



Legal Memorandum

To: XYZ Law Firm

From: SKJ Legal

Date: February 2, 2009

Re: Lifting of the Corporate Veil of a bankrupt company in order to make the parent company liable to pay damages

Questions Presented

Can Mrs. X file a suit against Professional Training Institute, a parent company of the bankrupt subsidiary company, _____ Academy for recovery of the amount of their course fees along with damages for making false claims and causing harassment to them?

Brief Answer

Probably, Professional Training Institute can be made liable to pay the damages to the students of the _____ Academy as it is its parent company based on the principle of 'Lifting of Corporate Veil'.

Facts

_____ Academy is an air hostess and cabin crew training academy incorporated in ----- . It provides six-month training to its students to become an air hostess or cabin crew, and at the end of the course, it guarantees a job in the aviation industry to all its students. The Academy also promises to return the entire course fee to any student who does not get a job within 3 months of the completion of the course. Mrs. X joined _____ Academy on January 1, 2007. She completed her training on 1st July 2006. At the end of the course, the academy neither provided a job to her nor any of its 60 students. The Academy did not return the course fee to any of them. On December 12, 2007, _____ Academy filed for bankruptcy.

Discussion:

A company is considered as a separate legal entity and it is always distinguished for the legal and regulatory purposes. In certain situation, it is required to look beyond the legal fiction and regulate the persons, who are committing the tort and protected under the shield of the company. When a corporation is facing legal liability and transfers its assets and business to another corporation with the intention of committing fraud or gaining personal profit, then in such cases, the corporate veil can be pierced and regulatory proceedings can be taken against a shell corporation, including directors and officer acting on behalf of such corporations.

In USA, Corporate Veil can be pierced on a number of occasions through the laid down principles and precedents and not by way of statutory provisions. Hence to pierce the corporate veil, court has to rely on the principles stated in the past cases and factual

situation. Judge Sanborn had rightly stated that, 'a corporation will be looked as a legal entity as a general rule, until sufficient reason to the contrary appears; but when the notion of public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.'

Courts initially considered the principle of equity in piercing the corporate veil.¹ Later, in 1980's, keeping aside the principle of equity, it was revealed by the courts that in order to pierce the corporate veil, mere control of the subsidiary company by the parent company is not sufficient. Courts approached towards the controlling shareholder's improper conduct factor along with dominant control as the basic ingredient for piercing the corporate veil. In *Amfac Foods, Inc v. International Systems & Controls Corp*², the Court held that 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.³ Likewise, the shareholder's conduct must have been improper either in relation to the plaintiff's entering the transaction or in preventing or interfering with the corporation's performance or ability to perform its obligations toward the plaintiff.⁴

¹ *Walkovszky v. Carlton.*, 18 N.Y. 2d 414, 276 N.Y.S.2d 585, 223 N.E.2d. 6 (1966).

² 294 Or. 94, 654 P. 2d 1092 (1982).

³ *Amfac Foods, Inc v. International Systems & Controls Corp.*, 294 Or. 94, 654 P. 2d 1092 (1982).

⁴ *Ibid*

In 1990's, courts have generally laid down various labels in its different tests adopted to discuss the topic of corporate veil. In the case of *Sea-land Services, Inc. v. Pepper Source, Inc.*⁵, Court laid down a two prong test which stated that; first, there must be such a unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.

In determining whether there exist unity of interest and ownership, Court had taken various factors into consideration such as (1) the failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) under-capitalization, and (4) one corporation treating the assets of another corporation as its own.

After establishing the first factor of two prong tests, Court then proceeded to the second factor in which it laid down that there should either be fraud or injustice done in order to pierce the corporate veil.⁶ Though, it seems not so difficult to understand the concept of fraud, however, it was very difficult to get the real meaning of promoting justice.

The two prong test as laid down in the above case was also considered in *Kinney Shoe Corp v. Polan*⁷, where Court had to determine whether to pierce a corporate veil in a breach of contract case. Interestingly, in this case, prior presumed knowledge with the plaintiff about undercapitalized Defendant was considered of great importance for benefit of the Defendants. Court labeled it as a

⁵ United States Court of Appeals, 7th Circuit, 941 F.2d 519 (1991).

⁶ Supra Note 31.

⁷ 939 F.2d 209 (4th Cir. 1991).

third prong test in addition to the aforesaid mentioned two prongs. Court stated that when, under the circumstances, it would be reasonable for that particular type of a party [those contract creditors capable of protecting themselves] entering into a contract with the corporation, for example, a bank or other lending institution, to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged with the knowledge that a reasonable credit investigation would disclose.⁸ If such an investigation would disclose that the corporation is grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil.⁹ However, Court in this case held that this third prong test is permissive and not mandatory.¹⁰ Court on the basis of the equitable remedy and the totality of the circumstances test that each case to be decided on its own facts to pierce the corporate veil, held the Defendant personally liable. In this case, it was established that Polan did not observe any corporate formalities and it was incorporated with inadequate capitalization.¹¹ Court held that grossly inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil in order to hold the shareholders actively participating in the operation of the business personally liable for a breach of contract to the party who entered into a contract with the corporation. The factor of inadequate capitalization was also discussed in *Radaszewski v. Telecom Corp*¹², where Court held that “the whole purpose of asking whether a subsidiary is “properly capitalized”, is precisely to determine its “financial responsibility”. The court further lay down that ‘undercapitalization factor proved that control over

⁸ *Kinney Shoe Corp v. Polan.*, 939 F.2d 209 (4th Cir. 1991).

⁹ *Ibid*

¹⁰ *Ibid*

¹¹ *Ibid*

¹² 981 F. 2d 305 (8th Cir. 1992).

subsidiary was used to commit fraud, wrong or unjust act injuring plaintiff's rights.'¹³ Undercapitalized subsidiary justifies an inference that the parent is either deliberately or recklessly creating business that will not be able to pay its bills or satisfy judgments against it.¹⁴

In *Perpetual Real Estate Services, Inc. v. Michaelson Properties, Inc.*,¹⁵ the Supreme Court of Virginia held that 'something more than proof that some person may dominate or control corporation, or treat it as a mere instrumentality or agency, is required to pierce corporate veil. Plaintiff must also establish that corporation was a device or sham used to disguise wrongs, obscure fraud or conceal crime.'

CONCLUSION: From the above mentioned discussion, it is concluded that the corporate veil of 'separate legal personality' can be pierced under certain circumstances and by the satisfaction of the Court. Court has considered that the satisfaction of two prong test of control and improper conduct is an important factor for piercing the veil. Court has also relied on certain other factors like inadequate capitalization; unity of interest and ownership and dominant control between the parent and subsidiary companies. Similarly, courts invented the totality of the circumstances test where it looked into all the circumstances of each case to decide the corporate veil issue. Hence, Corporate Veil can be pierced by the powers of judiciary on the principles stated in the concrete cases.

¹³ *Radaszewski v. Telecom Corp.*, 981 F. 2d 305 (8th Cir. 1992).

¹⁴ *Ibid*

¹⁵ 974 F.2d 545 (4th Cir. 1992).