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CORPORATIONS—LIABILITIES—INADEQUATE CAPITALIZATION AS GROUND FOR DISREGARDING CORPORATE ENTITY—Defendant Resnick, meeting minimum statutory incorporation requirements, organized a corporation and thereafter persuaded defendants Cowan to join him in operating a used car enterprise under the corporate name. No stock was issued, nor capital paid in,[1] although a checking account was opened for use by the business. Car purchases were financed through loans made or guaranteed by the elder Cowan, who held title until resale. Proceeds from resale transactions were deposited in the checking account, from which defendant Resnick reimbursed Cowan for money advanced. Sales volume averaged from $100,-000 to $150,000 monthly. Assured that the elder Cowan was "backing" the corporation, plaintiff sold cars to defendants following the described procedure. Corporate checks drawn by Resnick for the balance due on eight cars were dishonored, and when the corporation filed in bankruptcy, plaintiff sued defendants on a theory of individual liability. The trial court held for plaintiff. On appeal, *held,* affirmed, one justice dissenting. Capital investment was totally inadequate for the volume of business conducted, and this factor, together with the failure to issue stock, is under the circumstances sufficient ground for disregarding the corporate entity. *Automotriz Del Golfo de California v. Resnick,* (Cal. 1957) 306 P. (2d) 1.

Judicial readiness to ignore the protective corporate veil when failure to do so would sanction fraud or promote injustice[2] is today widely evident.[3] More sketchy, however, is support for the principal court's specific reliance upon inadequate capitalization as the basis for permitting suit against corporate personnel stripped of their normal liability limitation privilege.[4] While this particular approach has been used frequently when

[1] Cal. Corp. Code Ann. (Deering, 1953) §1900 requires that every stock corporation have a stated capital, but §25154 permits the directors to organize and transact business prior to issuing shares.

[2] E.g., In re Hedgeside Distillery Corp., (N.D. Cal. 1952) 123 F. Supp. 933; Watson v. Commonwealth Ins. Co., 8 Cal. (2d) 61, 63 P. (2d) 295 (1936).

[3] Cases are collected in 1 FLETCHER, CYC. CORP. §41 (1931). For California decisions, see Schifferman, "The Alter Ego," 32 CAL. B. J. 143 (1957). Following California precedent initiated by Stark v. Coker, 20 Cal. (2d) 839, 129 P. (2d) 390 (1942), the majority treated the issue of whether defendants had abused the corporate form as a question of fact. Thus the decision of the lower court was binding if supported by the record. While it is clear that the fact-finding body should be called upon to decide disputes as to past occurrences, questions of policy, viz., whether the abuse justifies holding the directors individually liable, should be determined as a matter of law. See note by Professor Ballantine, "Disregarding the Corporate Entity as a Regulatory Process," 31 CALIF. L. REV. 426 (1943).

[4] The following decisions turned, in a substantial degree, upon inadequacy of capitalization: Shafford v. Otto Sales Company, (Cal. 1957) 308 P. (2d) 428 (invested capital of $50, loan of $25,000, sales of $250,000 in 6 months, corporate entity was disregarded); Arnold v. Phillips, (5th Cir. 1941) 117 F. (2d) 497, cert. den. 313 U.S. 583 (1941) (invested capital of $50,000, loaned capital of $75,000, later additional substantial loans, first $75,000 loan treated as invested capital); Eastern Products Corp. v. Tenn. Coal, Iron & R. Co., 151 Tenn. 239, 269 S.W. 4 (1924) (invested capital of $800, executory contract for $485,000, the court refused to enforce the contract in favor of the under-

a parent corporation creates a dummy subsidiary in order to achieve "double insulation" for parent shareholders and directors,[5] no more than a handful of decisions are reported in which a court accepted inadequate corporate financing as the ground for reaching the shareholders of a single corporation.[6] In arriving at their result, these few courts have often tempered a naked "inadequate capital" attack by considering, in addition to low ratios of paid-in capital to debt obligations or to business volume, such factors as the cause of the default or insolvency,[7] capital normally required for comparable businesses,[8] and knowledge by plaintiff of capital structure.[9] That a greater number of jurisdictions have not established inadequate capitalization alone as a ground for unlimited entrepreneur liability is perhaps explained by three considerations: (1) fear that hindsight would play too dominant a role in determining adequacy of capital;[10] (2) difficulties apparent in formulating a workable mathematical ratio of capital to debt or to business volume;[11] and (3) feeling in some quarters that, in view of the stated relationship of the legislature and the judiciary, compliance with minimum statutory capitalization standards should be decisive in establishing limited liability.[12] One court's reaction to this final objection has been to require that actual fraud be shown before individual liability is created, once the corporation attains *de jure* existence.[13] A less rigid

capitalized corporation); Dixie Coal Mining and Manufacturing Co. v. Williams, 221 Ala. 331, 128 S. 799 (1930) (the corporation operated without assets and was managed as a proprietorship, *held,* legal fraud); Christian & Craft Grocery Co. v. Fruitdale Lumber Co., 121 Ala. 340, 25 S. 566 (1898) (corporation wholly without capital, defendant told plaintiff the organization was a partnership, *held,* fraud); Taylor v. Newton, 117 Cal. App. (2d) 752, 257 P. (2d) 68 (1953) (individual transferred all his assets to a corporation, *held,* the corporation is the alter ego of the individual).

[5] E.g., Luckenbach S.S. Co. v. W.R. Grace & Co., (4th Cir. 1920) 267 F. 676; Bartle v. Home Owners Cooperative, 309 N.Y. 103, 127 N.E. (2d) 832 (1955). See LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 194 (1936) for collected cases. It is questionable whether the double insulation argument is valid. If the corporation in question was organized with grossly inadequate capital it would seem to be immaterial whether another corporation or an individual was held liable as the alter ego. 19 UNIV. CHI. L. REV. 872 (1952). See Fuller, "The Incorporated Individual," 51 HARV. L. REV. 1373 at 1382 (1938), in support of the distinction.

[6] Note 4 supra.

[7] Taylor v. Newton, note 4 supra; Dixie Coal Mining and Manufacturing Co. v. Williams, note 4 supra.

[8] Carlesimo v. Schwebel, 87 Cal. App. (2d) 482, 197 P. (2d) 167 (1948).

[9] Carlesimo v. Schwebel, note 8 supra, (contract and all correspondence written on stationery with the corporate name as a heading); Hanson v. Bradley, 298 Mass. 371, 10 N.E. (2d) 259 (1937) (plaintiff, manager of the bankrupt hotel, was aware of the lack of invested capital at the time he entered into the contract). On the basis of these two cases, both of which refused to disregard the corporate entity because of the knowledge of the plaintiffs, the court in the principal case could have found that plaintiff assumed the risk of undercapitalization by knowingly dealing with a corporation.

[10] Opinion of the dissenting justice, principal case at 6.

[11] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 136 (1936).

[12] Moe v. Harris, 142 Minn. 442, 172 N.W. 494 (1919).

[13] Ibid.

balance of investor and creditor interests has been suggested, which would allow such non-capital contributions as are normally available to similar corporations in similar circumstances.[14] Ballantine would require investment of that amount of capital needed to meet normally expected debts.[15] The majority opinion in the principal case, citing Ballantine at length, ostensibly applies his test to the facts before it, and personal liability was easily found since proved capital contribution was zero. It is interesting to speculate whether the court might have been forced back to a fraud finding to reach the same result, had even a small amount of paid-in capital been shown, because little capital is ordinarily required in a buy-sell used car operation. It would appear that if the primary purpose of this area of our commercial law is to assure investor and creditor certainty, courts would do better to refuse to disregard the corporate entity, absent individual fraud, if minimum statutory requirements have been met. If, on the other hand, policy requires that an entrepreneur risk capital commensurate with his possible economic gain, the more flexible "similar corporation" or "reasonable need" tests should be applied, even when the conditions of the statute have been strictly met. In any event, it is clear that judges do not consider their hands tied by the mere *de jure* existence of a corporation, if it was formed for fraudulent or purely insulative purposes. Although the tests for determination of individual liability may vary with the jurisdiction, they will almost certainly be framed everywhere so as to provide the court some discretionary basis for reaching behind the financially indefensible corporate structure.

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[14] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 136 (1936). This author also suggests a ratio of 1:1, contributed capital to loaned capital, as a possible practical mathematical test.

[15] BALLANTINE, CORPORATIONS, rev. ed., 302 (1946). See also Cataldo, "Limited Liability with One Man Companies and Subsidiary Corporations," 18 LAW AND CONTEM. PROB. 473 at 484 (1953) to the same effect.