C.C.E.D. Wisc., 1905) 142 Fed. 247, 255.

⁴ *In re Trust under Will of Clarke* (1939) 204 Minn. 574, 578, 284 N. W. 876, 878, noted in (1939) 25 MINN. L. REV. 107. See Note (1925) 13 CALIF. L. REV. 235.

the basis of such judicial regulation is that of preventing abuse of a statutory privilege where observance of the privilege of separate corporate existence and capacity would under the circumstances of the case promote fraud or injustice.⁵

As Latty has shown,⁶ the tests which have been laid down by the courts for guidance are for the most part illusory and give no intelligible principle. The usual formulae employed to test the liability of a parent corporation for the acts of its subsidiary and in other cases are (1) agency, (2) instrumentality, (3) identity and (4) inequitable result and the prevention of wrong. In regard to the instrumentality doctrine or rule, as Professor Latty has shown, this formula, which is indiscriminately applied to all sorts of situations, is really meaningless. We have to ask, instrumentality for what? For attaining limited liability? For combining to stifle competition? For discriminating against certain shippers over a railroad where the circumstances do not justify the discrimination? For evading an obligation? "The amount, form and directness of control exercised by a parent corporation are far from explaining the holdings in various tort cases. Let the attention be fixed upon what harm, if any, has been done to the complainant by the control and domination in question. . . . 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."⁷ Among the circumstances to be considered as bearing upon the equities of a case are the extent to which the financial affairs and accounts of the corporation and of those who control it are confused to the prejudice of creditors; the adequacy and good faith of the financing of the corporation; the undue diversion of its funds to individual use; the holding out of a subsidiary as a mere department, branch or part of a system, especially in contract cases; the evasion of contracts or statutes; the abuse of control.⁸

In *Stark v. Coker*,⁹ a case where the corporate maker of a trust deed was held the "alter ego" of the individual defendants who were held personally liable on the note, the California Supreme Court re-

⁵ *Stark v. Coker*, *supra* note 2, and cases cited; *Grotheer v. Meyer Rosenberg, Inc.*, *supra* note 1.

⁶ LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* (1936) ch. III.

⁷ LATTY, *ibid.* 177, 191. See Thomas, *Parent and Subsidiary: Theories Used in Holding Parent Liable for Acts and Obligations of Subsidiary* (1936) 24 CALIF. L. REV. 447.

⁸ *Weisser v. Mursam Shoe Corp.* (C.C.A. 2d, 1942) 127 F. (2d) 344 (inadequate capitalization and representations as to credit); *Shea v. Leonis* (1939) 14 Cal. (2d) 666, 96 P. (2d) 332, 333 (inadequate capitalization, device to escape burdens of lease); *Berkey v. Third Ave. Ry. Co.* (1926) 244 N. Y. 84, 155 N. E. 58, 50 A. L. R. 599, citing Ballantine, *Separate Entity of Parent and Subsidiary Corporations* (1925) 14 CALIF. L. REV. 12, 18, 19, 20.

⁹ *Supra* note 2, per Carter, J.

cently laid down an interesting proposition as to the conditions under which the separate corporate entity may be "disregarded". These conditions "vary according to the circumstances in each case inasmuch as the doctrine is essentially an equitable one and *for that reason is particularly within the province of the trial court*. Only general rules may be laid down for guidance."

Does this mean that the inferences of the jury, or trial judge sitting without a jury, are conclusive as to what is an abuse of the corporate entity privilege? Surely we do not wish the jury or the trier of facts to be final judge of what justifies legal limitation of the corporate capacity, thus making the law anew in each case. The facts and circumstances indicating fraud, evasion or other abuse must of course be fully proved in the trial court.¹⁰ But the situation here should be the same as in other cases. The jury or the trier of the facts should settle disputed questions of fact, while questions of policy and limitations of legal privilege are ultimately for the appellate courts to determine.

An interesting recent case in which the proposition laid down in *Stark v. Coker* was again repeated is *H.A.S. Loan Service v. McColgan*.¹¹ This case involved two corporations which were secretly affiliated and operated as a unit. The plaintiff was nominally a broker and the Marshall Finance Co., its affiliate, was the nominal lender. The plaintiff as a broker negotiated small loans for borrowers for the Marshall Finance Co. for a fee which was charged to the borrower and it guaranteed payment of the loan.

The court states that the circumstantial evidence showed that the corporate device or instrumentality was used to evade usury and franchise tax laws and that the two corporations were really engaged in a single business although they pretended to operate independently. The loan service corporation was accordingly held to be a "financial corporation" within the franchise tax law. It was not a mere agent of the borrower but was really a lender. Here then we have what was clearly the use or abuse of a separate corporate entity to carry out a scheme for evasion of statutes and tax laws and the attempt was defeated.

An interesting case to compare with this is the New York decision of *Jenkins v. Moyse*¹² in which it was held not to be an evasion of the New York usury statute for the borrower to form a one man com-

¹⁰ See *Berkey v. Third Ave. Ry. Co.* (1926) 217 App. Div. 504, 217 N.Y. Supp. 156, 157, *rev'd* (1926) 244 N. Y. 84, 155 N. E. 58; *Ross v. Penn. R. Co.* (1930) 106 N. J. L. 536, 148 Atl. 741, limited strictly to the facts in the case in *Cintas v. American Car & Foundry Co.* (1942) 131 N. J. Eq. 419, 25 A. (2d) 418, 421.

¹¹ (1943) 21 A. C. 551, 133 P. (2d) 391.

¹² (1930) 254 N. Y. 319, 172 N. E. 521, 74 A. L. R. 205.