

RICHARD M. BUXBAUM

## Commercial Law—Single Shareholder Company

## 1. THE CONCEPT OF PLURALITY

In 1966, when this topic was on the agenda of the VIIth Congress in Stockholm, the American reporter, the late Dean Miguel de Capriles, still could point to approximately 24 state statutes, at that time half the total, that retained a vestigial form of the maxim, "three is a collective." The comment to Section 2.01, the relevant provision of the Model Business Corporation Act, an unofficial document of the American Bar Association that is an influential source of state statutes, describes the evolution:

[The predecessor] Section 47 became section 53 in the 1969 edition of the Model Act. The comment [thereto] noted a continuing movement away from the 'traditional concept' of incorporators: whereas in 1960 only Kentucky, Michigan, and Wisconsin allowed a single incorporator, by 1969 27 states had a provision permitting a single incorporator similar to the Model Act. This trend has continued: by 1982 a single incorporator was permitted in all but six jurisdictions."<sup>1</sup>

This process now is all but complete. Today, in 1990, only two state statutes retain a minimum-number requirement: Arizona (General Corporation Law, Section 10-053) and Utah (Business Corporation Act, Section 16-10-48). Even these minor exceptions, however, do not necessarily mean what they say. The very concept of incorporation is now so trivialized that incorporators may not also need to be shareholders, and in a realistic if not in a formal sense corporations typically commence existence before shareholders, let alone shareholders' capital contributions, have arrived.

Since the incorporator is, if anything, an embryonic shareholder in the American legal regime, it can be said that if a single incorporator suffices, then a single shareholder by definition also suffices. The reverse, however, is not true. Thus, one of the two mentioned state statutes, that of Utah, goes on to say, in Business Corporation

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1. 1 *Model Business Corporation Act Annotated* 98 (3d ed. 1985).

Act Section 16-10-34(b)(ii), that "[a]fter shares are issued and for as long as a corporation has less than three shareholders entitled to vote for the election of directors, a corporation may have a minimum number of directors equal to the number of those shareholders." The clear inference is that while the incorporation process, for what it is worth, requires more than a single incorporator, a corporation is legitimate though it is owned by only a single shareholder.

Decades ago, the problem implied in the foregoing point — that a corporation which was required to have, say, a minimum of three shareholders and which upon its formation did have that minimum number might by attrition or purchase end up owned by a lesser number — troubled courts and commentators. One of the famous papers on the "single-shareholder" corporation, Latty, "A Conceptualistic Tangle and the One- or Two-Man Corporation,"<sup>2</sup> discussed this issue. It criticized the formal approach of those courts which had found this "defect" a cause for nullity, and used instead a complex, behaviorally oriented analysis to hold the enterprise owners liable for the "entity's" obligations.

In recent decades, however, to the extent the multiple shareholder issue remained relevant under any given statutory regime (and, as mentioned, it has become essentially irrelevant), it tended to be resolved more directly by statutory ukases such as the following, taken from the Missouri General and Business Corporation Law, Section 351.050 (and illustrating the absurd length to which the private bar's drafters go when they apply their contract drafting style to legislative drafting):

Nothing contained in this chapter shall be construed as an indication of any legislative intention that the existence of a corporation, hereafter or heretofore formed, is in any respect impaired by the direct or indirect ownership of all of the shares of such corporation by one owner or by two owners or that by such ownership the corporation becomes dormant, inactive or incapable of acting as a corporation or ceases to possess any of the capacities, powers or authority which it otherwise would possess. The direct or indirect acquisition, heretofore or hereafter, of all of the shares of a corporation by one owner or by two owners and the having of only one shareholder or two shareholders at any time are declared to violate no policy or provision of the laws of this state.

In short, that single persons may in principle limit the risk of liability to a portion of their fortunes, safeguarding the balance from

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2. 34 *North Carolina Law Rev.* 471 (1956).

the vagaries of this one investment, now is a prevalent fact of life in the American economy and thus in American law. Furthermore, in probably all of these state statutes, including specifically in those two that still retain the multiple incorporator requirement, corporate persons and not only natural persons may be incorporators.

This does not mean that abuses of the easy and facilitative incorporation process are unknown; but the relevant corrective doctrines that react to abuses of this power, and that, indeed, may be particularly applicable to these situations, are another matter, discussed below. In the context of enabling powers, however, old debates about the minimum collective nature of pooled resources and collective decisionmaking no longer exercise the American legal mind.

## 2. THE PUBLIC NATURE AND PUBLIC-LAW CONTROL OF INCORPORATION

In the prevalent American law(s), the document forming the basis of the formal incorporation process typically is a skeletal one, and does little more than to set forth the particular identifying marks of the particular corporation — not much more than its name and address. Even its capital structure, until recently specified as a potential rather than an actual quantity of ownership units, with a formal and usually minimal per-unit capitalization, today — under the influence of California law as adapted by the newest revision of the Model Act — need be no more than a single aggregate number. The relevant Model Act provision, Section 6.01, is instructive:

The articles of incorporation must prescribe the classes of shares and the number of shares of each class that the corporation is authorized to issue. . . .

The actual simplifying message of this elliptic provision is clarified if put in the context of the parallel statutory prescription concerning the mandatory content of these articles of incorporation, Section 2.02:

- (a) The articles of incorporation must set forth:
  - (1) a corporate name for the corporation. . . ;
  - (2) the number of shares the corporation is authorized to issue;
  - (3) the street address of the corporation's initial registered office and the name of its initial registered agent at that office [n.b., primarily an agent upon whom process may be served — in connection with litigation against the corporation];
  - (4) the name and address of each incorporator.

That is it! Of course, more information may be provided, but seldom

is, except for equally skeletal provisions concerning special classes of stock (e.g., reverting to Section 6.01 of the Model Act: "If more than one class of shares is authorized, the articles of incorporation must prescribe a distinguishing designation for each class. . ."). In short, the document itself —the *Statut* — does not provide the information about the particular company in its individualized form, but only gives notice to claimants against the company where it can be found and sued.

The necessary particularized information is found in a variety of other documents, which may have their own constitutive or declaratory status; that is, a registration statement and prospectus in the case of companies seeking external capital, private agreements among prospective shareholders or (since we are addressing the case of the company with only one shareholder) with credit providers, or even third-party credit reports about the company that are made available as a commercial service to prospective investors and creditors.

This easy facilitative informality is only understandable if we recall that American law, unlike that of most Civilian systems, does not subject the initial capitalization process to scrutiny by a public agency like a commercial registrar or a commercial court; that, furthermore, again unlike most other legal regimes, American law requires no minimum capitalization of a company as a condition precedent or indeed a condition subsequent of incorporation. The capitalization process may be scrutinized, but only as a species of investor (i.e., consumer) protection associated with the well-known and highly technical field of securities regulation. So far as most state laws are concerned, a corporation may begin life with a capital of one penny. The constitutive document, the articles of incorporation, usually would not even reveal this situation: Recall the sole mandatory provision of Section 2.02 of the Model Act, above, that the articles need only specify the number of shares, but not their attributes.

An underlying reason for this extreme facilitative approach, or at least a reason why it would be difficult to alter it if that were ever deemed desirable, is the historical fact that American corporation law has been unitary law; that is, it has not distinguished between classes of entities on the model of the S.a.r.l./S.A. or GmbH/AG distinction. (The so-called "close corporation statutes" that recently have proliferated are not self-contained, comprehensive statutes, but primarily were enacted to correct some judicial missteps that invalidated shareholder agreements on the ground that they contradicted some abstract, "structural" corporate-form requirement; only occasionally do they go on and list some mandatory or limiting attributes such as maximum number of shareholder or obligatory share-trans-

fer restrictions). As a result, IBM and General Motors have been the beneficiaries of a statutory system that was designed to permit a minimum number of prospective owners to pool a minimum amount of privately raised capital in a corporate form; alternatively, one might as legitimately say that the assumptions of size and seriousness attached to an IBM or a GM have also enured, deservedly or not, to the close, small, and even one-owner corporation.

Perhaps the single most practical consequence of this approach to corporate formation is the absence of any prospective review of the value of (non-cash) assets contributed to the entity in exchange for equity ownership shares: property, promotional services, goodwill associated with the transfer of an existing business, and other, especially intangible, forms of non-cash contributions. No independent auditor need be appointed to provide an opinion concerning value, and no public agency or court gets involved in double-checking these types of transfers. Of course, the contrast between prospective and no review may be more apparent than real. The *de facto* autonomy of independent appraisers is a perennial source of dispute even in legal systems that require these preliminary reviews and reports.<sup>3</sup> And by the same token, the retrospective control practiced under American state law regimes, reviewed below, also may trivialize that contrast.

### 3. THE SPECIAL PROBLEMS OF THIRD-PARTY PROTECTION IN THE ONE-OWNER CORPORATION

The story of that retrospective control is the story of the disregard of the corporate entity, sometimes overgeneralized as the *alter ego* problem. As one compiler puts it,

[while] the mere fact that all or almost all of the corporate stock is owned by one individual or a few individuals will not afford sufficient grounds for disregarding corporateness[,] [w]hen substantial ownership of all the stock of a corporation in a single individual is combined with other factors clearly supporting disregard of the corporate fiction on grounds of fundamental equity and fairness, courts have experienced little difficulty. . . in applying what is described as the "alter ego". . . theory.<sup>4</sup>

That comment, however, does not permit a general conclusion about the degree to which single ownership facilitates piercing the corporate veil all other factors being equal. This cannot be done in

<sup>3</sup> 3. See Buxbaum, "The Formation of Marketable Share Companies," Chapter 3 of *Business and Private Organizations* 20-21 (Vol. XIII, *International Encyclopedia of Comparative Law*, A. Conard, ed., [fasc., n.d.]).

<sup>4</sup> 1 *Fletcher Cyclopedia Corporations* 446 (rev. ed. 1983).

practical terms except on a state-by-state basis and even then, given the highly idiosyncratic and factual basis of particular judicial decisions, does not lend itself to generalization. Those states that profess the most stringent rules and highest threshold requirements for a "disregard" finding probably also are the most unwilling to let single ownership become an important contradictory factor; and vice versa.<sup>5</sup>

In any event, critical in this disregard-of-corporate-entity field are not the straightforward and highly fact-specific "doctrines" governing a private creditor's effort to hold the shareholder liable for a corporate obligation. Important instead are the special problems arising in two areas that are in their turn more important to the case of the corporate sole shareholder than to the natural person; viz., disregard of the corporate status of a local subsidiary (or, occasionally, parent) in order to obtain personal jurisdiction over the foreign parent (or subsidiary), and disregard of the corporate status of a subsidiary or parent in order to attach some obligation or sanction arising under a specific, typically regulatory statute on the other party. To review these (and other) problems, however, it is first appropriate to turn to the question of intercorporate ownership as such.

#### 4. AFFILIATED-ENTERPRISE STRUCTURES: THE KONZERN

Professor Phillip Blumberg, whose multi-volume treatise, *The Law of Corporate Groups* (variously dated, 1983- ) has done much to sensitize the American legal community to the unique set of one-owner corporation (law) problems posed by the affiliated enterprise system, has set the context of this critical issue succinctly:

An increasing part of the world economy is being conducted by multinational enterprises in the form of groups of companies with structures of "incredible complexity operating in dozens of countries, through scores, if not hundreds, of subsidiaries.<sup>6</sup>

He cites evidence that British Petroleum, for example, directly or indirectly owns over 1,000 subsidiaries; and among the United States enterprises, a major oil company such as Mobil Corporation may own over 500.

In this context, he goes on to say:

[Many problems] in the law of corporate groups. . . arise

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5. See generally R. Jennings & R. Buxbaum, *Corporations — Cases and Materials* 983-87 (5th ed. 1979).

6. Blumberg, "Intragroup (Upstream, Cross-Stream, and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act," 9 *Cardozo Law Rev.* 685, 688 (1987).

. . . primarily from the conflict between managerial direction of the group in the interest of the enterprise as a whole and legal doctrines that have traditionally insisted on the recognition of each corporate component of the enterprise as a separate legal entity. Thus, in order to achieve profit maximization for the enterprise as a whole, the parent's managers will typically wish to structure the group's credit transactions in a way that will optimally exploit the creditworthiness of its stronger components. In addition, management should attempt to allocate the resources obtained to the most promising investment opportunities within the group.<sup>7</sup>

a. *Jurisdictional Alter Ego*

The first problem created in this set of sole-owner situations is the mentioned one of "jurisdictional *alter ego*." Hundreds of these cases litter the state and federal reporter systems, and while most of them purport to track "standard" creditors' remedies disregard-of-entity cases, they often vary from these themselves disparate cases for the simple reason that, since the entity being disregarded often is perfectly solvent but not the appropriate one to reach, standard criteria for standard disregard holdings often simply are not relevant. What is unique about intercorporate situations, however, is the way in which the *active* holistic management of the corporate group by its central administration may be reflected in judicial responses.

A good case study is *Bulova Watch Co., Inc. v. K. Hattori & Co., Ltd.*,<sup>8</sup> construing the "personal presence" portion of New York's long-arm personal jurisdiction statute. The plaintiff sued the Japanese defendant on a number of unfair competition claims, and asserted personal jurisdiction on the basis of the activities in the forum of the defendant's subsidiary, Seiko Corporation of America and of its local subsidiaries. According to the court,

[t]he parent-subsidiary relationship has not in itself been treated as sufficient to establish personal jurisdiction over the foreign parent. Some additional factor has been needed. Such circumstances include direct and indirect control of the local distributor, treating the subsidiary as an "incorporated division" for some purposes, and as an agent for others. . . . One scholarly analysis suggests that the cases should be read as treating the principal and subsidiary as one for jurisdictional purposes where parent and subsidiary

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7. Id. at 690.

8. *Bulova Watch Co., Inc. v. K. Hattori & Co., Ltd.*, 508 F.Supp. 1322 (S.D.N.Y. 1981).

are part of a "single economic entity." . . . Much depends on details of the relationship. . . .

Going on to analyze the factual situation of the defendants' relationship in detail, the court added:

Although with time, the Hattori subsidiaries might well evolve, along with their parent, into the later stages of multinational development, today Hattori is a highly effective export manufacturer and not a fully developed multinational. It is monocentric more than polycentric. Large and sophisticated as it may be, it is very much the hub of a wheel with many spokes. It is appropriate, therefore, to look to the center of the wheel in Japan when the spokes violate substantive rights in other countries.

*b. Regulatory Alter Ego*

The second major issue is the mentioned one of "regulatory *alter ego*." A pair of cases involving labor legislation and environmental protection legislation respectively provide a nice contrast as they illustrate the two poles to the question, whether traditional and private-law related (i.e., creditors' remedies-related) disregard-of-entity doctrine should apply in aid of construing the specific purpose of regulatory statutes. The first, *Bowater Steamship Co. v. Patterson*,<sup>9</sup> involved a provision of the Norris-LaGuardia Act, which prevents courts from issuing injunctions in the case of a labor dispute that would restrain a person participating or interested in the dispute from committing certain acts. Plaintiff was the shipping subsidiary of a corporation, which also owned (through another level) a pulp and paper subsidiary that was engaged in a dispute with defendant union members. Answering the argument that because plaintiff was not in the pulp and paper industry it was not "a person participating or interested in" this dispute, an argument that of course rested on the separate corporate status of the various units of the plaintiff enterprise, the court said:

Apart from other possible answers, this argument places more weight on the separate corporate identities of the various Bowater companies than these can properly bear. Assuming, as we may, that plaintiff and Bowater's Newfoundland had sufficient independence to be regarded, in contract or tort litigation, as separate both from the ultimate. . . and from each other, . . . it does not follow that they ought to be so regarded for application of the Norris-LaGuardia Act. Whether a subsidiary corporation is to be con-

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9. *Bowater Steamship Co. v. Patterson*, 303 F.2d 369, 370 (2d Cir. 1962).



sidered a separate entity "cannot be asked, or answered, *in vacuo*". . . ; the issues in each case must be resolved in the light of the policy underlying the applicable legal rule, whether of statute or common law. . . .As the Supreme Court has repeatedly taught, the policy behind the Norris-LaGuardia Act was a strong one; we cannot think that Congress would have meant this to be defeated by the fragmentation of an integrated business into a congeries of corporate entities, however much these might properly be respected for other purposes.

The second, recent case arose under one of the most contested of modern regulatory statutes, the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). In *Joslyn Manufacturing Company v. T.L. James & Co., Inc.*<sup>10</sup>, the court rejected an argument that the corporate parent of an offending subsidiary could be liable as the *alter ego* of that subsidiary under statutory language which makes liable an owner or operator of the facility, other than one who "holds indicia of ownership primarily to protect his security interests [i.e., secured-lender status] in the . . .facility." The court stated, at 82-83:

Significantly, CERCLA does not define "owners" or "operators" as including the parent company of offending wholly-owned subsidiaries. Nor does the legislative history indicate that Congress intended to alter so substantially a basic tenet of corporation law. . . .Joslyn asks this court to rewrite the language of the Act significantly and hold parents directly liable for their subsidiaries' activities. To do so would dramatically alter traditional concepts of corporation law. . . .

If Congress wanted to extend liability to parent corporations it could have done so, and it remains free to do so. . . .As the district court observed, Congress is quite capable of creating statutes that hold shareholder or controlling entities liable for the acts of valid corporations. In fact, Congress adopted a "control" test in the next subsection of the statute. Under CERCLA, the term "owner or operator" is defined for facilities conveyed to state or local governments by . . .abandonment, as "any person who owned, operated or otherwise controlled activities at such facility immediately" before conveyance. . . .No such "control" test appears in subsection (ii). . .and we will imply none. . . .

Further, the facts here militate against piercing the cor-

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10. *Joslyn Manufacturing Company v. T.L. James & Co., Inc.*, 893 F.2d 80 (5th Cir. 1990).

porate veil. Lincoln faithfully adhered to basic corporate formalities by keeping its own books and records and holding frequent shareholder and directors meetings.

Of course, the latter criteria are among those governing the "traditional" creditors' remedies test and would not without more have any bearing in this regulatory situation.

c. *Unlawful Preferences and Fraudulent Transfer Issues*

The turn from this entity-disregard situation to other aspects of the sole owner's responsibility to corporate creditors requires a return to the general case, that involving the individual as well as the corporate parent shareholder. It also requires a brief introduction to the general role of creditors' remedies as well as of corporate law in the matter of unlawful undercapitalization or unlawful distribution of assets. After all, the intracorporate guaranties to which the previously quoted *Blumberg* comment refers are not the only problem in this subset of one-owner situations which threatens to swallow the larger set. Indeed, the first problem, at least in the American, especially the federal, legal system, is not substantive at all, but doctrinal-organizational: the reconciliation of disparate and often inconsistent doctrines of corporation law on the one hand and of (state) creditors' remedies and (federal) bankruptcy/reorganization law on the other.

The simplest problem arises when, to the detriment of corporate creditors, corporate assets either are illegitimately transferred to the consenting owner or were illegitimately overvalued on the occasion of their original transfer to the corporation in exchange for the entity's stock. While this is not uniquely a one-owner situation or transaction, the unanimous consent of the sole or of all owner(s) to that transaction creates the functional equivalent of that one-owner situation; namely, the assertion that, in Justice Cardozo's winged words, "[n]o consent of shareholders could make such conduct lawful when challenged by the receiver as the representative of creditors. . . . The interests affected by approval will shape the power to approve".<sup>11</sup>

It is beyond the scope of this report on United States corporation law to review the complex web of corporation law, securities regulation law, creditors' remedies law, and bankruptcy law that combines often disparate doctrinal elements to handle the two mentioned transactions as well as other analogous ones such as the dissipation of assets through self-interested transactions. Nonetheless, a brief review of the combination of substantive doctrine and proce-

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11. *McCandless v. Furlaud*, 296 U.S. 140, 159 (1935).

dural or remedial issues (including, significantly, issues of the *locus standi* of complainants to object to these transactions) is an essential introduction to the special situation posed by the (sole) corporate parent-shareholder as distinguished from the natural person-shareholder.

The first transaction involves the transfer of overvalued property in exchange for stock. Traditionally, if the wrongful undercapitalization (overvaluation of property contributed to the corporation in exchange for stock) took place upon the initial incorporation and capitalization of the corporation, so that *all* the then-issued shares went to the very persons contributing the overvalued consideration, the entity, being no more than these same owners, typically had no right to complain of any damage done to it. The owners had only cheated "themselves."

That transaction, however, might be only the first stage of a promoters' deception of the investing public, a fraud which could then be accomplished by using one of two approaches. In the first approach, the same promoters-initial owners could cause the corporation to issue further stock to new investors who, deceived by the false picture created by the earlier transaction, contributed good money in exchange for a lesser proportion of stock than the true valuation of the respective contributions should have given them. The second approach would involve no further initial corporate stock issuance by these promoters but simply the resale to such incoming purchasers of the stock these promoters had originally issued to themselves (again, for more than the transferred property had been worth).

The right of these later shareholders to sue promoters directly for this fraud was never in question, but was procedurally difficult to vindicate. What was in question, and what justifies this excursion into a field beyond the scope of this "sole-owner" report, is whether the inability of *shareholders* to clothe "their" corporation with standing to sue for promoter's fraud necessarily also disabled *creditors* from generating that corporate right to sue the original promoter/ shareholder(s). This was the issue on which one of the most famous pairs of American cases<sup>12</sup>, *Old Dominion Copper Mining & Smelting Co. v. Lewisohn* and *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, involving the identical fact situation but different defendant/promoters, came to exactly contradictory conclusions.

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12. *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1908) and *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193 (1909) (confirming its earlier decision, 188 Mass. 315, 74 N.E. 653 (1906) after the decision in the cited federal case).

Beginning early in the 1900s both state and federal courts began to remove any such limitations on a corporate remedy for original-issuance promoters' fraud in the common situation in which the promoters caused the corporation to issue not only equity but also debt securities. There, the consent of (all) the shareholder(s) of the corporation to accept a gross overvaluation of the property transferred to the entity was deemed inadequate to bind the corporation — or at least to bind the corporate receiver or bankruptcy trustee — to that acquiescence in the fraud. The presence of creditors provided the corporation, acting via its receiver, with the standing to correct the earlier fraud even to the point of recovering rescissionary-type damages from the original promoters who meantime had resold the debt securities, that had been issued to them, to the general public.

This liberalization was accomplished in great part through the protean Rule 10b-5, derived from § 10(b) of the Securities Exchange Act of 1934, which prohibits (and by implication makes actionable) false or misleading statements or omissions made in connection with the purchase or sale of a security. In *Hooper v. Mountain States Securities, Inc.*<sup>13</sup>, for perhaps questionable reasons having to do with an expanded view of implied tort concepts inherent in the scheme of securities regulation, a corporation *issuing* stock was held to be a *seller* of stock, and its damages were deemed to be measured by the fraud inherent in conveying to it overvalued assets for those shares; i.e., it could recover the value purported to inhere in those assets. In *Hooper*, however, the corporation, already in existence, was owned by innocent as well as defrauding shareholders and therefore provided no test of the initial-status problem of *Old Dominion*.

In *Bailes v. Colonial Press*<sup>14</sup>, finally, an *initial* promoters' fraud situation was resolved for Rule 10b-5 purposes in accord with and under roughly the same formulation as in the Massachusetts (*Bigelow*) *Old Dominion* case. It is possible that only the first type of promoters' fraud (in which the promoters cause the corporation to issue some stock to new innocent shareholders directly) can be caught under this approach; *Colonial Press* itself did not decide whether Rule 10b-5 might cover even a case in which the *only* issue (i.e., "sale") by the corporation is to the promoters, with innocent and deceived buyers coming in only via these promoters. It is possible to read this broader reach into *Superintendent of Insurance v. Bankers Life & Cas. Co.*<sup>15</sup>, but only by implication.

As already mentioned, the creditors of a corporation always had a direct remedy for such initial capitalization fraud, but only if all

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13. *Hooper v. Mountain States Securities, Inc.*, 282 F.2d 195 (5th Cir.).

14. *Bailes v. Colonial Press*, 444 F.2d 1241 (5th Cir. 1971).

15. *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

aspects of a fraud claim, including deception and reliance, could be proved. A more generous doctrine, or set of doctrines, not necessarily requiring such reliance, had developed not in the capitalization field, but in the related field of protecting corporate assets, once contributed as capital, from illegitimate *distribution* to shareholders (in the form of dividends or of payments in repurchase of shares). The earliest form, the trust fund doctrine, seemed to be available whether creditors using it had relied upon the maintenance of these assets or not; of course, it would be natural that most such credit extensions would precede the wrongful dissipation of assets and that in this sense all prior creditors were relying creditors.

There is, of course, an important difference, as to reliance, between such wrongful capital *distribution* events and wrongful capital *acquisition* (overcapitalization) events: In at least mid-stream fraudulent overcapitalization cases like *Hooper*, creditors extending credit *before* the fraudulent transaction usually could not prove such reliance — the opposite of distribution cases.

In any event this trust fund doctrine (or label — one find it used occasionally even today) later was joined by a traditional and reliance-requiring fraud doctrine, and then by a so-called “statutory theory,” which requires some explanation. It was based on the universal requirement of early corporation law statutes that stock issued for a given par value per unit (an arbitrary number) had to be paid for by cash or property worth at least par. In the days when par value and the actual market price received for issued stock coincided, this requirement, converted into a creditors’ remedy by other statutes granting creditors a direct right of action on any such claim of a corporation against wrongdoing subscribers, was read by courts as eliminating the requirement of reliance by suing creditors on the false financial picture so created. This view, as well as a minority view that required proof of reliance, both became irrelevant once the practice of issuing stock for much more than par value (so-called low-par or no-par stock) became prevalent: Even grossly overvalued assets typically were then worth at least this nominal par value. With that, the direct creditors’ remedy collapsed back into the general fraud area with its attendant reliance requirement.

A remedy combining the ability of the creditor to ignore the corporation’s own inability to complain of the fraud with the avoidance of proof of reliance has developed in the bankruptcy context. Upon opening of bankruptcy or corporate reorganization proceedings a trustee is appointed to marshal the entity’s assets in preparation for distribution to claimants. This is not confined to converting all assets into liquid ones, but includes suing on the corporation’s various claims against others, including such items as unpaid subscription installments for shares. Though the trustee acts for the

benefit of creditors, the claims pursued have to be claims belonging to the corporation; thus, of the original promoters' fraud transactions only those of the first type (*Old Dominion*) can be pursued by the trustee. Of course, mid-stream fraudulent watered stock transactions (*Hooper*) also can be pursued, since the corporation does have standing to complain of them.

The only questionable case, then, is the second type of original promoters' fraud. While the trustee's powers do extend to fraudulent *distributions* of assets even when effected with the corporation's active participation (under concepts of fraudulent conveyance and unlawful preference briefly reviewed below) their extension to this case seems blocked by the analogous Supreme Court opinion in *Caplin v. Marine Midland Corp.*<sup>16</sup> Here the court refused to permit the trustee to pursue the claims of corporate bondholders (not stockholders) who charged that they had been fraudulently induced to purchase these bonds by the institution acting as the mortgage trustee between the "issuing" corporation and the bondholders.

As to permissible bankruptcy trustee actions, however, few as these may be in the area of fraudulent overcapitalization, the proceeds of such successful lawsuits may be distributed to all creditors alike, whether individually they relied upon the falsity of the underlying fraudulent transaction or not.<sup>17</sup> Furthermore, while at first a matter of some doubt, the right of the trustee to sue the former shareholder *directly* on what is only a creditors' claim of disregard of the corporate entity, and thereby obtain direct recovery from the shareholder on an undercapitalization argument, increasingly has come to be accepted.<sup>18</sup>

With this preliminary review completed, it is possible to return again to those aspects of the reviewed issues which derive from the fact that a parent corporation is the sole owner of one or a set of subsidiaries and affiliated companies. A useful simplification is to recognize as a likely *fact* that the sole shareholder who is a natural person typically makes a controlling investment in only one company; whereas the corporate person typically makes a controlling investment in several companies and thus not only may have transactional relations between itself and any given company but may also cause these companies to have transactional relations among themselves. What is then unique to the corporate owner is what animated German theorists to develop the operational concept of the *Konzern*; namely, the notion that the controlling shareholder

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16. *Caplin v. Marine Midland Corp.*, 406 U.S. 416 (1972).

17. See the old Supreme Court decision of Justice Holmes, to this degree still operative, of *Moore v. Bay*, 284 U.S. 4 (1931).

18. See, e.g., *Koch Refining v. Farmers Union Central Exchange*, 831 F.2d 1339 (7th Cir. 1987).

of the set of companies treats them as subservient to a larger, *Konzern*-level or enterprise-level mission. Of course, natural persons also may solely own not one but several companies, but usually they do not, at least not on the scale at which corporate owners own them. The natural-person sole owner may overvalue assets contributed to the company in exchange for stock, or may drain assets out of the company for personal uses, but typically does not go beyond these simple transactions. The corporate owner, on the other hand, generates complex transactions, and it is these that cause most of the complex problems suggested by the prior references to state and federal creditors' remedies, bankruptcy/reorganization, and securities laws.

The prototypical complex problem is the one suggested by the already mentioned *Blumberg* article, the cross-guarantee. From the overall perspective of the enterprise and its central management, any subsidiary or affiliate, because of its relatively strong financial position, may be an appropriate guarantor of any other member firm's obligations, including those of the parent company. From the standpoint of other creditors of the guaranteeing firm, of course, that Olympian perspective is inappropriate.

Traditional corporation law rules treat this problem as one of corporate powers in the *ultra vires* sense, and resolve the right of a company to back the debts of another by asking whether the transaction is to the benefit of the guaranteeing firm. This question of "benefit" was originally strictly, more recently loosely construed, so that under what might be called the "traditional" state statutes it now suffices to legitimate a guarantee against a charge of *ultra vires* or waste of assets to claim that the general corporate interests of the guarantor are served, in the judgment of the directors or other appropriate management.<sup>19</sup> Whether this approach requires a disinterested board of directors' judgment — a contradiction in the case of a board of directors appointed by the parent company and usually comprised of officers of that parent — is a different issue, and one not uniformly answered.<sup>20</sup>

A more modern statutory variant dispenses with the question of corporate benefit altogether and substitutes therefor either the unanimous or majority vote of the (probably disinterested) shareholders as the test of legitimacy in this enabling power sense. The most noteworthy examples of this approach are Section 908 of the New York Business Corporation Law:

A guarantee may be given by a corporation, although not in

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19. See generally Note, "Upstream Financing and Use of the Corporate Guaranty," 53 *Notre Dame L. Rev.* 840 (1978).

20. See *Blumberg*, *supra* at 692-93.

furtherance of its corporate purposes, when authorized at a meeting of its shareholders by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon. If authorized by a like vote, such guarantee may be secured by a mortgage or pledge of, or the creation of a security interest in, all or any part of the corporate property, or any interest therein, wherever situated. . . ;

and Section 14A:3-3 of the New Jersey Statutes:

(1) A corporation may give a guaranty not in furtherance of its direct or indirect business interests only when authorized by the affirmative vote of all of the votes cast by the holders of each class and series entitled to vote thereon. If authorized by such a vote, the guaranty may be secured by a mortgage of or a security interest in all or any part of the corporate property, or any interest therein, wherever situated.

(2) Nothing in subsection 14 A:3-3(1) shall be deemed to diminish the rights, if any, of the corporation's creditors.

Finally, a few statutes directly accept the *Konzern* rationale, and specifically authorize a company to issue a guaranty on behalf of a controlling parent *corporation*. See, e.g., Section 302A.501(1) of the Minnesota Statutes Annotated:

A corporation may lend money to, guarantee an obligation of, become a surety for, or otherwise financially assist a person, in the transaction, or a class of transactions to which the transaction belongs, is approved by the affirmative vote of a majority present and: . . . .

(b) Is with, or for the benefit of, a related corporation, an organization in which the corporation has a financial interest, an organization with which the corporation has a business relationship, or an organization to which the corporation has the power to make donations.

According to a Reporter's Note cited by *Blumberg, supra* at 693:

The ability to bolster the finances of a related corporation. . . is important because these related corporations are often part of one economic unit within which artificial distinctions should not prevent internal transfers of funds.

Perhaps most relevant to the topic of this report is the new Delaware provision, since so many major American corporations are incorporated there. Section 122 of its General Corporation Law now provides:



Every corporation. . . shall have power to:

. . . (13) Make. . . contracts of guaranty and suretyship which are necessary or convenient to the conduct, promotion or attainment of the business of (a) a corporation all of the outstanding stock of which is owned, directly or indirectly, by the contracting corporation, or (b) a corporation which owns, directly or indirectly, all of the outstanding stock of the contracting corporation, or (c) a corporation all of the outstanding stock of which is owned, directly or indirectly, by a corporation which owns, directly or indirectly, all of the outstanding stock of the contracting corporation, which contracts of guaranty and suretyship shall be deemed to be necessary or convenient to the conduct, promotion or attainment of the business of the contracting corporation. . . .

Traditional state corporation law, thus, rapidly is passing from forbidding or regulating to facilitating these intercorporate, intra-enterprise arrangements. That is only half the story, however, since both state and federal creditors' remedies rules also need to be reviewed for their impact on this situation. Federal law, if contradictory, would preempt inconsistent state law under the Supremacy Clause of the US Constitution; but even parallel state law, by explicit or implicit legislative mandate, typically overrides these company law provisions. Both these federal and state sets of laws are of relatively recent vintage, the federal Bankruptcy Code having been substantially recodified in 1982, and the major relevant state law, the Fraudulent Conveyance (now Fraudulent Transfer) Act, having been recodified, at least in its Uniform Act form, to harmonize it with its federal analogue (fraudulent conveyance was an early object of unification efforts under the aegis of the National Conference of Commissioners on Uniform State Laws, a semi-official body that drafts and then recommends uniform laws to state legislatures, with varying degrees of success).

*Blumberg*, whose treatment in the cited paper I follow here, has identified four areas of concern:

— the value of a guaranty, an issue of concern if the guarantor corporation is threatened with insolvency or bankruptcy proceedings. Critical here is whether the contingent value of a subrogation or indemnification provision to the guarantor's benefit, running either against the guaranty-receiving entity or an affiliated one, should be deemed a positive element of "counter-value," and whether the full face amount of the guarantee or only its value discounted by the probability of a call under it should be the measure of the "liability" of the financially insecure guarantor.

— whether a guarantee to a parent or affiliated corporation is a preferential “insider” transaction, leading to potential invalidation of the issuance of the guaranty or recapture of payments actually made under it. If, in addition, the beneficiary corporation is at the same time indebted to the guaranteeing affiliate, these transactions may separately be challenged as unlawful or fraudulent transfers apart from the basic challenge.

— whether the guaranty issued for the benefit of the overall enterprise creates a “reasonably equivalent value” for the guarantor, thus avoiding a challenge that the guaranty was constructively fraudulent under the relevant “unlawful guaranty” section of the modern (uniform) state act.

— whether the guarantor’s obligation is incurred already upon issuance or only when payments are made under the guaranty. This is relevant to the question of unlawful preferences and fraudulent transfers, since the financial position of the guarantor may be good at the first point in time and weak at the second. The new statutory solution chooses the first point, and thus aids commercial lending transactions “by relieving lenders of the ongoing burden of having to continue to police the condition of the guarantor and its affiliates to determine whether their condition at the time of the [later] advance would render the guaranty fraudulent [or, if occurring within 90 days before the guarantor’s own insolvency, an unlawful preference].”<sup>21</sup>

The bottom line as to the overriding potential of these creditor protection provisions of state law (and of analogous federal bankruptcy and reorganization provisions, not separately analyzed here) is that some convergence towards facilitating these guaranty transactions, as an aid to the availability of commercial loans, is occurring, but that the full facilitative approach of the modern state statutes like Delaware’s has not been fully matched even by the recent revision of the uniform version of this segment of state law.

#### *d. Substantive Consolidation in Bankruptcy*

The last special case to be discussed in this report is the problem of intra-enterprise bankruptcy or reorganization processes. In its simplest terms, it involves a parent and a network of direct and indirect subsidiaries, and the *variable, not uniform* financial distress of one or more of the latter entities. It is distinguished from the straightforward disregard-of-corporate-entity case because the conflict now is not between one or more creditors and the owner(s) of the firm but is one among the different creditors of different firms.

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21. Blumberg, *supra* at 725.

The creditors who have a financially healthy or less distressed corporate debtor facing them do not want to be thrown into a common pot with other creditors whose respective debtors are more distressed, to share and share alike whatever common liquidating dividend can be gained from the pooled remaining assets of all the involved debtor firms.

In this situation the courts (federal courts, since bankruptcy law is federal law) have tended to a restrained approach, even if part of the consolidation problem arose from the existence of intercompany transactions among the affiliate family. Generally, they require proof that the intercompany affairs were so entangled that inordinate time and money would be lost trying to recreate separate accounts, and permit objecting creditors to demonstrate that they had reasonably relied on the credit of the particular affiliate with which they had dealt. For good examples, compare *Chemical Bank New York Trust Co. v. Kheel*<sup>22</sup>, permitting consolidation, with *In re Gulfco Investment Corp.*<sup>23</sup>, denying consolidation.

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22. *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966).

23. *In re Gulfco Investment Corp.*, 593 F.2d 921 (5th Cir. 1979). See generally "Comment, Substantive Consolidation in Bankruptcy: A Primer," 43 *Notre Dame L. Rev.* 207 (1990).

