

CHAPTER TEN

SHAREHOLDER LIABILITY TO THIRD PARTIES

- 10.01 Shareholder Liability, Generally
 - A. Successor corporation & agency distinguished
 - B. Miscellaneous
- 10.02 Theory of Corporate Disregard
 - A. Extraordinary remedy
 - B. Question of fact
 - C. Early cases
 - D. Washington test today
 - F. Similar tests
 - G. Reverse piercing
- 10.03 Intentionally Improper Conduct
- 10.04 Milking
- 10.05 Commingling & Confusion
- 10.06 Violations of Statute
 - A. Generally
 - B. Licensing cases
- 10.07 Corporate Formalities
- 10.08 Inadequate Capitalization
 - A. Generally
 - B. Funds considered as part of capitalization
 - C. When measured
 - D. How much is enough?
 - E. Miscellaneous
- 10.09 Proximate Cause
 - A. Generally
 - B. Recovery may be limited to sum milked
- 10.10 Control
 - A. Early development
 - B. Control is not enough
 - C. Degree of control
 - D. Active & latent control distinguished
 - E. Who has actual control?
- 10.11 Unpaid Subscriptions
 - A. Generally
 - B. Failure to issue shares

- C. Consideration permitted
- D. Calls & assessments
- E. Actions by corporation
- F. Actions by creditors

10.12 Distributions Upon Dissolution

- A. Generally
- B. Procedures for cutting off corporate debts after dissolution

Section 10.01 Shareholder Liability, Generally

As a general rule, shareholders are not personally liable for the debts of their corporations. *Barnett Brothers v. Lynn*, 118 Wash 308, 203 P 387 (1922); *Shlim v. CML, Inc.*, 112 Or App 597, 829 P2d 1012, *review denied*, 313 Or 627, 835 P2d 916 (1992); *Fields v. Synthetic Ropes, Inc.*, 215 A2d 427 (Del 1965).

Although it has not always been the case (See: Chapter One herein), the limited liability of shareholders has been one of the cornerstones of corporation law for more than a century and a half.

Today, RCW 23B.06.220 continues this policy. It limits a shareholder's liability to any unpaid consideration owed to the corporation for its shares.

Throughout history, creditors have tried to circumvent this strong policy favoring limited shareholder liability. In doing so, they have urged courts to disregard the corporation and instead impose liability directly on its shareholders and on others who control the corporation.

In such cases, courts have used varying terminology. Some courts speak in terms of "piercing the corporate veil." *Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wash 2d 400, 562 P2d 244 (1977). Others have said that liability may be imposed when the corporation is the "alter ego" of the persons in control. *Grayson v. Nordic Construction Company, Inc.*, 92 Wash 2d 548, 599 P2d 1271 (1979). The more generic term "disregarding the corporate entity" may be more appropriate, and most recently the Washington courts have preferred this term over the other terms. *Morgan v. Burks*, 22 Wash App 768, 770, n 1, 592 P2d 658, 659, n 1 (1979), *reversed on other grounds*, 93 Wash 2d 580, 611 P2d 751 (1980); Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, n 2 (1981).

All of these terms essentially refer to the same doctrine and these terms are used interchangeable by courts and in this book.

Section 10.01

Generally, only third parties may invoke and rely on the theory of corporate disregard. *Gavin v. Matthews*, 193 Wash 152, 74 P2d 990 (1938); Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, 256 (1981).

A. Successor corporation & agency distinguished.

There are other, distinct theories which are sometimes used to impose liability on shareholders. For instance, although cases commonly involve facts which give rise to discussion of both theories, the theory supporting piercing of a corporate veil and the theory regarding "successor corporation" liability are distinct. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 645 P2d 689 (1982). The liability of a successor corporation is discussed in Section 11.05 of this book.

A corporation may be the agent of its shareholder (usually a parent corporation). *Elvalsons v. Industrial Covers, Inc.*, 269 Or 441, 525 P2d 105 (1974). If so, a shareholder's liability will be determined by principles of agency. The theory supporting piercing a corporate veil is separate from the theory of agency.

The [theory of corporate disregard] should be distinguished from the doctrine of agency, actual or apparent, or estoppel, equitable or promissory. If the facts permit the application of any of these doctrines, any one of them alone may be used to impose liability against the actual or apparent principal, or against the person whose conduct creates the estoppel. Agency and equitable or promissory estoppel principles, of course, are well understood. (citations omitted) *Soderberg Advertising, Inc. v. Kent-Moore Corp.*, 11 Wash App 721, 732, 524 P2d 1355, 1363 (1974).

In another decision, the court stated:

Agency and alter ego are two different and distinct concepts. In the case of an alter ego, the court pierces the corporate veil. In the case of an agency the corporate identity is preserved but the principal is held liable for the acts of its agent. *Northern Natural Gas Company of Omaha, Nebraska v. Superior Court*, 64 Cal App 3d 983, 134 Cal Rptr 850, 857 (1976).

Agency is discussed in Chapter Six of this book.

B. Miscellaneous

As discussed below, the theory of corporate disregard allows a court to impose liability for corporate debts on shareholders who control the corporation. While this control is usually found in situations where the shareholder happens to also be an officer or director, the theory of corporate disregard is largely one used for imposing liability on shareholders, not usually a theory used for imposing liability on officers and directors, as such. But as discussed in Section 10.10 herein, there

Section 10.02

are a few cases where the theory of corporate disregard has been used to impose liability for corporate debts on non-shareholder officers and directors. See, for example: *Shades Ridge Holding Co., Inc. v. United States*, 888 F2d 725 (11th Cir 1989); *Glenn v. Wagner*, 313 NC 450, 329 SE2d 326 (1985). But see: *Castillo v. First City Bancorporation of Texas*, 43 F3d 953 (5th Cir 1994).

Shareholders may be liable to the corporation and its creditors for other reasons. The two principal reasons for such liability - unpaid subscriptions and improper distributions - are discussed in Sections 10.11 and 10.12 of this book. In addition, a shareholder is individually liable for his/her own tortious acts, even acts taken on behalf of the corporation, as well as for contracts entered into on behalf of an undisclosed corporate principal. *Roderick Timber Co. v. Willapa Harbor Cedar Products, Inc.*, 29 Wash App 311, 627 P2d 1352 (1981); *Moore v. Barge*, 210 Ga App 552, 436 SE2d 746 (1993).

Section 10.02 Theory of Corporate Disregard

Typically, a corporation is considered an entity separate and distinct from its shareholders. *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 618 P2d 1017 (1980); *Grayson v. Nordic Construction Co.*, 92 Wash 2d 548, 599 P2d 1271 (1979). There is a strong public policy in favor of the limited liability rights of shareholders, but the courts have long exercised their equitable powers to disregard the corporate form where fairness and justice so require. In an early case, the Washington Supreme Court stated:

It is also well-settled law that, while in general, a corporation is a separate legal entity, nevertheless when one corporation so dominates and controls another as to make that other a simple instrumentality or adjunct to it, the courts will look beyond the legal fiction of distinct corporate existence, as the interests of justice require; and where stock ownership is resorted to not for the purpose of participating in the affairs of the corporation in the customary and usual manner, but for the purpose of controlling the subsidiary company so that it may be used as a mere agency or instrumentality of the owning company, the court will not permit itself to be blinded by mere corporate form, but will, in a proper case, disregard corporate entity, and treat the two corporations as one. *Platt v. Bradner Co.*, 131 Wash 573, 579, 230 P 633, 635 (1924).

More recently, the Washington Supreme Court stated:

It is a well-recognized principle of law that a corporation may not be used as a cloak or disguise to escape corporate liability, and that the corporate veil may be pierced when necessary to do justice in particular cases. *Superior Portland Cement, Inc. v. Pacific Coast Cement Co.*, 33 Wash 2d 169, 212, 205 P2d 597, 620 (1949).

Section 10.02

See also: *Harrison v. Puga*, 4 Wash App 52, 480 P2d 247 (1971).

In disregarding the corporate form, a court exercises its equitable powers. *Hiller Corp. v. Port of Port Angeles*, 96 Wash App 918, 982 P2d 131 (1999).

A. Extraordinary remedy.

This equitable power to disregard the corporation is an extraordinary one which is exercised only where there is clear evidence that 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 unique situations. It is a power which courts emphasize is exercised "reluctantly" and "cautiously." *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F2d 681, 683 (4th Cir 1976).

Long ago, the United States Supreme Court said:

Normally, the corporation is an insulator from liability on claims of creditors. The fact that incorporation was desired to obtain limited liability does not defeat that purpose. Limited liability is the rule, not the exception; and on the assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted. But there are occasions when the limited liability sought to be obtained through the corporation will be qualified or denied. Mr. Justice Cardozo stated that a surrender of that principle of limited liability would be made "when the sacrifice is essential to the end that some accepted public policy may be defended or upheld." (citations omitted) *Anderson v. Abbott*, 321 US 349, 361-2, *rehearing denied*, 321 US 804 (1944).

Harm alone is not sufficient grounds for disregarding the corporate form. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 811 P2d 221 (1991). "The absence of an adequate remedy alone does not establish corporate misconduct." *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 411, 645 P2d 689, 693 (1982).

Disregard of the corporate structure is generally viewed as an extraordinary remedy because it strips the shareholders of the immunity which is the very heart of the corporate fiction. *Oregon RSA No. 6 v. Castle Rock Cellular of Oregon Limited Partnership*, 840 F Supp 770, 779 (D Or 1993).

See also: *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 618 P2d 1017 (1980); *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 481, 719 P2d 899, 903 (1986).

Yet, to prevent fraud and inequity, courts will pierce the corporate veil under the proper circumstances.

Section 10.02

B. Question of fact.

"The question of whether the corporate form should be disregarded is a question of fact." *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 643, 618 P2d 1017, 1021 (1980). A finding on this issue by the trier of fact will not be disturbed if it is supported by substantial evidence. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 811 P2d 221 (1991). But the court will review de novo the legal conclusions drawn to support the disregarding of the corporate form. *Hiller Corp. v. Port of Port Angeles*, 96 Wash App 918, 982 P2d 131 (1999).

C. Early cases.

Until relatively recently, courts have disregarded the corporate form on a case by case basis. There was no universally accepted test, nor even universally accepted terminology. Each case turned on its own merits. "The question of whether the corporate entity should be disregarded depends upon the particular circumstances of each case." (citations omitted) *Hogan v. Mayor & Alderman of Savannah*, 171 Ga App 671, 673, 320 SE2d 555, 558 (1984).

Over time, courts developed a laundry list of acts which justified disregarding the corporate form.

such abuse typically involves fraud, misrepresentation, or some form of manipulation of the corporation to the stockholder's benefit and the creditor's detriment. (citation & internal quotation marks omitted) *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 410, 645 P2d 689, 692 (1982).

In another decision, the court stated:

While, for all ordinary purposes, a corporation is regarded as a legal entity separate and distinct from its shareholders, yet, . . . "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." (citations omitted) *McIver v. Norman*, 187 Or 516, 537-8, 213 P2d 144, 149 (1949).

Fraud was often present in one form or another, but it was not the only basis for disregarding the corporate form. *Anderson v. Abbott*, 321 US 349, *rehearing denied*, 321 US 804 (1944). Gross undercapitalization and other acts against public policy have sometimes been held to provide a sufficient basis for disregarding the corporate form.

D. Washington test today.

Early cases cited a variety reasons for disregarding the corporation and imposing liability on its shareholders.

Section 10.02

Often the reason given [for disregarding the corporate form] is public advantage, requirements of justice, alter ego, fraud, bad faith, or other wrong. Such cases mean nothing more than that the violation of duty will result if the entity is not disregarded. *Harrison v. Puga*, 4 Wash App 52, 62-3, 480 P2d 247, 254 (1971).

Only recently have the courts attempted to formulate a test broad enough to distinguish between cases where the general rule is to be applied and cases where instead the corporate form is to be disregarded.

Most of the recent Washington cases which have analyzed the theory of corporate disregard have applied a test which contains two elements:

The corporate entity is disregarded and liability assessed against shareholders in the corporation when the corporation has been intentionally used to violate or evade a duty owed to another. The court's statement of the doctrine identifies two essential factors: (1) the corporate form must be intentionally used to violate or evade a duty and (2) disregard must be necessary and required to prevent unjustified loss to the injured party. (footnotes, citations & internal quotes omitted) *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 398-9, 811 P2d 221, 222-3 (1991).

The first element of this two-element test is intentional conduct by the person sought to be held liable for corporate acts:

The corporate entity is disregarded and liability assessed against shareholders in the corporation when the corporation has been intentionally used to violate or evade a duty owed to another. *Morgan v. Burks*, 93 Wash 2d 580, 585, 611 P2d 751, 755 (1980).

This duty may arise out of the common law, equity, a contract or by statute. *Hiller Corp. v. Port of Port Angeles*, 96 Wash App 918, 982 P2d 131 (1999).

The second element of the Washington test requires that there must be some causal link between the intentional misconduct and the harm which the disregard is necessary to relieve.

With regard to the second element, wrongful corporate activities must actually harm the party seeking relief so that disregard is necessary. Intentional misconduct must be the cause of the harm that is avoided by disregard. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 410, 645 P2d 689, 691 (1982).

Although not included in the articulated two-element Washington test, tests adopted in other jurisdictions usually has a third element: a person sought to be held liable for the corporate wrongdoing must be a person who controlled or dominated the corporation. *Dwyer v. Ing Investment Company, Inc.*, 889 SW2d 902 (Mo App 1994); *Scott v. AZL*

Section 10.02

Resources, Inc., 107 NM 118, 753 P2d 897, 900 (1988); *Messick v. Moring*, 514 So2d 892, 894-5 (Ala 1987); *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982). While this element has not been articulated as such in Washington, some Washington cases have looked to the issue of control in order to determine whether liability should be imposed. *Soderberg Advertising, Inc. v. Kent-Moore Corp.*, 11 Wash App 721, 524 P2d 1355 (1974).

In the context of a parent and subsidiary, one Washington decision expressed test for disregarding the corporation as follows:

- (a) If there is overt intention to regard or disregard the corporate entity, effect will be given thereto unless so to do will violate a duty owing.
- (b) The overt intention is that of the corporation whose entity is sought to be disregarded or of the person or persons owning its stock and sought to be visited with the consequence of regard or disregard of the corporate entity.
- (c) The duty owing must be owing to the person seeking to invoke the doctrine, and such duty may arise from common law and equity, contract or statute. *Anderson v. Section 11, Inc.*, 28 Wash App 814, 819, 626 P2d 1027, 1030 (1981).

Additional discussion of the theory of corporate disregard appears in the following law review articles: Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253 (1981); 22 N KY L REV 541 (1995); 68 TULANE L REV 1008 (1994); Knight & Knight, *Disregarding of the Corporate Entity and Nominee Corporations after Bolinger*, 21 U TOLEDO L REV 203 (1989); Barber, *Piercing the Corporate Veil*, 17 WILL L REV 371 (1981).

E. Similar tests.

The precise wording of the test used for disregarding the corporate form varies widely, but the essential elements are the same in most states. For instance, the New Mexico courts have expressed the test as follows:

New Mexico decisions have held that piercing the corporate veil is an equitable remedy. Three requirements must be satisfied to obtain this relief: a showing of instrumentality or domination, improper purpose and proximate cause. *Scott v. AZL Resources, Inc.*, 107 NM 118, 753 P2d 897, 900 (1988).

In Alabama, the test for disregarding the corporate form has been expressed as follows:

In an attempt to circumvent some of the difficulties in applying conclusory terms such as "instrumentality," "alter ego" and "adjunct," we announced, in *Kwick Set Components, Inc. v. Davison Ind., Inc.*, 411 So2d 134 (Ala 1982), a standard to be applied in order to determine

Section 10.02

whether the corporate entity should be disregarded when excessive control is the ground. While acknowledging that the dominating party may be an individual or another corporation, we stated the elements essential for imposition of liability on the dominant party as follows:

- 1) The dominant party must have complete control and domination of the subservient corporation's finances, policy and business practices so that at the time of the attacked transaction the subservient corporation had no separate mind, will, or existence of its own;
- 2) The control must have been misused by the dominant party. Although fraud or the violation of a statutory or other positive legal duty is misuse of control, when it is necessary to prevent injustice or inequitable circumstances, misuse of control will be presumed;
- 3) The misuse of this control must proximately cause the harm or unjust loss complained of.

Messick v. Moring, 514 So2d 892, 894-5 (Ala 1987).

In Oregon, a corporate disregard test was first articulated in *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982), a case which includes a thorough analysis of this issue. *Amfac* stated the test as follows:

We state the exception to the rule as follows: When a plaintiff seeks to collect a corporate debt from a shareholder by virtue of the shareholder's control over the debtor corporation rather than on some other theory, the plaintiff must allege and prove not only that the debtor corporation was under the actual control of the shareholder but also that the plaintiff's inability to collect from the corporation resulted from some form of improper conduct on the part of the shareholder. This causation requirement has two implications. 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. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 108-9, 654 P2d 1092, 1101-2 (1982).

Subsequent Oregon decisions have condensed the *Amfac* language, restating it as follows:

There are three criteria for imposing liability on a shareholder:

- (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,

Section 10.02

707 P2d 1250, 1255 (1985).

Other states have expressed the test for disregarding the corporate entity in much the same way. See, for example: *Dwyer v. Ing Investment Company, Inc.*, 889 SW2d 902 (Mo App 1994); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F2d 157, 160 (7th Cir 1963).

F. Reverse piercing.

Although nearly all corporate disregard cases are brought by corporate creditors seeking to hold a shareholder, officer, director, or another control person liable for a corporate debt, there are a few cases where a control person seeks to have the court disregard his/her own corporation. Most such attempts have been unsuccessful. See, for example: *Gavin v. Matthews*, 193 Wash 152, 74 P2d 990 (1938)(receiver, standing in shoes of corporation, could not sue shareholder on theory that corporation was alter ego of the corporation); *In re Morgan-Stanley Lumber Co., Inc.*, 70 BR 1986 (Bkrcty D Or 1986)(bankruptcy trustee, standing in shoes of corporation, may not sue officers of debtor corporation on theory of piercing the corporate veil); *West Bearing & Parts, Inc. v. Peet*, 253 Or 639, 456 P2d 993 (1969)(new corporation unsuccessfully sought to have Department of Employment disregard its corporate form and base its unemployment rate on the experiences of its shareholder before he incorporated the business); *Hogan v. Mayor & Alderman of Savannah*, 171 Ga App 671, 320 SE2d 555 (1984)(corporate officer unsuccessfully sought to have corporation disregarded so that he could claim coverage under corporate insurance policy). But, see: *McKay v. Horseshoe Lake Hop Harvesters, Inc.*, 260 Or 612, 491 P2d 1180 (1971); *Crum v. Krol*, 99 Ill App 3d 651, 425 NE2d 1081 (1981)(court permitted shareholder to recover damages suffered by his corporation in a breach of contract action in which shareholder, but not corporation, was a party); *Roepke v. Western National Mutual Insurance Co.*, 302 NW2d 350 (Minn 1981)(court pierced corporate veil to treat sole shareholder as an insured on corporate auto insurance policy).

While most corporate disregard cases involve creditors of the corporation trying to reach the personal assets of the shareholders, Washington will sometimes disregard the corporate form to treat the act of a shareholder as being the act of the corporation. *Pepper v. J.J. Welcome Construction Co.*, 73 Wash App 563, 871 P2d 601 (1994); *Standard Fire Insurance Co. v. Blakeslee*, 54 Wash App 5, 771 P2d 1172 (1989).

Section 10.03

Section 10.03 Intentionally Improper Conduct

The first element usually cited by the Washington courts in analyzing whether to disregard the corporate form is that "the corporate form must be intentionally used to violate or evade a duty." *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 410, 645 P2d 689, 692 (1982). See also: *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 811 P2d 221 (1991).

such abuse typically involves "fraud, misrepresentations, or some form of manipulation of the corporation to the stockholder's benefit and creditor's detriment." The doctrine can be understood as a judicial expansion of the principles of fraudulent conveyance law to circumstances in which that doctrine could not apply. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d 403, 410, 645 P2d 689, 692 (1982)(quoting in part from *Truckweld Equip. Co. v. Olson*, 26 Wash App 638, 645, 618 P2d 1017 (1980).

The Washington courts have never compiled a thorough list of forbidden corporate activities. Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, 260, n 38 (1981). Commonly mentioned misconduct includes milking, misrepresentation, commingling, holding out, and violations of statute. *Amfac Foods, Inc. v. International Systems & Controls, Inc.*, 294 Or 94, 109-110, 654 P2d 1092, 1102-3 (1982). Other factors may include:

Factors which can prompt the piercing of the corporate veil include the inadequate capitalization of the controlled corporation, the siphoning of its funds by those who dominate it, the absence of adequate corporate records, and the debtor corporation's insolvency. (citations omitted) *Copley Triangle Associates v. Apparel America, Inc.*, 96 NC App 263, 385 SE2d 201, 203 (1989).

Sections 10.04 through 10.08 below discuss some examples of intentionally improper conduct.

In many cases, more than one allegation of misconduct is present when the corporate form is disregarded. This often makes it difficult to determine the weight given to each alleged type of misconduct. See: Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, 260, n 38 (1981).

Section 10.04 Milking

"Milking" is another basis for disregarding the corporate form. Milking is a term used to describe various forms of misconduct by which those in control of a corporation improperly transfer corporate assets to themselves in order to avoid paying corporate creditors.

Section 10.04

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. (citations and footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 109, 654 P2d 1092, 1102 (1982).

Courts sometime use other, similar terms to describe the same conduct. In *Morgan v. Burks*, 93 Wash 2d 580, 585, 611 P2d 751, 755 (1980), the court referred stated that the corporation had been "gutted and left without funds" by those controlling it. In *Harrison v. Puga*, 4 Wash App 52, 64, 480 P2d 247, 255 (1971), the court held liable a shareholder who "stripped the corporation of all its assets."

In *Culinary Workers and Bartenders Union No. 596 Health and Welfare Trust v. Gateway Cafe, Inc.*, 91 Wash 2d 353, 588 P2d 1334 (1979), the court held that it may be appropriate to disregard the corporate entity when, after a judgment was entered against the first corporation, the first corporation was dissolved and a second corporation was formed by the same owners and received all of the first corporation's assets.

In *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986), at dissolution a corporation transferred all of its assets to its officers/shareholders for past services. Outside creditors were not paid. The court pierced the corporate veil and allowed the creditors to recover from the shareholders and their new corporation.

In *Harrison v. Puga*, 4 Wash App 52, 480 P2d 247 (1971), the defendant husband and wife stripped the corporation of all its assets. The court disregarded the corporation and imposed joint liability on them for a corporate contract.

In *Vermeer v. Dismantling Contractors, Inc.*, 90 Or 74, 751 P2d 796, *review denied*, 306 Or 156, 758 P2d 347 (1988), the court found that the principal shareholder of one business formed another business primarily, if not exclusively, to avoid contractual obligations to a union. Applying federal law, the court pierced the corporate veil.

Disregarding the corporate form is inappropriate where the controlling shareholders pay sufficient consideration for the corporate assets. *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 85 Wash App 695, 934 P2d 715 (1997), *affirmed in part, reversed in part on other grounds*, 135 Wash 2d 894, 959 P2d 1052 (1998).

NOTE: Many milking cases involve "black box" facts: (i) a corporation starts by owning all assets and liabilities; (ii) an

Section 10.04

undocumented transaction occurs, often a transaction which its shareholders have difficulty explaining; and (iii) the old corporation's shareholders, either personally or through a new corporation, end up owning the old corporation's assets while the old corporation is left holding all of the old liabilities.

To avoid charges of milking, a corporation or its shareholders should document what happens inside the black box. Agreements should recite in detail the consideration paid for the old corporation's assets. If the consideration at least equals the value of the assets received, charges of milking likely will fail.

In a milking case, alternative theories of recovery may exist. These include claims of successor liability, creditor's bills, derivative suits, and direct actions against directors. *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 85 Wash App 695, 934 P2d 715 (1997), *affirmed in part, reversed in part on other grounds*, 135 Wash 2d 894, 959 P2d 1052 (1998); *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, n 16, 654 P2d 1092, 1102 (1982).

Section 10.05 Commingling & Confusion

Courts have often found commingling or confusion to be another basis for disregarding the corporate form. *Thornton v. Interstate Securities Co.*, 35 Wash App 19, 666 P2d 370 (1983).

The decisions in this state defining when the courts will "pierce the veil" to look through the corporate organization and determine identity of responsibility are not so clearly harmonious as to render the law easy of application. The purport of the cases is that all of the elements of sameness just noted are insufficient in themselves to enable a court to declare two corporations to be identical in responsibility, but 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. *J.I. Case Credit Corp. v. Stark*, 64 Wash 2d 470, 475, 392 P2d 215, 218 (1964).

In another decision, the court stated:

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. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, 654 P2d 1092, 1102 (1982).

If a corporation and its shareholder do not act as if there is a difference between corporate property and shareholder property, courts are inclined to follow their lead. One court noted, "if the officer has demonstrated disregard of the corporate form, treating the corporation

Section 10.06

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).

It is well established that where corporate affairs are confused with those of the stockholders, a subsidiary or an affiliate corporation the corporate veil may be lifted to protect persons whose rights have been jeopardized by the corporate device. (citations omitted) *Abbott v. Bob's U-Drive*, 222 Or 147, 161-2, 352 P2d 598, 605 (1960).

One or two acts of commingling are not enough; there needs to be significant confusion. The degree of commingling can be a significant factor. *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)(quoting from *J.I. Case Credit Corp. v. Stark*, 64 Wash 2d 470, 475, 392 P2d 215 (1964)).

Other cases have disregarded the corporate form based on commingling and confusion. For instance, in *McCombs Construction, Inc. v. Barnes*, 32 Wash App 70, 645 P2d 1131 (1982), the court imposed liability on the principal owner of a corporation who "commingled his personal affairs with those of the corporation." In *Emrich v. Emery*, 216 Or 88, 337 P2d 972 (1959), the court found that transactions and accounts between the corporation and its shareholder to be so hopelessly interwoven that both should be treated as one.

Section 10.06 Violations of Statute

A. Generally.

Courts have also disregarded the corporate form after finding that the corporation violated a statute.

In a number of cases involving regulations, courts have enjoined conduct of parent corporations which, in order to evade federal or state regulation, were doing business by means of wholly-owned subsidiaries. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 110, 654 P2d 1092, 1102 (1982).

For example, in *United States v. Reading Co.*, 253 US 26 (1920), the court enjoined a parent railroad company from conducting mining operations through a subsidiary. At the time, railroads were themselves legally prohibited from engaging in mining operations.

Section 10.07

On the other hand, organizing a corporation merely to obtain a tax advantage is not improper conduct sufficient to set aside the corporate form. *El Salto, S.A. v. PSG Co.*, 444 F2d 477 (9th Cir), *cert denied*, 404 US 940 (1971).

A discussion of the liability of parent corporations for their subsidiaries' acts under particular statutes appears in 99 HARV L REV 986 (1986)(illegal disposal of hazardous wastes) and 35 U FLA L REV 701 (1983)(workers' compensation).

B. Licensing cases.

Closely related to this issue are licensing cases where the licensing authority looks through the corporate entity at a shareholder or at a predecessor corporation to determine whether or not to issue or revoke a license. For example, in *Palm Gardens, Inc. v. Oregon Liquor Control Commission*, 15 Or App 20, 514 P2d 888 (1974), the OLCC was permitted to look through the corporate form at past liquor violations of the principal shareholder. See also: *A.J. Rose & Son, Inc. v. Board of Funeral Directors and Embalmers*, 31 Or App 537, 570 P2d 1008 (1977).

Section 10.07 Corporate Formalities

A corporation's failure to observe corporate formalities has sometimes been cited as one of the basis for disregarding the corporate form. See, for example: *Lambert v. Farmers Bank, Frankfort, Indiana*, 519 NE2d 745 (Ind App 1988); *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475, 719 P2d 899 (1986); *Rice v. Oriental Fireworks Co.*, 75 Or App 627, 707 P2d 1250 (1985).

But few courts have disregarded the corporate form merely because the corporation failed to conduct regular directors meetings or to keep proper minutes. *Uni-Com Northwest, Ltd. v. Argus Publishing Co.*, 47 Wash App 787, 737 P2d 304, *reviewed denied*, 108 Wash 2d 1032 (1987); *Truckweld Equipment Co. v. Olson*, 26 Wash App 638, 618 P2d 1017 (1980).

Washington courts have generally been lenient with close corporations when they fail to hold meetings and keep proper minutes. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 604 P2d 1317 (1979).

[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. (footnote omitted) *Consumer's Co-op of Walworth County*, 142 Wis 2d 165, 419 NW2d 211, 220 (1988).

Section 10.08

See *also*: Section 4.04 of this book.

The one corporate formality to which courts do attach particular attention is the keeping of separate financial books and records. If shareholder and corporate assets are commingled, there is a risk that a court will permit corporate creditors to look to shareholder assets for repayment. See: Section 10.05 above.

In a divorce action, a court may look behind the corporate veil at the assets and income of a corporation owned entirely by one spouse. *State ex rel Grabhorn v. Grabhorn*, 28 Or App 357, 559 P2d 923 (1977).

Section 10.08 Inadequate Capitalization

A. Generally.

At one time, a corporation was required to raise a minimum amount of capital before it could begin doing business. *Statutory Minimum Capitalization Requirements*, 5 WILL L REV 331 (1969). This is no longer true in Washington or most other states. But courts sometimes cite failure to contribute sufficient capital as one basis for piercing the corporate veil.

It has been held that gross 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. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls, Inc.*, 294 Or 94, 109, 654 P2d 1092, 1102 (1982).

The United States Supreme Court once stated:

An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in denying stockholders their defense of limited liability. *Anderson v. Abbott*, 321 US 349, 362, *rehearing denied*, 321 US 804 (1944).

Some earlier Washington cases cited inadequate capitalization as one of the basis for disregarding the corporate form.

An individual may form a corporation with limited capitalization and thereby attempt to avoid personal liability. When one acts in such fashion, however, the inadequate capitalization is a factor in determining whether to disregard the corporate entity. *Frigidaire Sales Corp. v. Union Properties, Inc.*, 14 Wash App 634, 638, 544 P2d 781, 784 (1975).

But more recently, the Washington courts have refused to disregard the corporate form on the basis of undercapitalization alone. For instance, one Washington decision involving initial capitalization of only \$500. The court noted that it knew "of no rule of law requiring a corporate stockholder to commit additional funds to an already faltering

Section 10.08

corporation." (footnote omitted). *Truckweld Equipment Co. v. Olson*, 26 Wash App 638, 645, 618 P2d 1017, 1022 (1980). It may have been significant in *Truckweld* that the defendants had acquired the corporation after it was initially capitalized by predecessor shareholders.

Even more recently, the Washington Court of Appeals stated:

[Plaintiff's] argument is contrary to Washington case law which holds that the separate existence of a corporation should not be disregarded solely because its assets are not sufficient to discharge its obligations. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 399-400, 811 P2d 221, 223 (1991).

In another case decided under Georgia law, the court said:

Appellant readily acknowledged that the holding company was not sufficiently capitalized to begin operations; however, undercapitalization of a corporation will justify piercing the corporate veil only when "coupled with evidence of an intent at the time of the capitalization to improperly avoid future debts of the corporation." Here, appellant offered a valid business reason for the manner in which the acquisition was financed and gave an un rebutted explanation of the investors' capitalization plans and the ultimate failure of that effort. Thus, there is no evidence of fraudulent intent at the time of capitalization. (citations omitted) *Marett v. Professional Insurance Careers, Inc.*, 201 Ga App 178, 181, 410 SE2d 373, 375 (1991).

But unlike Washington, many states will disregard the corporate form on the basis of gross undercapitalization alone.

Where it is sought on the one hand to make available to general or tort creditors only an illusory amount compared with the size of the business and the public responsibility inherent in its very nature, while on the other hand advancing necessary expenses through secured devices, it would be a gross inequity to allow such a flimsy organization to provide a shield for personal liability. Courts will not tolerate arrangements which throw all the risks on the public and which enable stockholders to reap profits while being insulated against losses. *Mull v. Colt Co.*, 31 FRD 154, 164-5 (SD NY 1962).

Oregon also recognizes gross undercapitalization as a basis for piercing the corporate veil.

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. (citations omitted) *Gardner v. First Escrow Corp.*, 72 Or App 715, 723 696 P2d 1172, 1177-8, review denied, 299 Or 314, 702 P2d 1111 (1985).

Section 10.08

B. Funds considered part of capitalization.

By "capitalization," courts are referring to the consideration paid for a corporation's stock. Of course, this includes cash and other physical property paid for the stock. It may also including intangible assets, such as an employment contract with an experienced manager and potential contracts with customers. *Murphy Logging Co. v. United States*, 378 F2d 222 (9th Cir 1967).

Some courts consider shareholder loans in determining whether or not a corporation is undercapitalized. *Hartkopf v. Heinrich Ad. Berkemann*, 200 Ga App 355, 408 SE2d 450 (1991). "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, *review denied*, 313 Or 354, 833 P2d 1283 (1992). *See also: Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968).

Third party loans do not increase a corporation's worth and are not part of its capitalization. Therefore, a "corporation is undercapitalized if the shareholders do not place at risk assets that are reasonably related to the corporation's anticipated business and liabilities." *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, 912 P2d 929, 929, *review denied*, 323 Or 690, 920 P2d 549 (1996).

Appropriate insurance may be considered in determining whether a corporation is inadequately capitalized. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 405-6, n 7, 912 P2d 929, 929, *review denied*, 323 Or 690, 920 P2d 549 (1996).

C. When measured?

Some courts hold that inadequate capitalization is to be measured only at a corporation's formation or at the beginning of its operations. *Stirling-Wanner v. Pocket Novels, Inc.*, 129 Or App 337, 879 P2d 210, *review denied*, 320 Or 272, 882 P2d 1114 (1994); *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172, *review denied*, 299 Or 314, 702 P2d 1111 (1985)(also significant that the defendant corporation had a long history of inadequate capitalization). Other courts have stated that inadequate capitalization can be measured at any point in a corporation's existence. *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F2d 681 (4th Cir 1976).

D. How much is enough?

The United State Supreme Court has indicated that the adequacy of the capitalization should be "measured by the nature and magnitude

Section 10.08

of the corporate undertaking." *Anderson v. Abbott*, 321 US 349, 362, *rehearing denied*, 321 US 804 (1944). Some commentators have suggested a reasonable person standard while others have suggested a comparative analysis of corporations in the same industry. *Comment*, 14 BALT L REV 311 (1985).

The mere fact that a corporation goes out of business and cannot pay its debts is not a sufficient basis to conclude that it was undercapitalized. *Aero Planning International, Inc. v. Air Associates, Inc.*, 94 Or App 143, 764 P2d 610 (1988).

E. Miscellaneous.

Some authorities believe that a distinction should be drawn between inadequate capitalization cases involving contracts and cases involving torts. See: *Secon Service System, Inc. v. St. Joseph Bank and Trust*, 855 F2d 406, 413-4 (7th Cir 1988); *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 109, n 15, 654 P2d 1092, 1102 (1982); Barber, *Piercing the Corporate Veil*, 17 WILL L REV 371 (1981); *Comment*, 14 BALT L REV 311 (1985).

Additional discussion of undercapitalization appears in Downs, *Piercing the Corporate Veil: Do Corporations Provide Limited Personal Liability?*, 53 UMKC L REV 174 (1985) and Gelb, *Piercing the Corporate Veil: The Undercapitalization Factor*, 59 CHI-KENT L REV 1 (1982).

Section 10.09 Proximate Cause

A. Generally.

Injury alone is not enough to disregard the corporate form. If injury alone were sufficient, the corporate form would provide little protection to shareholders because creditors of insolvent corporations are nearly always injured. 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.

Thus, the second element necessary to disregard the corporate form is that there be a proximate link between the intentional misconduct and the plaintiff's harm which would be remedied by disregard the corporate form. *Uni-Com Northwest, Ltd. v. Argus Publishing Co.*, 47 Wash App 787, 737 P2d 304, *reviewed denied*, 108 Wash 2d 1032 (1987).

With regard to the second element, wrongful corporate activities must actually harm the party seeking relief so that disregard is necessary. Intentional misconduct must be the cause of the harm that is avoided by disregard. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash 2d

Section 10.09

403, 410, 645 P2d 689, 693 (1982).

More recently, the Washington Court of Appeals has stated:

Although the intent factor is satisfied, the doctrine of corporate disregard will not apply unless it is necessary and required to prevent unjustified loss to the injured party. No plaintiff is entitled to a solvent defendant. [Plaintiff] may not create solvency here by asserting disregard when the alleged misconduct had no effect on its ability to collect a judgment from the defendant corporation. (citations & internal quotations omitted) *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 85 Wash App 695, 708, 934 P2d 715, 721 (1997), *affirmed in part, reversed in part on other grounds*, 135 Wash 2d 894, 959 P2d 1052 (1998).

Another court has described this element as follows:

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. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 111, 654 P2d 1092, 1103 (1982).

In *Gardner v. First Escrow Corp.*, 72 Or App 715, 696 P2d 1172 (1985), plaintiffs were induced to use the corporation's escrow services through the fraud of one of its shareholders. The corporation was inadequately capitalized. After the transaction resulted in plaintiffs' loss, the corporation was unable to satisfy a judgment by the creditor.

There was evidence from which the jury could have found that Daniels' and Reieron's control was exercised in a manner "either causing plaintiff to enter the transaction with the corporation or causing the corporation's default on the transaction or the resulting obligation." Daniels negotiated the escrow services for office space agreement with Praggastis. Laeger, Praggastis' agent, was responsible for having the escrow transferred from Nevada to First Escrow. First Escrow and its shareholders had a financial interest in acting as escrow agent, because providing such services for Praggastis was in lieu of rent. A jury could have found that plaintiffs would not have agreed to have First Escrow close the exchange had they been aware of the relationship between First Escrow and Praggastis. Plaintiffs recovered a judgment against First Escrow. Because it has no assets, it has been unable to satisfy that judgment. A jury could have found that First Escrow's lack of assets was directly attributable to the failure of Daniels and Reieron to provide adequate capital for the corporation. (citations omitted) *Gardner v. First Escrow Corp.*, 72 Or App 715, 724, 696 P2d 1172 (1985).

B. Recovery may be limited to sum milked.

In cases involving milking or inadequate capitalization, a shareholder's liability to a corporate creditor may be limited to no more than the amount milked by the shareholder or to an amount no more than

Section 10.10

the difference between adequate capitalization and the amount actually contributed.

The rule contained in the text, 294 Or at 108-09, although easily stated, may not be easily applied. The damages which flow from, say, improper capitalization or milking, may or may not be limited to the amount of the shortage of capital or amount milked from the corporation. In some cases the causal relationship will be clear. In others, the causal relationship will be less clear, but still sufficient to 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. (citations omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 111, n 18, 654 P2d 1092, 1103 (1982).

In *Harrison v. Puga*, 4 Wash App 52, 480 P2d 247 (1971), the defendant's husband and wife stripped the corporation of all its assets. The court disregarded the corporation and imposed joint liability on the defendant for a corporate contract.

But cases will turn on their own facts. *Klokke Corp. v. Classis Exposition, Inc.*, 139 Or App 399, 912 P2d 929, review denied, 323 Or 690, 920 P2d 549 (1996), involved undercapitalization and milking. After noting that damages flowing from cases may involve "significant factual issues," the appellate court upheld a decision by the trial court to limit damages awarded against one shareholder to the sum improperly transferred to that shareholder alone, not the total amount milked by all shareholders.

Section 10.10 Control

Under Washington law, the theory of corporate disregard may be applied in any situation in which the corporate form has been abused. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 399, n 1, 811 P2d 221, 222 (1991). The theory may be applied to close corporations, parent-subsidiary corporations, brother-sister corporations, and possibly even public corporations. *Norhawk Investments, Inc. v. Subway Sandwich Shops, Inc.*, 61 Wash App 395, 399, n 1, 811 P2d 221, 222 (1991); Harris, *Washington's Doctrine of Corporate Disregard*, 56 WASH L REV 253, 253-4 (1981).

Although the Washington two-element test for disregarding the corporate form does not include a "control" element, the tests adopted by most other states do articulate the necessity of holding liable only those in control of the corporation. *Dwyer v. Ing Investment Company, Inc.*, 889 SW2d 902 (Mo App 1994); *Scott v. AZL Resources, Inc.*, 107 NM 118, 753 P2d 897, 900 (1988); *Messick v. Moring*, 514 So2d 892, 894-5 (Ala

Section 10.10

1987); *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982).

Some Washington decisions have indicated that control is an element necessary to disregard the corporate form. For instance, in *Morgan v. Burks*, 93 Wash 2d 580, 585, 611 P2d 751, 755 (1980), the court held liable the shareholder "because the liable corporation has been 'gutted' and left without funds by those controlling it."

Some Washington decisions focus on "control" and "domination" in analyzing whether to disregard the corporate form. *Kueckelhan v. Federal Old Line Insurance Co.*, 69 Wash 2d 392, 418 P2d 443 (1966); *Briggs & Co. v. Harper Clay Products Co.*, 150 Wash 235, 272 P 962 (1928):

In order to justify the judicial disregard of corporate identities, one, at least, of two things must clearly appear. Either the dominant corporation must control and use the other as a mere tool or instrument in carrying out its own plans and purposes so that justice requires that it be held liable for the results, or there must be such a confusion of identities and acts as to work a fraud upon third persons. In most, if not all, of the Washington decisions, in which corporate entities have been disregarded, both elements have appeared. *Pittsburgh Reflector Co. v. Dwyer & Rhodes Co.*, 173 Wash 552, 555, 23 P2d 1114, 1115 (1933).

One commentator states that the defendant must have "control, not merely majority or complete stock control, but complete domination." 1 FLETCHER CYC CORP § 41.10 (Perm Ed 1999). In a leading case, the court stated that control must be "actual control."

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. (footnote omitted) *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 108-9, 654 P2d 1092, 1101-2 (1982).

In one case, the Washington Court of Appeals upheld a judgment against a corporation which had previously held an *option* to acquire stock in the debtor corporation, even though the option was never exercised and the option holder had no power to *vote* as a shareholder. This holding turned on the fact that the option holder had provided the funds necessary to keep the debtor corporation alive.

KM contends the doctrine of disregarding the corporation entity is or should be confined to shareholders and not extended to one who holds an option to purchase all the shares of a corporation. It is true the

Section 10.10

doctrine of disregard is often applied in parent-subsidary corporation cases to impose liability upon a shareholder for the debts of his corporation. F. Powell, *Parent and Subsidiary Corporations* §§ 3-20 (1931). However, for all practical purposes, the optionee KM had all the powers of a shareholder and much more. KM possessed and exercised life and death power over PK through its fiscal control. *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 733, 524 P2d 1355, 1363 (1974).

But even in decisions which recognized "control" as a element, control alone is not enough to disregard the corporate form. One or more persons control every corporation. Both of the two, non-control related elements in the Washington test must be met for a court to disregard the corporate form and impose liability on those in control. *Grayson v. Nordic Construction Company, Inc.*, 92 Wash 2d 548, 599 P2d 1271 (1979).

A. Early development.

The earliest discussions of control in this context usually arose in connection with parent and subsidiary corporations. Often, a creditor tried to force a parent corporation to pay the debts of its subsidiary. Early cases turned on whether the subsidiary was a mere "instrumentality" of the parent.

The first major attempt to synthesize these early case was in a 1931 book by Frederick J. Powell, *Parent and Subsidiary Corporations*:

In 1931 Frederick J. Powell published a monumental study, *Parent and Subsidiary Corporations*, which attempted to synthesize those cases which had disregarded the corporate entity. Powell described an "instrumentality" test which he perceived to be the test for determining whether a subsidiary is in fact so dominated by its parent that its veil should be pierced to find the parent liable. Although Powell's test was derived from a study of the parent-subsidary relationship and may have been meant to apply exclusively to that relationship, it has been applied with equal force to pierce the veil of closely held corporations to hold the individual shareholders liable. Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DEN L J 1, 11 (1978).

Frederick Powell developed a list of eleven factors which he believed had been relied upon by courts in determining whether actual control existed. (Powell used the term "instrumentality" rather than the term "actual control"). Although no single factor or set of factors is determinative, Powell identified eleven circumstances which indicate that a subsidiary is a mere instrumentality of its parent. These circumstances are:

1. The parent corporation owns all or most of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.

Section 10.10

3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation.
5. The subsidiary has grossly inadequate capital.
6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation, or no assets except the ones conveyed to it by the parent corporation.
8. In the papers of the parent corporation or in the statements of the 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.
9. The parent corporation uses the property of the subsidiary as its own.
10. 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.
11. The formal legal requirements of the subsidiary are not observed. Krendl & Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DEN L J 1, 16-17 (1978).

See also: *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 524 P2d 1355, 1363 (1974); *Amfac Foods, Inc. v. International Systems & Controls Corp.*, 294 Or 94, 654 P2d 1092 (1982); *Old Town Development Co. v. Langford*, 349 NE2d 744, 778 n 39 (Ind App 1976); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F2d 157, 161 (7th Cir 1963).

B. Control is not enough.

Mere control is not enough to cause the corporate form to be disregarded. The other two elements, discussed above, must also be present. *Grayson v. Nordic Construction Company, Inc.*, 92 Wash 2d 548, 599 P2d 1271 (1979).

the mere fact that [defendant] was or would become the sole stockholder of Olympic is not enough to justify disregarding the corporate form. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 944, 604 P2d 1317, 1321 (1979).

In another decision, the court stated:

What is meant is this: that simply because a company is reduced in number to one or two, or a very few stockholders, does not warrant for a single instant, per se, the disregard of the corporate entity. Whether there is one shareholder in a corporation or whether there are ten thousand makes no difference, in other words, unless some of the

Section 10.10

circumstances aforementioned which warrant a disregard of the theory of corporate entity are present. *Miller Lumber Corp. v. Miller*, 225 Or 427, 431-2, 357 P2d 503, 506 (1961)(quoting from 12 COL L REV 496 (1912).

Merely owning 100% of a corporation's stock is simply not enough to create personal liability for that shareholder. *Seattle Int'l Corp. v. Commerce & Industry Insurance Co.*, 24 Wash App 108, 600 P2d 612 (1979); *Levine v. Alpha Anesthesia, Inc.*, 145 Or App 549, 931 P2d 812, review denied, 325 Or 368, 939 P2d 45 (1997); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971). Two corporations will not be treated as one solely because both are entirely owned by a single shareholder, *Pittsburgh Reflector Co. v. Dwyer & Rhodes Co.*, 173 Wash 552, 23 P2d 1114 (1933); *Associate Oil Co. v. Seiberling Rubber Co.*, 172 Wash 204, 19 P2d 940 (1933); *Howco Leasing Corp. v. Oregon Lumber Export Co.*, 283 Or 225, 582 P2d 4 (1978); *Finn v. George T. Mickle Lumber Company of Oregon*, 41 F2d 676 (9th Cir 1930), or because one is the wholly-owned subsidiary of the other. *Anderson v. Section 11, Inc.*, 28 Wash App 814, 626 P2d 1027 (1981); *Agristor Credit Corp. v. Schmidlin*, 601 F Supp 1307 (D Or 1985); *Schlecht v. Equitable Builders, Inc.*, 272 Or 92, 535 P2d 86 (1975).

NOTE: Shareholders, particularly corporate shareholders, have sometimes been held liable on the theory that the subsidiary corporation was acting as the "agent" of its parent in connection with the transaction for which the creditor seeks to hold the parent liable. These cases apply theories of principal and agent, not theories of corporate disregard. See, for example: *Soderberg Advertising, Inc. v. Kent-Moore Corp.*, 11 Wash App 721, 524 P2d 1355 (1974); *Davis v. Tye Industries, Inc.*, 58 Or App 292, 648 P2d 388 (1982), affirmed, 295 Or 467, 668 P2d 1186 (1983); *Northern Natural Gas Company of Omaha, Nebraska v. Superior Court*, 64 Cal App 3d 983, 134 Cal Rptr 850, 857 (1976); *Elvalsons v. Industrial Covers, Inc.*, 269 Or 441, 525 P2d 105 (1974).

C. Degree of control.

According to a leading commentator, the defendant must have "control, not merely majority or complete stock control, but complete domination." 1 FLETCHER CYC CORP § 41.10 (Perm Ed 1999). One court has said that:

The control necessary to invoke what is sometimes called the "instrumentality rule" is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled

Section 10.10

corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal. It must be kept in mind that *the control must be shown to have been exercised at the time the acts complained of took place in order that the entities be disregarded at the time.* (emphasis in original) *Glenn v. Wagner*, 67 NC App 563, 313 SE2d 832, 841 (1984)(quoting from *Acceptance Corp. v. Spencer*, 268 NC 1, 9, 149 SE2d 570, 576 (1966)).

In the context of defining the word "acquisition" in an insurance contract covering officers and directors, the Washington Supreme Court has stated: "Ownership is different from control." *Lynott v. National Union Fire Ins. Co.*, 123 Wash 2d 678, 693, 871 P2d 146, 154 (1994).

D. Active & latent control distinguished.

"Actual control" may take many forms. Control may be "active" or "latent".

Active control is power which is exercised on a regular basis. In many corporations, active control is exercised by management (*i.e.*, officers and employees who manage the business on a day to day basis).

"Latent" control is "power that is exercised intermittently, often in times of stress". *Corporate Power*, 83 COL L REV 215, 242 (1983). Such control may be exercised by a majority shareholder not actively involved in management. A shareholder who controls the purse-strings may possess latent control.

E. Who has actual control?

Actual control may exist in any number of circumstances. It is obviously present when a single person owns all the stock and serves as the corporation's sole director and officer. But a shareholder can have actual control even if the shareholder is neither an officer or director. Such will always be the case when a corporation is a shareholder since directors and officers must be natural persons.

Although most cases in which the courts disregard the corporate entity involve lawsuits against shareholders, in a few cases non-shareholders who control a corporation have been held liable.

For example, in *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 524 P2d 1355 (1974), a judgment was upheld against a person who had previously held an **option** to acquire stock in the debtor corporation even though the option was never exercised and the option holder had no power to vote as a shareholder. This holding turned on the fact that the option holder had provided the funds necessary to keep the debtor corporation alive.

KM contends the doctrine of disregarding the corporation entity is or

Section 10.11

should be confined to shareholders and not extended to one who holds an option to purchase all the shares of a corporation. It is true the doctrine of disregard is often applied in parent-subsidary corporation cases to impose liability upon a shareholder for the debts of his corporation. F. Powell, *Parent and Subsidiary Corporations* §§ 3-20 (1931). However, for all practical purposes, the optionee KM had all the powers of a shareholder and much more. KM possessed and exercised life and death power over PK through its fiscal control. *Soderberg Advertising, Inc. v. Kent - More Corp.*, 11 Wash App 721, 524 P2d 1355, 1363 (1974).

In *Glenn v. Wagner*, 313 NC 450, 329 SE2d 326 (1985), the North Carolina Supreme Court upheld a jury verdict against an affiliate corporation under common control with the debtor corporation.

In *Shades Ridge Holding Co., Inc. v. United States*, 888 F2d 725 (11th Cir 1989), a father was held liable to the IRS for a debt of a corporation owned by family members. The father owned no stock in the debtor corporation, but financially supported it.

On the other hand, more recently a court granted summary judgment in favor of a law firm, holding that there needed to be some ownership relation in order to impose liability on an alter ego theory. *Castillo v. First City Bancorporation of Texas*, 43 F3d 953 (5th Cir 1994).

Section 10.11 Unpaid Subscriptions

A. Generally.

At one time, each share was assigned a "par value" and a corporation could not issue a share for less than its par value. *Frankowski v. Palermo*, 47 App Div 2d 579, 363 NYS 2d 159 (1975). At one time, a shareholder was liable to the corporation for the difference between the subscription price (the amount offered for the shares in the subscription) and the amount actually paid for the shares. In effect, the aggregate par value of all of a corporation's issued and outstanding shares was deemed to be a corporation's minimum capitalization and was sometimes considered to be a trust fund for its creditors.

As discussed in Section 3.09, Washington no longer requires a corporation to assign a par value to its shares, although a designation of par value is still permitted. RCW 23B.02.020(5)(b).

Today, there is no minimum price that a corporation must receive for its shares. But the shareholders are still liable for the price offered in their subscriptions for the shares. If a portion of this price is not paid upon issuance of the shares, these shareholders are liable to the corporation, and ultimately to its creditors, for the unpaid portion of their subscription price. RCW 23B.06.220 provides:

Section 10.11

A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued under RCW 23B.06.210 or specified in the subscription agreement under RCW 23B.06.200.

If the holder of a share which is not fully paid up transfers the share, the transferor ceases to be liable for the unpaid balance, provided the transfer is not made for the mere purpose of evading liability. *Walton Lumber Co. v. Commonwealth Lumber Co.*, 95 Wash 295, 163 P 762 (1917). This might occur if the transfer is made to a knowingly insolvent transferee. After the transfer, a transferee who takes with notice that the share is not paid up becomes liable for any sum still unpaid on the original shareholder's subscription. *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917); *Walton Lumber Co. v. Commonwealth Lumber Co.*, 95 Wash 295, 163 P 762 (1917). There is presumption, however, that stock is fully paid. *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917); *Smith v. Schmitt*, 112 Or 687, 231 P 176 (1924).

B. Failure to issue shares.

As discussed more fully in Section 3.10 of this book, a person whose subscription is accepted acquires all of the rights of a shareholder even though the corporation never actually issues a share certificate. *Child v. Idaho Hewer Mines*, 155 Wash 280, 284 P 80 (1930); *Babbitt v. Pacco Investors Corp.*, 246 Or 261, 425 P2d 489 (1967). "One who has subscribed and paid for corporate stock is entitled to all the rights and responsibilities of ownership, whether the stock certificates have been issued to him or not." *Haas v. Koskey*, 138 Ga App 448, 226 SE2d 279, 283 (1976).

There can be no question that an actual subscription is not always necessary in order to establish a stockholder's status as that of a subscriber.

"Any agreement by which a person shows an intention to become a stockholder is sufficient to bind both him and the corporation. When one accepts or assumes the position and duties, and claims the rights and privileges and emoluments, of a stockholder, and the corporation accepts or acquiesces therein, such person is estopped to deny that he is a subscriber, even though there may have been something irregular or defective in the form or manner of his subscription, or there may have been no formal subscription at all." *Davies v. Ball*, 64 Wash 292, 299, 116 P 833, 835 (1922)(quoting Cook on Stock & Stockholders).

Even if the subscriber has not yet paid for the shares, the subscriber possesses all the rights of a shareholder once a subscription is accepted. *Pfeifer v. DME Liquidating, Inc.*, 91 Or App 47, 753 P2d

Section 10.11

1389 (1988), *appeal after remand*, 101 Or App 106, 753 P2d 266 (1990). As a consequence, a subscriber's obligation to pay for the accepted subscription attaches even if the subscriber's name is not entered on the transfer ledger. *Shiffer, Trustee v. Okenbrook*, 75 Ind App 149, 130 NE 241, 244 (1921).

C. Consideration permitted.

A corporation may accept just about anything of value in exchange for its shares. *Hills v. Skagit Steel & Iron Works*, 122 Wash 22, 210 P 17 (1922). Cash is the most common consideration, but real, personal and intellectual property, promissory notes, past services, and promises of future services are now all acceptable forms of consideration. RCW 23B.06.210(2).

Before a corporation issues shares, the board of directors must make a determination as to the adequacy of the consideration. If made in good faith, this determination is conclusive. RCW 23B.06.210(3); *In the Matter of Delk Road Associates, Ltd.*, 37 BR 354 (ND Ga 1984); *Garbe v. Excel Mold, Inc.*, 397 NE2d 296 (Ind App 1979); *Huson v. Portland & Southeastern Railway Co.*, 107 Or 187, 211 P 897, 213 P 408 (1923).

Article 12, Section 6 of the Washington Constitution provides:

Corporations shall not issue stock, except to *bona fide* subscribers therefor, or their assignees; nor shall any corporation issue any bond, or other obligation, for the payment of money, except for money or property received or labor done. . . . All fictitious increase of stock or indebtedness shall be void.

In *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995), the Washington Supreme Court assumed, without deciding, that a corporation's borrowings from a bank and its repeated issuances of notes to the bank constituted an *ultra vires* act in violation of the Article 12, Section 6 of the Washington Constitution. In an action by the corporation's trustee in bankruptcy to avoid the notes, the Court held that the trustee's claim was barred by the doctrine of estoppel and ratification, stating:

So long as a contractual agreement is not contrary to public policy or the terms of a statute, a corporation that has received directly or indirectly the benefits of a contract, including a contract of guaranty, generally is estopped from asserting the defense of *ultra vires*. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 277, 892 P2d 98, 103 (1995).

Section 10.11

Apparently, the court believed that violation of the state's constitution is not as grave as the violation of a statute or public policy. The court went on to hold that absent fraud, the business judgment of the corporation's board of directors should be respected and the board's repeated ratification of the note likewise estopped the corporation and the trustee from asserting the note to be *ultra vires*.

Once issued, there is a presumption that a share was issued for consideration and that it was fully paid. *Frisch v. Victor Industries, Inc.*, 51 Wash App 377, 753 P2d 1000 (1988); *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917).

D. Calls & assessments.

A corporation's demand for the unpaid portion of a subscription is generally referred to as a "call." An "assessment" is a demand for pro rata payment by the shareholders over and above the subscription price. (Sometimes a call is also referred to as an assessment.)

Strictly speaking, the word "assessment" means a demand upon stockholders for payments above the par value of their stock to meet the money demands of creditors of the corporation; while the word "call" or "installments," strictly speaking, means the action of the board of directors or corporation demanding the payment of all or a portion of unpaid subscriptions. These two words, however, are used interchangeably in the statute of this state, and the strict

legal distinction as herein given is not observed. *Wall v. Basin Mining Co.*, 16 Idaho 313, 101 P 733, 736 (1909).

Assessments must be levied and collected pro rata among all shareholders, at least shareholders of the same class. *Grismer v. Merger Mines Corp.*, 43 F Supp 990, 994 (ED Wa 1942), *modified*, 137 F2d 335 (9th Cir), *cert denied*, 320 US 794 (1943).

Once a shareholder pays the consideration promised in the subscription, that shareholder is not liable for any additional sum. RCW 23B.06.220. This is consistent with the common law.

Under the common law full paid up stock could not be assessed, and we believe it is now accepted as the general doctrine by the courts of this country that in the absence of statutory authority, or power given by the articles of incorporation, there can be no assessment against or on the paid-up stock of a corporation. To warrant the respondent, therefore, in making an assessment against the stock of the appellant, which it is conceded was fully paid up, the authority to make such assessment must be found in either the statute or the Constitution of this state or the provisions of the articles of incorporation of the respondent company. *Wall v. Basin Mining Co.*, 16 Idaho 313, 101 P 733, 734-5 (1909).

Likewise, if a corporation indicates on a certificate that the share is "non-assessable," that provision becomes part of the contract between

Section 10.11

the corporation and the shareholder and the corporation is prohibited from later levying an assessment on the shares. *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 586, 21 P2d 253 (1933).

Revised Model Act § 2.02(b)(2)(v) permits a corporation to provide in its articles of incorporation that its shareholders may be liable for a specified amount of a corporation's debts, over and above the subscription price. Washington did not adopt this provision.

E. Actions by corporation.

The amount unpaid on a subscription is an asset of the corporation. *Adamant Manufacturing Co. v. Wallace*, 16 Wash 614, 48 P 415 (1898); *Tintic Indian Chief Min. & Mill. Co. v. Clyde*, 79 Utah 337, 10 P2d 932 (1932).

If a subscriber gives a note in exchange for shares, the corporation may either sue on the note or sue on the underlying subscription debt. *Doyle v. Chladek*, 240 Or 598, 401 P2d 18, *modified*, 403 P2d 381 (1965). A shareholder may not use personal debts owed to the shareholder by the corporation as an offset against the shareholder's subscription debt. *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917); *Amacher v. Western Realty Corp.*, 148 Or 611, 38 P2d 64 (1935). *But see: Selig v. Hamilton*, 234 US 652 (1914).

A subscriber's debt to a solvent corporation is an individual debt to the corporation; a subscriber is not jointly liable with other subscribers who have not paid their subscriptions. *Bergman v. Evans*, 92 Wash 158, 158 P 961 (1916); *Laing v. Hutton*, 138 Or 307, 6 P2d 884 (1932); *Shipman v. Portland Const. Co.*, 64 Or 1, 128 P 989 (1913). Subscribers may, however, seek contribution from other subscribers who have also failed to pay their full amount due. *Davis v. Olson*, 4 Wash App 390, 482 P2d 795 (1971); *Wilson v. Cruthers*, 176 Okla 481, 56 P2d 416 (1936); *Brundage v. Monumental Gold and Silver Mining Co.*, 12 Or 322, 7 P 314 (1885); *Hodges v. Silver Hill Mining Co.*, 9 Or 200 (1881).

Subscription debts are assignable by a corporation. *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913).

F. Actions by creditors.

Under Washington law, a creditor seeking to collect on the unpaid subscription of a shareholder must bring the action on behalf of all creditors and must seek pro rata payments from all shareholders whose subscriptions remain unpaid. *Davis v. Olson*, 4 Wash App 390, 482 P2d 795 (1971); *Royer v. Maib*, 6 Wash 2d 286, 107 P2d 593 (1940). Thus,

Section 10.11

a creditor can bring an action for a creditor's bill or an action for the appointment of a receiver pursuant to RCW 23B.14.320. *See also: Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909).

Under some circumstances, a creditor who is not paid prior to the distribution of assets to the shareholders may recover from the shareholders. *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39 (1982); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971).

A recent decision by the Washington Court of Appeals held that a creditor could proceed directly against the shareholders without mentioning any obligation to include other creditors as parties to the lawsuit.

Recovery of corporate assets distributed to former shareholders upon dissolution is permissible in certain circumstances. Such recovery may be proper here, and we hold that Smith may proceed against [the shareholder defendants] individually. (footnotes omitted) *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 619, 969 P2d 1090, 1093, *review denied*, 138 Wash 2d 1003 (1999).

The doctrine of laches may apply to lawsuits by creditors against shareholder for improper distributions. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1980).

Section 10.12 Distributions Upon Dissolution

A. Generally.

It is a well-established doctrine that upon dissolution, the assets of a corporation are to be applied first to the payment of corporate debts and then, if there are assets remaining, to its shareholders. *Georgia, Florida & Alabama R. Co. v. Bankers Trust Co.*, 170 F2d 733 (5th Cir 1948); *United States v. Butterworth Corp.*, 269 US 504 (1926); *Smyth v. Kenwood Land Co.*, 97 Or 19, 190 P 962 (1920). In the event that assets of a dissolved corporation are distributed to its shareholders before payment of corporate debts, creditors may seek satisfaction from its shareholders to the extent of the distributed assets. *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385 (1983); *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39 (1982).

More important, a creditor of a corporation can satisfy his claim against the corporation out of the assets distributed to stockholders upon dissolution. (citations omitted) *Wakeman v. Paulson*, 257 Or 542, 546-7, 480 P2d 434, 437 (1971).

Section 10.12

As describe in Section 10.11 above, as a general rule a creditor may recover debts owed to the corporation by shareholders only through an equitable proceeding naming all creditors and shareholders located within the jurisdiction. Most courts have held that this also true in actions to collect improper distributions after dissolution.

From the principle thus established in this state the proper remedy of a creditor of an insolvent corporation to reach the fund alleged to have been paid to a stockholder as a dividend in liquidation is by a suit in equity and not by an action at law as commenced in the case at bar. *Garetson Lumber Co. v. Hinson*, 69 Or 605, 610, 140 P 633, 635 (1914).

But a recent decision by the Washington Court of Appeals held that a creditor could proceed directly against the shareholders without mentioning any obligation to include other creditors as parties to the lawsuit.

Recovery of corporate assets distributed to former shareholders upon dissolution is permissible in certain circumstances. Such recovery may be proper here, and we hold that Smith may proceed against [the shareholder defendants] individually. (footnotes omitted) *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 619, 969 P2d 1090, 1093, review denied, 138 Wash 2d 1003 (1999).

The doctrine of laches applies to lawsuits by creditors against shareholders for improper distributions. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1980).

RCW 23B.08.310(1) provides that a director who votes for an unlawful distribution may be liable to the corporation for that unlawful distribution, unless the director complies with the standards of conduct set out in RCW 23B.08.300. This topic is discussed in more detail in Section 9.07 of this book.

A director who is held liable for an unlawful distribution is entitled to contribution from "each shareholder for the amount the shareholder accepted knowing the distribution was made in violation of RCW 23B.06.400 or the articles of incorporation." RCW 23B.08.310(2)(b). This topic is discussed in more detail in Section 10.12 of this book.

There is a two-year period for bringing such lawsuits. RCW 23B.08.310(3).

B. Procedures for cutting off corporate debts after dissolution.

Creditors have first priority to corporate assets. But at some point, the board of directors needs to know how much is available for distribution to the shareholders.

Section 10.12

Generally, a corporation will pay all known, undisputed claims and establish a reserve for the payment of disputed and unknown claims. It will then distribute the remaining assets to the shareholders.

RCW 23B.14.060 (based upon RMBCA § 14.06) sets forth the procedure for cutting off corporate liability for known claims. It provides:

- (1) A dissolved corporation may dispose of the known claims against it by following the procedure described in this section.
- (2) The dissolved corporation shall notify its known claimants in writing of the dissolution at any time after its effective date. The written notice must:
 - (a) Describe information that must be included in a claim;
 - (b) Provide a mailing address where a claim may be sent;
 - (c) State the deadline, which may not be fewer than one hundred and twenty days from the effective date of the written notice, by which the dissolved corporation must receive the claim; and
 - (d) State that the claim will be barred if not received by the deadline.
- (3) A claim against the dissolved corporation is barred:
 - (a) If a claimant who was given written notice under subsection (2) of this section does not deliver the claim to the dissolved corporation by the deadline; or
 - (b) If a claimant whose claim was rejected by the dissolved corporation does not commence a proceeding to enforce the claim within ninety days from the effective date of the rejection notice.
- (4) For purposes of this section, "claim" does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.

Washington did not adopt a procedure for cutting off corporate liability for unknown claims. *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 969 P2d 1090, *review denied*, 138 Wash 2d 1003 (1999).

NOTE: In *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 617-18, 969 P2d 1090, 1093, *review denied*, 138 Wash 2d 1003 (1999), the court states: "RCW 23B.14.340 is based upon section 14.06 of the Model Business Corporation Act." Actually, RCW 23B.14.060 is based upon Section 14.06 of the Model Act. RCW 23B.14.340 has no corresponding section in the Model Act.

Section 10.12

RCW 23B.14.340 provides that a creditor must file suit within two years of dissolution. But this two-year limitation may not apply to a known claimant who does not receive notice as required by RCW 23B.14.060. *University of Alaska v. Thomas Architectural Products, Inc.*, 907 P2d 448 (Alaska 1995) (interpreting Washington law).