

Disregarding the Corporate/LLC Veil: The most litigated issue in corporate law

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1. *Amfac* test
2. Improper conduct
3. Disappearing assets
4. Milking
5. Commingling & confusion
6. Gross Undercapitalization
7. Corporate formalities
8. Actual control
9. Proximate cause
10. Recovery may be limited to sum milked
11. Related theories

A 1991 study found that piercing the corporate veil was the most litigated issue in corporate law. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L REV 1036 (1991).

Despite strong public policy favoring shareholder limited liability, creditors repeatedly try to collect corporate debts from corporate shareholders.

Generally, the law of the state of incorporation – not the state in which the shareholder or creditor resides – determines whether the corporate veil should be pierced. *Bartholomae Oil Corp. v. Booth*, 146 Or 154, 28 P2d 1083 (1934); *Garetson-Hilton Lumber Co. v. Hinson*, 69 Or 605, 140 P 633 (1914). *But see* fn 2 in *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000). A state court does not have personal jurisdiction over a shareholder merely because the corporation did business in a foreign state. *Cannon Mfg. Co. v. Cudahy Packing Co.*, 267 US 333 (1925).

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Oregon case law regarding corporate piercing also applies to LLCs. *BDL Products, LTC v. Technical Plastics of Oregon, LLC*, 2006 WL 3628062 (D Or).

1. Amfac test

Oregon has one of the better articulated tests for determining when the corporate form can be disregarded to impose liability on individual shareholders, a test first set out in *Amfac Foods, Inc. v. Int'l Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982).

The *Amfac* criteria are:

- (1) The shareholder must have controlled the corporation.
- (2) The shareholder must have engaged in improper conduct in his exercise of control over the corporation; and
- (3) The shareholder's improper conduct must have caused plaintiff's inability to obtain an adequate remedy from the corporation. (footnotes omitted) *Rice v. Oriental Fireworks Co.*, 75 Or App 627, 633, 707 P2d 1250, 1255 (1985).

2. Improper conduct

Strong public policy favors the limited liability rights of shareholders, but courts will exercise their equitable powers and disregard the corporate form where fairness and justice so require. But this is an extraordinary power exercised only if there is clear evidence those who control the corporation have used the corporation to defeat justice by perpetuating fraud, improperly shielding themselves from contractual or tort responsibility or in other improper conduct. Improper conduct can occur at formation, during operations or as creditors are beating on the door.

3. Disappearing assets

Sometimes when a corporation is failing, the shareholders transfer corporate assets to themselves (or to another corporation owned by themselves) for little (or often no) consideration. Such transfers are improper. *Allen v. Meinig*, 109 Or App 341, 819 P2d 744 (1991); *rev den*, 313 Or 209, 830 P2d 595 (1992); *Vermeer v. Dismantling Contractors, Inc.*, 90 Or 74, 751 P2d 796, *rev den*, 306 Or 156, 758 P2d 347 (1988); *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986).

Closely related are the concepts of a *de facto* merger and fraudulent conveyances, both of which are discussed at the end of this article.

4. Milking

Milking involves paying excessive dividends or diverting corporate assets to owners – it goes well beyond the payment of normal dividends and salaries. “Piercing a corporate veil based on “milking” of “excessive dividends” makes sense in cases of corporate manipulation where corporate assets are systematically and extensively removed from the corporation.” *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F3d 1217, 1231 (9th Cir 2005).

Shareholders have been held liable for a corporation's debts because they have milked a corporation by the payment of excessive dividends, by the sale of products to the shareholders at a reduced price, or by exacting unreasonable management charges. *Amfac, supra*, 294 Or 94, 109, 654 P2d 1092 (1982).

In *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 83 P3d 350 (2004), the court upheld a trial court finding that by transferring \$1 million to themselves, controlling shareholders had “milked” the corporation because the reduction in operating capital had reduced the chances the corporation could attract additional investors and, without these additional investors, the corporation failed.

5. Commingling & confusion

“In some number of cases, shareholders have been held liable for corporate debts because of misrepresentations by the shareholder to the creditor, confusion or commingling of assets, or because the respective enterprises were not held out to the public as separate enterprises.” *Amfac Foods, supra*, 294 Or 94, 110, 654 P2d 1092, 1102 (1982).

If a corporation and its shareholder fail to act as if there is a difference between corporate property and shareholder property, courts are inclined to do the same. One court noted: “if the officer has demonstrated disregard of the corporate form, treating the corporation essentially as a conduit for personal business affairs, the court may likewise disregard the corporate entity to avoid injustice.” *Weeks v. Kerr*, 486 NE2d 10, 12 (Ind App 1985).

An isolated act of commingling is not enough; there need be substantial confusion. *Aero Planning International, Inc. v. Air Associates, Inc.*, 94 Or App 143, 764 P2d 610 (1988).

There must be such a commingling of property rights or interests as to render it apparent that they are intended to function as one, and, further, to regard them as separate would aid the consummation of a fraud or wrong upon others. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 401, 811 P2d 221, 224 (1991).

See, also: *BDL Products, LTC v. Technical Plastics of Oregon, LLC*, 2006 WL 3628062 (D Or). *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 482, 719 P2d 899, 903 (1986).

6. Gross Undercapitalization

"[G]ross undercapitalization of the debtor corporation, by itself, may suffice to hold the shareholder liable to a creditor who is unable to collect against the corporation because it was inadequately capitalized." *Amfac Foods, supra.*, 294 Or 94, 109, 654 P2d 1092, 1102 (1982).

Inadequate capitalization of a corporation is a form of improper conduct. Although there is no statutory minimum capitalization requirement in Oregon, a corporation must have sufficient capital to cover its reasonably anticipated liabilities, measured by the nature and magnitude of its undertaking, the risks attendant to the particular enterprise and normal operating costs associated with its business. Sufficiency of capital is measured at the time a corporation is formed and begins operations. *Gardner v. First Escrow Corp.*, 72 Or App 715, 723 696 P2d 1172, 1177-8, *rev den*, 299 Or 314, 702 P2d 1111 (1985).

See, also: *Stirling-Wanner v. Pocket Novels, Inc.*, 129 Or App 337, 341, 879 P2d 210, *rev den*, 320 Or 272, 882 P2d 1114 (1994).

"Capitalization" means the consideration paid for a corporation's shares. It includes cash and other physical property paid for the stock, and may include intangible assets, such as an employment contract with an experienced manager and potential contracts with customers. *Murphy Logging Co. v. U.S.*, 378 F2d 222 (9th Cir 1967). "A shareholder loan is deemed a capital contribution if it is made to an initially undercapitalized corporation." *Houston's Inc. v. Hill*, 111 Or App 502, 506, 826 P2d 644, 646, *rev den*, 313 Or 354, 833 P2d 1283 (1992). See, also: *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968).

Inadequate capitalization is measured at a corporation's formation or at the beginning of its operations. *Vuyksteke v. Broan*, 172 Or App 74, 17 P3d 1072 (2000); *Stirling-Wannerv. Pocket Novels, Inc.*, 129 Or App 337, 879 P2d 210, *rev den*, 320 Or 272, 882 P2d 1114 (1994); *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172, *rev den*, 299 Or 314, 702 P2d 1111 (1985). *But see: DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F2d 681 (4th Cir 1976).

The US Supreme Court has indicated the adequacy of the capitalization should be "measured by the nature and magnitude of the corporate undertaking." *Anderson v. Abbott*, 321 US 349, 362, *rehearing den*, 321 US 804 (1944).

Adequate capitalization takes into account the assets placed at risk by the shareholders in relation to the corporation's anticipated business and liabilities. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, 912 P2d 929, 929, *rev den*, 323 Or 690, 920 P2d 549 (1996).

In some states, undercapitalization is not grounds for piercing the corporate veil. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 811 P2d 221, 223 (1991); *Marett v. Professional Insurance Careers, Inc.*, 201 Ga App 178, 410 SE2d 373, 375 (1991).

7. Corporate formalities

While failure to observe corporate formalities (minutes, director & shareholder meetings, etc.) is often mentioned as one of the wrongs committed by a corporation which has engaged in multiple wrongs, such a failure does not appear to be reason alone for piercing the corporate veil.

Although it would have been more orderly and businesslike, if the directors of the corporation had evidenced the understandings between the different stockholders by formal resolutions, rather than to proceed in the informal manner which they chose, nevertheless in such an instance as this, wherein all the stock of the corporation is owned by a few, and all or most of the stockholders are actively engaged in the enterprise of the corporation, it is often the practice to transact ordinary business without formal resolutions. *Roles v. Roles Shingle Co.*, 147 Or 365, 371, 31 P2d 180, 182 (1934).

See, also: McMunn v. ML&H Lumber, Inc., 247 Or 319, 429 P2d 798

(1967); *Uni-Com Northwest, Ltd. v. Argus Publishing Co.*, 47 Wash App 787, 737 P2d 304, *rev den*, 108 Wash 2d 1032 (1987).

Particularly in close corporations, courts seldom rely on this ground alone.

[A] failure of shareholders in a closely held corporation to strictly observe corporate formalities is not relevant to our decision of whether to pierce the corporate veil of a close corporation absent evidence indicative of and amounting to a true disregard of the corporate entity. *Consumer's Co-op of Walworth County*, 142 Wis 2d 165, 419 NW2d 211, 220 (1988).

The one corporate formality to which courts do attach particular attention, however, is the keeping of separate financial books and records. If shareholder and corporate assets are commingled, corporate creditors may be able to look to shareholder assets for repayment.

8. Actual control

If a corporation or its shareholders have engaged in improper conduct, a creditor may be able to pierce the corporate form and impose liability for corporate debts onto those who had “actual control” over the improper conduct.

The shareholder's alleged control over the corporation must not be only potential but must actually have been exercised in a manner either causing the plaintiff to enter the transaction with the corporation or causing the corporation's default on the transaction or a resulting obligation. Likewise, the shareholder's conduct must have been improper either in relation to the plaintiff's entering the transaction or in presenting or interfering with the corporation's performance or ability to perform its obligations toward the plaintiff. *Amfac Foods, supra*, 294 Or 94, 108-9, 654 P2d 1092 (1982).

The test for “actual control” has two prongs: the person sought to be held liable must have actual control over the improper conduct itself and actual control over the corporation as a whole. *Or Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*, 191 Or App 408, 83 P3d 350 (2004).

It bears repeating: All three prongs of the Amfac test must be present for a shareholder to be liable for corporate debts. Simply owning 100% of the stock – without any improper conduct – alone is not enough to make the shareholder liable. *Levine v. Alpha Anesthesia, Inc.*, 145 Or App 549, 931 P2d 812, *rev den*, 325 Or 368, 939 P2d 45 (1997); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971); *Miller Lumber Corp. v. Miller*, 225 Or 427, 357 P2d 503 (1961).

9. Proximate cause

To be held liable on a theory of corporate disregard, there must be some link between a shareholder's misconduct and the creditor's harm. Proximate cause is the third element of the *Amfac* test.

Given improper conduct by the shareholder exercising control over the corporation, the plaintiff must also demonstrate a relationship between the misconduct and the plaintiff's injury. If a shareholder's improper conduct causes no injury to a corporate creditor, there is no basis for a recovery from the shareholder. Consistent with the general policy of shareholder immunity, a shareholder's improper conduct does not give a hunting license to a corporate creditor to redress a general wrong. Surprisingly, this requirement has received little express attention in many of the appellate court opinions. *Amfac Foods, supra*, 294 Or 94, 111, 654 P2d 1092 (1982).

In *Oregon Public Employees' Retirement Bd. v. Simat, Helliesen & Eichner*; 191 Or App 408, 83 P3d 350 (2004), the court found causation between the shareholders' act of transferring \$1 million to themselves (thus reducing operating capital and the probability of attracting outside investors) and the collapse of the corporation. See, also: *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (1985).

In *J.C. Compton Co. v. Brewster*, 185 Or App 382, 59 P3d 1288 (2002), affirmed, 187 Or App 709 (2003), the court upheld jury findings that there had been improper conduct – but held that no damages resulted from that conduct.

10. Recovery may be limited to sum milked

In cases involving inadequate capitalization or milking, a shareholder's liability to the creditor may be limited to no more than the amount milked by that shareholder or to an amount no more than the difference between adequate capitalization and the amount actually contributed.

The damages which flow from milking or improper capitalization may or may not be limited to the shortage of capital or amount milked. In some cases, the causal relationship will be clear. Sometimes, the facts will create a question for the trier of fact. For example, if the sole effect of a shareholder milking \$200,000 from a corporation is to reduce the amount available for creditors, the shareholder's liability to corporate creditors would be limited to \$200,000. *Amfac, supra*, 294 Or

94, 111, n 18, 654 P2d 1092 (1982).

Klokke Corp. v. Classis Exposition, Inc., 139 Or App 399, 912 P2d 929, *rev den*, 323 Or 690, 920 P2d 549 (1996), involved undercapitalization and milking. After noting that damages flowing from improper conduct may involve "significant factual issues," the court upheld the trial court's decision to limit damages against one shareholder to the sum improperly transferred to that shareholder alone, not the amount milked by all shareholders.

11. Related theories

Other theories exist to allow creditors to obtain relief after a corporation fails and goes out of business.

If corporate assets have been transferred to insiders (or entities controlled by insiders), the transfer may constitute a fraudulent conveyance under ORS 95.200 *et seq*; *Allen v. Meinig*, 109 Or App 341, 819 P2d 744 (1991), *rev den*, 313 Or 209, 830 P2d 595 (1992).

Sometimes when the assets of an insolvent corporation are acquired by another corporation, the acquiring corporation can become liable at least for the value of the assets acquired – maybe more. There are 4 generally accepted exceptions to the general rule that a corporation purchasing all of the assets of another corporation acquires only these assets and not the liabilities:

To this general rule there are four well recognized exceptions, under which the purchasing corporation becomes liable for the debts and liabilities of the selling corporation. (1) Where the purchaser expressly or impliedly agrees to assume such debts; (2) where the transaction amounts to a consolidation or merger of the corporations; (3) where the purchasing corporation is merely a continuation of the selling corporation; and (4) where the transaction is entered into fraudulently in order to escape liability for such debts. *Erickson v. Grande Ronde Lumber Co.*, 162 Or 556, 568, 92 P2d 170, 174, 94 P2d 139 (1939).

See, also: *Tyree Oil, Inc. v. BOLI*, 168 Or App 278, 7 P3d 571 (2000); *Western Helicopter Services, Inc. v. Rogerson Aircraft Corp.*, 728 F Supp 1506 (D Or 1990).

Distributions made to shareholders while the corporation is insolvent are void. *Enron Corp. v. Bear, Stearns Int'l Limited*, 323 BR 857 (SD NY 2005).; *Field*

v. Hauptert, 58 Or App 117, 647 P2d 952 (1982). Directors can be liable to the corporation for declaring illegal distributions. ORS 60.367(1); *Rapid Displays Inc. v. Gorder*, 155 Fed Appx 962, 2005 WL 3271355 (9th Cir 2005).

ORS 60.367 does **not** create an action at law by creditors against directors or shareholders for illegal distributions. *Wakeman v. Paulson*, 264 Or 524, 506 P2d 683 (1973). However, creditors may be able to impose liability upon “bad faith” shareholders and negligent directors through a bankruptcy trustee, a receiver or some other proceeding in equity. *Id.*; *In re Sheffield Steel Corp.*, 320 BR 405 (NE OK 2004); *Rosebud Corp. v. Boggio*, 39 Colo App 84, 561 P2d 367 (1977).

If a dissolved corporation’s assets are distributed to shareholders before payment of corporation's debts, creditors may seek satisfaction from shareholders to the extent of the distributed assets. ORS 60.645(2); *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385 (1983); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39 (1982).