UNDERCAPITALIZATION AS AN INDEPENDENT GROUND FOR SHAREHOLDER LIABILITY: THE CASE FOR CORPORATE STAKEHOLDERS

By

Lathia Stubbs

Submitted in partial fulfilment of the requirements for the degree of Master of Laws

at

Dalhousie University
Halifax, Nova Scotia
August 2016

© Copyright by Lathia Stubbs 2016
# Table of Contents

Abstract .................................................................................................................................................. iii
Acknowledgments ................................................................................................................................. iv
Chapter 1 Introduction ........................................................................................................................... 1
Chapter 2 The Doctrine of Limited Liability and Veil Piercing ......................................................... 7
Chapter 3 Early Rise of the Limited Liability Company ................................................................... 15
Chapter 4 A Need to Protect Corporate Stakeholders ................................................................. 29
  4.1 Introduction .................................................................................................................................. 29
  4.2 The Shareholder Wealth Maximization Theory ........................................................................... 32
  4.3 The Incentive to Externalize Unnecessary Risks to Stakeholders ........................................... 37
  4.4 The Social, Moral, and Ethical Responsibility of Companies and Shareholders .................. 41
  4.5 Types of Social Responsibilities ................................................................................................. 51
    4.5.1 Economic Responsibility ........................................................................................................ 51
    4.5.2 Legal Responsibility ............................................................................................................... 53
    4.5.3 Ethical and Philanthropic Responsibilities .............................................................................. 54
  4.6 Liability for Corporate Wrongs .................................................................................................. 55
  4.7 Equitable Subordination for Undercapitalization ........................................................................ 65
  4.8 Conclusion .................................................................................................................................. 69
Chapter 5 Justified or Unjustified: Undercapitalization as an Independent Factor for Corporate Veil Piercing? ................................................................. 71
  5.1 Introduction .................................................................................................................................. 71
  5.2 What is Undercapitalization? ........................................................................................................ 73
  5.3 How is Undercapitalization Measured? ......................................................................................... 78
  5.4 The Critical Nature of Undercapitalization .................................................................................. 85
  5.5 Undercapitalization: The Underlying Problem ......................................................................... 89
  5.6 The Case for Independence: A Critical Analysis of the Undercapitalization Factor .............. 91
  5.7 Conclusion .................................................................................................................................. 113
  6.1 Introduction .................................................................................................................................. 115
  6.2 Undercapitalization in Tort Cases ............................................................................................... 116
  6.3 Undercapitalization in Contract Cases ....................................................................................... 118
  6.4 Conclusion .................................................................................................................................. 123
Chapter 7 Recommendations and Conclusion ............................................................................... 125
Bibliography ......................................................................................................................................... 129
Abstract

This thesis defends the position that undercapitalization of private companies should be an independent basis for shareholder liability. The thesis examines the developments in the law by exploring the work of commentators, legal scholars, and judges on the importance of protecting corporate stakeholders against undercapitalized corporations. American courts have also dealt with the issue in a number of cases, the majority in which the courts have not considered undercapitalization to be an independent ground for shareholder liability. These cases are critically examined to determine the reasoning behind the courts’ decisions. Ultimately, this thesis concludes that the arguments in favour of undercapitalization as an independent factor for veil piercing are more persuasive than the arguments against this view.
Acknowledgments

I would like to thank my parents, Anthony and Sharon Stubbs for making this possible and for their never ending love and support as I pursued my LLM degree. I would also like to thank Professor Michael Deturbide and Professor Kim Brooks for their outstanding academic support, supervision, and guidance. Thirdly, I thank David Dzidzornu for dedicating his time to make this paper a success. Last but not least, I thank God for this blessing.
Chapter 1
Introduction

In the corporate and financial world, companies possess the legal capacity and privilege of a natural person, subject to the incorporating legislation.¹ By law, when a company is born, it must possess a birth certificate (Certificate of Incorporation); and by law, when it dies, a death certificate (Certificate of Dissolution) must be made in its name. Like human beings, it enjoys its own separate legal personality and can sue and be sued in its own name. This widely accepted metaphorical principle is thought to have been established in the landmark case of Salomon v A. Salomon² where the English Court of Appeal confirmed the separate legal personality of a company with the reasoning that a company is separate from its members. All the debts of a company are the responsibility of the company and not its shareholders, directors, or employers. As early as 1613, Lord Coke defined the corporation as an aggregate of many that is invisible, immortal, and rests on its intendment and consideration of the law.³

This well-known orthodox principle of corporate law has encouraged risky investments by shareholders. As a result, it has left many persons suffering at the ‘hands’ of corporations. However, no matter the extent of legal personality the law of most jurisdictions affords a company with, it cannot incorporate itself, nor operate under its own will. Who then should be responsible for the loss that stakeholders, such as judgment creditors, face, when they cannot receive compensation from the ‘hand’ of a corporation?

¹ Canada Business Corporations Act, RSC 1985, c. C-44, s 15 (1) [CBCA].
² Salomon v Salomon [1897] AC 22, 66 L.J. Ch. 35 (HL (Eng)) [Salomon].
This thesis argues, that undercapitalization of private companies should be an independent ground for piercing the corporate veil. As it relates to private companies, undercapitalization has gained some judicial attention, particularly in American states. While US courts believe that undercapitalization is a significant factor to be considered in deciding whether to lift the veil of incorporation, the outcome of most cases concerning undercapitalization show that courts have given only limited scope to this factor, with no clear justification. Additionally, the cases also show inconsistencies in the judges’ decisions on the issue. There are very few Canadian commentaries on the undercapitalization issue. Because American law has often had influence on Canadian law, a number of American cases are examined.4

From an economic standpoint, limited liability has encouraged investment for many years and will inevitably continue to do so. This makes shareholders liable only for the amount they invest in a company, and their personal assets are protected. This statutory rule stretches back to Salomon5 and has been enshrined into the law of countries all over the world. It is, indeed, the orthodox foundation of company law in common law legal systems. This same rule, however, has also encouraged corporate abuse by investors. The ways in which investors have abused the privilege of limited liability are many. This thesis discusses one of those abuses, undercapitalization, which has become a critical issue for corporations today. As the cases discussed in this thesis will show, stakeholders have often

---

4 Ronald Podolny, Fixing What Aint Broke: In Defence of Canadian Poison Pill Regulation (2009) 67 U Toronto Fac L Rev 47, confirms this by when he highlighted that “developments in the US have influenced Canada…..Canadian courts and regulators are influenced by American ideas and frequently look south of the border before formulating a Canadian approach.”

5 Salomon, supra note 2.
suffered uncompensated losses as a result of shareholders’ refusal to adequately capitalize the companies they invest in.

The underlying issue of this thesis is as follows. There are many instances in which private companies have been initially incorporated with capital that is totally inadequate for the nature of the business in question as the cases in chapter 5 of this thesis illustrates. There are also instances where companies have been incorporated with sufficient capital but, throughout the course of incorporation, the company’s assets have been tampered with by shareholders. This has become problematic for a number of reasons that are briefly set out.

When companies are undercapitalized, unnecessary risks are transferred to stakeholders. Consequently, they are disadvantaged when it comes to receiving relief in court actions where claims may be brought against companies. If, for example, a judgment creditor can only look to a company and not its shareholders to satisfy a claim, it is only fair that shareholders be required to adequately capitalize the companies in which they invest, so that those companies can satisfy their liabilities. The personal assets of shareholders are secured, but the only protection afforded creditors and other stakeholders is the hope that the company will have sufficient assets to compensate them in the event judgment is made in their favour. To effectively address the issue of undercapitalization, a number of methods are utilized.

First, a historical exploration traces the change from shareholders being fully liable for their company’s debts to being liable for only the amount unpaid on their shares. To do this, this thesis adopts a ‘law and history’ approach to help inform legal reasoning. As a corollary, the discussion explores the development of the limited liability principle to see whether this change in the area of company law was intended to benefit only a particular
group in society, whether any consideration was given to the interests of stakeholders, and to examine the overall impact that the change now has on society. This analysis exposes the use of limited liability not only as an investment incentive, but also as an avenue for manipulating the corporate form, which is exactly what undercapitalization does.

The historical approach shows how the law changed from shareholders being fully liable for their company’s debts, to being liable for only the amount unpaid on their shares. The analysis demonstrates both the legislative and judicial input into the evolution of the law in this regard, through the increase in capital during the industrial revolution in the face of opposition from prominent legal actors to the evolving change. Doctrinal research will be used to critically analyse the current state of the law on the issue and to examine the courts’ reasoning in each case where undercapitalization is present. A critical analysis will help to expose the weaknesses in court judgements such as the inconsistencies in judges’ opinions regarding the undercapitalization factor.

While the cases do not yield definitive conclusions as to whether undercapitalization justifies piercing the corporate veil to offer relief to corporate victims, the theories that undergird this area of the law namely, the shareholder wealth maximization theory, the stakeholder theory, and the concept of corporate social responsibility, seem, collectively, to help in justifying the need for corporations, shareholders, and directors to be concerned for the interests of creditors. These concepts highlight that justice and fairness or fair dealing should inform the relations between investors and corporate stakeholders. As this thesis argues, inadequate capitalization demands creditor protection. Put another way, stakeholder protection should justify laws that prevent the inadequate capitalizing of operating companies.
Chapter 2 provides an overview of the principles that underlie the limited liability and veil piercing doctrines. Limited liability is critical to any consideration regarding acts of abuse of the corporate form and, as the basis of corporate investment, it sets the stage for subsequent discussion. Chapter 3 explores the origin of the limited liability company and its rise to dominance during the early years of the industrial revolution in Britain. Highlighted here are the criticisms that confronted the development of limited liability, particularly for the exposure of the underhanded character of the nature of the activities that limited liability would encourage investors to perform.

Chapter 4 discusses the contribution of stakeholders to economic growth and success through business investment. The argument is that for the sake of the public’s trust and a legitimate expectation of protection for their investment, it is important that there be fair dealing by sufficient capitalization of companies. A number of corporate theories discussed help to illustrate the importance of creditor protection. Chapter 5 examines a number of American cases where the courts have acknowledged undercapitalization as a significant factor to justify veil piercing. However, the judges in those cases do not see it as critical enough to allow piercing of the veil on that factor alone. The discussion therefore points out the weaknesses in the judges’ opinions. This is notwithstanding the legal underpinnings of the corporate form that otherwise upholds it. Chapter 5 further argues that there is no logic behind the courts’ reasoning for limiting the role to be played by corporate undercapitalization.

Subsequent to illustrating why undercapitalization should be an independent ground for veil piercing, chapter 6 argues that the unsatisfactory outcome presented by the case law is not improved upon when veil piercing is contemplated to allow for tort and contract
creditors to be compensated by the shareholders of an undercapitalized company. The analysis shows essentially that both types of creditors remain unprotected. Tort creditors assume risks they are unaware of, while contract creditors, without capacity to assess the capital status of a company, also remain exposed to the consequences of the protection extended to an undercapitalized entity by the corporate form.

To conclude, the thesis first makes recommendations directed to the critical issue at the base of the argument regarding the undercapitalization issue. In sum, I argue that piercing the veil to satisfy the creditors of undercapitalized private companies is a matter of justice and equity, that is, fair dealing. Doing so recognizes the need to protect stakeholders, just as much as the dividends and profits of shareholders are protected. The reasons are intertwined: without transactions with stakeholders, those companies cannot contribute to socio-economic growth and development. Although not across the board, semi influential judicial opinion considers it necessary to pierce the veil of undercapitalized companies to secure creditor interests. As well, the duties owed by companies to society under the umbrella of corporate social responsibility demand it, and so does public policy. Consequently, the conclusion points out that it is fitting to pierce the veil where there is proven undercapitalization, and this would be in keeping with the historical evolution of the law and theoretical concepts in this area.
Chapter 2
The Doctrine of Limited Liability and Veil Piercing

Limited liability is an established principle of corporate law justified by both legal and economic rationales. It is the regime that applies where the liability of shareholders in a company for the debts or other obligations incurred with respect to that company, is limited to the company’s capital investment by the shareholders. Limited liability and separate legal personality are collectively referred to as the “unyielding rock” upon which the foundation of corporate law is founded. The underlying rationale for this view is that people will not invest their monies into companies if in their personal capacities they have no protection against the claims of creditors, especially where the investors are not in control of managing the corporation. Investors want to take risks in the hope of reaping great returns. At the same time, they want to ensure that their investments are secured and they are free of potential personal liability.

Company legislation in most countries provides that the liability of investors is limited only to the amount of their shares. Commonwealth countries around the world have accepted the principle laid down in Salomon as the fundamental rule of their corporate law. As earlier mentioned, this case confirmed the legal personality of corporations, holding that once the proper formalities of incorporating a company are carried out, even small one-
man companies are considered separate legal persons and are distinct from their shareholders who are liable only to the amount unpaid on their shares. As an entity separate and distinct from its shareholders, a company is to be treated as an individual holding all rights and liabilities appropriate to itself.\textsuperscript{11}

Limited liability is a privilege bestowed on investors.\textsuperscript{12} It provides many advantages not only to investors, but to society as a whole. It decreases the need for investors to monitor the corporation or to be overly concerned about their personal assets;\textsuperscript{13} it reduces the costs of monitoring other shareholders within the corporation; it gives managers incentives to act efficiently by promoting transferability of shares; it makes it possible for market prices to impound additional information about the value of corporations; it allows more efficient diversification; and it facilitates optimal investment decisions.\textsuperscript{14} For these reasons many people accept limited liability as economically justified. The principle has been summarized as follows:

\textsuperscript{11} See \textit{Salomon, supra} note 2 where Lord Macnaghten proclaimed the following:

The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same personas are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

See also \textit{Maclaine Watson & Co. Ltd. v International Tin Council} [1989] 3 All ER 523 at 531.

\textsuperscript{12} Easterbrook & Fischel, \textit{The Economic Structure of Corporate Law} (Massachusetts: Harvard University Press, 1991), at 40.

\textsuperscript{13} \textit{Ibid}. at 41.

Limited liability is now accepted in theory and in practice. It is ingrained in our economic and legal societies. The social and economic order is arranged accordingly. Our philosophy accepts it. It is legitimate for man or a group of men to stake only a portion of their fortune on an enterprise. Legislatures, courts and business usage have made it so.\footnote{Douglas & Shanks, “Insulation from Liability Through Subsidiary Corporations” (1929) 39 Yale LJ 193 at 193.}

While an economic advantage, the existence of limited liability has many disadvantages. From the inception of limited liability and separate legal personality, investors have found ways to manipulate the corporate form for their personal interests. As a result, courts were forced to establish exceptions to the limited liability principle in the interest of stakeholders. Therefore, while it creates a major economic incentive, it also encourages corrupt corporate activities. A number of circumstances in which the courts have seen it fit and proper to pierce the corporate veil have arisen in several jurisdictions.

Veil piercing was developed by the courts to enable the exercise of discretionary powers to allow the corporate veil to be pierced when the facts and circumstances of a case justifies it. Veil piercing is an important equitable remedy to the principle of limited liability since without such remedy, much injustice would occur. An example of this is where companies, by fault of their share investors, cannot satisfy their liabilities. But as Easterbrook and Fischel stated, piercing seems to happen freakishly. Like lightning it is rare, severe, and unprincipled.\footnote{Easterbrook & Fischel, supra note 14 at pg 89.} Although courts possess this discretionary jurisdiction, they are often reluctant to exercise it\footnote{DeWitt Truck Brothers v W. Ray Flemming Fruit Co., 540 F. (2d) 681 (4\textsuperscript{th} Cir 1976) [DeWitt Truck Brothers].}, despite the fact that it can encourage corporate responsibility and
accountability. Unfortunately, limited liability is sometimes upheld in cases where it is broadly recognized to be unjustified. Piercing the veil for lack of corporate capital when the facts of a case call for it should be done less reluctantly. In view of this, just as managers and directors are accountable for the proper management of corporations, shareholders should be made accountable for ensuring that corporations are adequately capitalized when they are incorporated.

Corporate stakeholders could endure much injustice if veil piercing is not exercised as part of the court’s discretionary jurisdiction. As the US Court of Appeal confirmed, the concept of separate legal personality is merely a legal theory, introduced for purposes of convenience and to serve the ends of justice. Therefore the courts may decline to recognize the corporate form whenever recognition of it would extend the principle of incorporation beyond its legitimate purpose, and would produce injustice or inequitable consequences.

Initially, the popular circumstances courts considered to determine whether the corporate entity should be disregarded were instances of agency and fraud. Since the issue of veil piercing is sui generis, the list has now been extended to include a number of other factors. Where an agency relationship exists between a parent and subsidiary corporation, it is easy for the parent to escape liability for the subsidiary’s debt because of the separate personalities that they each possess. Courts discovered in some cases that corporations

20 Judge Donald Russell in DeWitt Truck Brothers, supra note 17.
21 Ibid.
were being used as agents of both individual shareholders and parent corporations.\textsuperscript{22} For this reason courts found it necessary to pierce the veil and hold the individual shareholder or parent corporation personally liable.

An example of an agency situation is the early English case of \textit{Smith, Stone & Knight v Birmingham Corp.}\textsuperscript{23} The parent company in that case was happy to admit that the subsidiary company was its agent, since the compensation from a compulsory acquisition would fall to the parent. Judge Atkinson stated that the important thing to determine is whether the subsidiary company is carrying on business as the parent company’s business or as its own.\textsuperscript{24} He went further by identifying a number of factors that judges still use, such as, (1) who was really carrying on the business; (2) who received the profits; (3) who appointed those persons; (4) who was the head and brains of the venture; and (5) who was in effective and constant control of the business.\textsuperscript{25} The answers to these questions have ever since been the determining factors of liability and responsibility in cases of agency relationships.

Courts will also disregard the corporate veil when the facts of a case reveal acts of fraud. Fraud is the misrepresentation of material facts and can demonstrate financial irresponsibility of the shareholders of a corporation. For piercing cases, actual fraud does not need to be shown and the corporate entity should be disregarded when courts find

\begin{footnotesize}
\begin{enumerate}
\item See for example \textit{Adams v Cape Industries Plc.}, [1990] Ch 433.
\item \textit{Smith, Stone & Knight v Birmingham Corp.}, [1939] 4 All ER 116.
\item \textit{Ibid.} at 121.
\item \textit{Ibid.} See also Brenda Hannigan, \textit{Company Law}, 2\textsuperscript{nd} ed (New York: Oxford University Press, 2009) at 58.
\end{enumerate}
\end{footnotesize}
objective factors indicating misuse of the corporate form.\textsuperscript{26} It is said, however, that plain fraud is not a necessary element in a finding to disregard the corporate veil.\textsuperscript{27}

Other factors that the courts look for in determining whether to pierce the veil include failure to observe corporate formalities; non-payment of dividends; the insolvency of the debtor corporation at the time; siphoning of funds of the corporation by the dominant stockholder; non-functioning of officers or directors; absence of corporate records; undercapitalization of the corporation in question;\textsuperscript{28} intermingling of activities or assets of the corporation; treatment by an individual of the assets of the corporation as his/her own\textsuperscript{29}; use of the corporation as a “façade” for personal dealings; use of the corporation to promote fraud, injustice, or illegalities; and payment by the corporation of individual obligations.\textsuperscript{30}

\textsuperscript{26} William Hackney & Tracy Benson, “Shareholder Liability for Inadequate Capital” (1981) 43 U Pitt L Rev 837 at 850. Additional factors outlined by Hackney and Benson which can move the court to pierce the veil are the following:

\ldots...outright evasion of contracts and obligations or statutory and regulatory restrictions; a history of spoliation, mismanagement and faithless stewardship which is tantamount to fraud...explicit or implied misrepresentation as to financial responsibility; direct intervention or participation by the controlling shareholder in the management of the corporation as if it were the business of the shareholder or a division of the business of the parent.

\textsuperscript{27} See generally DeWitt Truck Brothers, supra note 17.

\textsuperscript{28} Ibid.

\textsuperscript{29} Treating the assets of a company as one’s own can result in the removable of corporate funds by investors, thereby reducing the assets of a company which was initially adequately funded. The purpose of the company legal form is to separate the property of an investor from that of the company. As such, limited liability cannot be abused to limit an investor’s liability and make him untouchable when he subtracts funds from the corporation’s possession for his personal use.

The accepted view is that a single factor will not suffice, but a number of these factors must exist in order for the courts to disregard the corporate entity.

For public policy reasons, the circumstances for veil piercing have been extended by courts. Courts are now inclined to pierce the corporate veil in instances of tax evasion or concealment of corporate assets in family law cases. Tax evasion involves the act of not paying taxes one is legally required to pay. As a generally note, the deliberate evasion of corporate tax is a serious issue that usually calls for the court’s intervention to pierce the corporate veil. Canadian courts have considered the veil piercing doctrine in a number of family law cases. For instance, in 2006, the Court of Appeal of Ontario decided three cases in this regard: *Wildman v. Wildman*, *Debora v. Debora* and *Lynch v. Segal*. The general position of the Court of Appeal in these cases is that when spouses control companies, or clearly conceal their involvement in companies as a way to avoid the

---


32 *Ibid*, see generally.

33 See the Canadian case of *Wildman v Wildman*, 2006 ONCA 82 OR (3d) 401, where the court thought it necessary to pierce the corporate veil when one spouse controlled the corporation and concealed the funds and handled corporate assets as personal assets. However, in a recent UK decision called *Petrodel Resources Ltd. v Prest* [2013] 2 AC 415, the Supreme Court held that the doctrine of English law which enable courts in limited circumstances to pierce the corporate veil, was only to be invoked where a person was under an existing legal obligation, or subject to an existing obligation which he deliberately evaded or whose enforcement he deliberately frustrated by interposing a company under his control.

34 *Wildman, supra* note 33 above.


exposure of their financial possession in matrimonial claims, the corporate veil must be pierced.

As previously mentioned, the focus of this paper is on only one of the veil piercing factors which some courts claim they consider significant in determining liability: the undercapitalization factor. The majority of cases discussed in this thesis reveal that courts do not generally consider undercapitalization to be an independent basis for shareholder liability. This paper asserts that undercapitalization alone is sufficient grounds to pierce the veil and hold shareholders liable to other stakeholders. To explain why this is the case, the next chapter will first explore the origins of limited liability.

Despite the fact that limited liability is a well-established doctrine, history reveals that it was met with discontent for several valid reasons. Lord Curriehill sought to criticize the development of limited liability as an investment incentive that makes way for misconduct and which releases investors from taking responsibility for their actions. For a very long time business was successfully conducted through partnership associations which made all investors personally liable for the company’s financial responsibilities. The following chapter reveals the historical controversy surrounding the rise of the limited liability company. This will help to illustrate how the incentive to undercapitalize corporations began.
Chapter 3
Early Rise of the Limited Liability Company

Historically, before the landmark case of *Salomon v Salomon*\(^{37}\) which involved a small one-man company, limited liability developed and was justified in the context of large corporations where the shareholders were passive investors, separate from the managers of the corporation.\(^{38}\) However, in private corporations the owners could operate closely with management and could have a much greater incentive to undercapitalize.\(^{39}\) Before examining the problems associated with private companies and shareholder’s incentive to undercapitalize the corporation, it is necessary to explore the historical significance of limited liability. An exploration of the historical development of limited liability will reveal some challenges that were faced with the rule as it developed, as well as some problems it created for certain members of society.

\(^{37}\) *Salomon, supra* note 2.


\(^{39}\) *Ibid.* at 600. See also *DeWitt Truck Brothers, supra* note 17 at 685 where the court Justice Donald Russell stated that “one fact which all the authorities consider significant in the inquiry, and particularly so in the case of the one-man or closely-held corporation, is whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking.” The following cases were listed: *Anderson v. Abbott*, 321 US 349 at 362 (1944); *Stone v. Eacho*, 127 F (2d) at 288 (1942); *Luckenback S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir 1920), 254 US 644, 41 S Ct 14, 65 L Ed 454; *Francis O. Day Co. v. Shapiro*, 105 US App DC 392 (1959), 267 F (2d) 669 at 673; *Arnold v. Phillips*, 117 F (2d) 497 (5th Cir 1941), 502, cert. denied, 313 US 583, 61 S Ct 1102, 85 L Ed 1539 (1940); *Puamier v. Barge BT*, 395 F Supp. at 1039, n. 10 (1793); *Mull v. Colt Co.*, 31 FRD 154 at 163 (SDNY 1962); *Kilpatrick Bros., Inc. v. Poynter*, 205 Kan 787 (1970), 473 P (2d) 33 at 40; *North Arlington Med. Bldg., Inc. v. Sanchez Const. Co.*, 86 Nev 515 (1970), 471 P (2d) 240 at 244; *Automotriz Del Golfo De Cal. v. Resnick*, 47 Cal (2d) 792 (1957), 306 P (2d) 1, 63 ALR (2d) 1042 at 1048.
This chapter traces the rise of the limited liability company in Britain, where the development of the industrial revolution began. Before the rise of the limited liability company, the usual form of conducting business was through partnership associations. According to Lord Curriehill, the economic justification for the law of partnership was that in every case, individuals had access to the benefits of capital, and should therefore feel the burden of any debts.40

Before the landmark principle arose in the Salomon case, the position of the House of Lords was presented in the early case of Salmon v The Hamborough.41 There the House of Lords thought it proper to hold the shareholders liable for a company’s debts where the corporation had no common stock. The House of Lords said that the corporation had the right to assess its shareholders for the cost of the corporation’s payment of the plaintiff’s claim, and that if the corporation did not have the money, the creditor had the right to require the corporation to obtain it by taking such action.

During the nineteenth century the law of partnership with unlimited liability was regarded as natural and beneficent.42 In fact, many believed that the partnership structure for conducting business was the main reason for economic success in Britain, particularly because it allowed for free play of economic forces.43 As a result, “the growing number of companies created fears that the partnership by which the nation’s industrial supremacy  

41 Salmon v The Hamborough (1671), 1 Ch 204.
43 Ibid.
had been built was being side-lined.”\textsuperscript{44} Such a fact reveals that before the development of the corporate form, the law of partnership was a major contribution to the economic success of society,

According to J.R. McCulloch, there was no shifting or narrowing of responsibilities. Every man was personally answerable to the utmost extent for all his actions.\textsuperscript{45} To some, this was proper, but some investors found this approach to be economically unsound. The law of partnership with unlimited liability was seen as an unfair burden upon businessmen. As society began to accumulate greater wealth during the industrial revolution in Britain, the idea of limiting investor liability became the preferred method of business operation.

The rise of this corporate incentive was by no means widely accepted during the industrial revolution, and many people saw the underlying problems associated with this corporate privilege. While the principle of limited liability has its justification in the context of large public corporations\textsuperscript{46}, according to Paddy Ireland, “the corporate legal form as presently constituted is not an economic necessity, but a political construct developed to further the interests of particular groups.”\textsuperscript{47} These groups consisted of wealthy investors eager to protect their investments. There was no means of incorporation until 1844.\textsuperscript{48} In fact, prior to 1855, corporate investors, during the eighteenth and nineteenth centuries did not have

\textsuperscript{47} Paddy Ireland, \textit{supra} note 42 at 837.
\textsuperscript{48} \textit{Ibid.} at 837.
the ability to take advantage of limited liability in Britain.\textsuperscript{49} In 1855, the limited liability company began to rise to prevalence, although even then, the characteristics of a corporate entity could be obtained only by a special Act of Parliament or by a Charter granted from the Crown.\textsuperscript{50}

It is not possible to discuss the historical origins of limited liability without referencing the joint stock company. The joint stock company contained characteristics of both a partnership and a company.\textsuperscript{51} “It was a form of partnership made up of many persons acting under articles of association to carry on a particular business, and having a capital stock divided into shares transferrable at the pleasure of the holder, without the consent of the other members.”\textsuperscript{52} Like a corporation, “it merges in the artificial body and drowns in it the individual rights and liabilities of the members.”\textsuperscript{53}

Many public companies were joint stock companies. This form of company was considered to be necessary for economic growth and development in society. It was thought that it was necessary to have some form of legal framework by which passive investors could invest their funds without fear of personal liability or inefficient management. The main distinguishing feature of the joint stock company from the partnership was the ability of

\textsuperscript{49} Ibid.
\textsuperscript{51} Charles Elliott, \textit{A Treatise on the Law of Private Corporations}, 5\textsuperscript{th} ed (Indianapolis: The Bobbs-Merrill Company, 1911) at §20.
\textsuperscript{53} \textit{People v Coleman}, 133 NY 279, 31 NE 96; see also Charles Elliott, \textit{supra} note 51 at §20.
members to dispose of their shares without receiving the consent of the others concerned.\textsuperscript{54}

This type of association attracted many investors who were more or less passive investors and not so much involved in the management of the business. Although eventually the joint stock company became a popular form of business operation, it did not rise to dominate the industrial economy as quickly.

While the joint stock company provided more efficient and investor friendly business operations, it also encouraged undesirable business practices. For example, the South Sea Company was established in 1711 as a way of reducing the cost of national debt in Britain at the time. It was considered to be a turning point in the history of British corporations.\textsuperscript{55}

However, when the Bubble burst and the stock market collapsed, it was considered to be one of the worst financial crashes in world history.\textsuperscript{56} Robert Wernick neatly summed up the events surrounding the bursting of the bubble:

\begin{quote}
The collapse of the South Sea stock led to a collapse of all credit. By October it was clear that a financial crisis had engulfed England. No one wanted paper any more. The real estate market collapsed. Unemployment, especially in the luxury trades, spread. So did bankruptcies. The government fell….. Everyone who had had any dealings with the South Sea Company, and that meant almost every one of consequence in Great Britain, was in a rage and a financial fix.\textsuperscript{57}
\end{quote}

It is believed that stock-jobbing, which involves the purchase and sale of securities in hopes of gaining quick profits, was the sole and sufficient explanation for the financial disaster that took place, and also the reason for the enactment of the Bubble Act that followed the

\begin{flushright}\textsuperscript{54} Paddy Ireland, \textit{supra} note 38 at 240. \\
\textsuperscript{55} Ron Harris, “The Bubble Act: Its Passage and its Effects on Business Organization” (1994) 54:3 The J of Economic History 610 at 611. \\
\textsuperscript{56} \textit{Ibid.} at 610. \\
\textsuperscript{57} Robert Wernick, “When the Bubble Burst, all of England Wound up Broke” (1989) 20:9 Smithsonian 155. \end{flushright}
collapse of the South Sea company. As pointed out, “resolutions were passed to the effect that the calamity was mainly owing to the vile arts of stock jobbers, and that nothing could tend more to the re-establishment of public credit than a law to prevent the infamous practice.”

The 1720 Bubble Act helped to shed light on the type of unfortunate business practices that the corporate form was causing. The Act has been described as “a response to a stock market scandal” and the “efforts of a panic-stricken Parliament to check the evils of frenzied finance.” It was established to prohibit corporate fraud and to prevent joint stock companies from operating without a Charter from the Crown. Hence, all joint stock companies not incorporated by royal charter from the Crown were considered as partnerships with all of the legal principles applicable to partnerships.

The Act was later repealed and replaced by the Companies Act of 1844, because wealthy businessmen became desperate to protect their investments and have influence on the political structure of society, to move in the direction of allowing complete freedom to incorporate with the privilege of limited liability. It was then that Britain saw the ‘rise to dominance’ of the joint stock company with its incorporation structure and limited

58 Ron Harris, supra note 55 at 611.
60 Bubble Act 1720 (UK), 6 Geo I, c 18.
63 Paddy Ireland, supra note 38 at 240.
64 Paddy Ireland, supra note 42.
65 Paddy Ireland, supra note 42 at 838.
liability privilege. Many early commentators believe that until British law provided the type of legal framework and incentives that the joint stock company required, full economic development was impossible.\(^6^6\) In other words, the formation of the corporation and its legal personality was believed to be inevitable.

This use of ‘economic necessity’ as an attempt to justify the rise of the corporate legal form during the eighteenth and nineteenth centuries is sharply criticized by other scholars. As Paddy Ireland observes, “the triumph of the corporate legal form was more the product of the growing political power and needs of *rentier* investors than it was of economic imperatives.”\(^6^7\) In other words, he argues that the corporate legal form was a political construct used to further the interests of particular groups in society, and such a construct has institutionalised corporate irresponsibility.\(^6^8\) Taylor agreed when he asserted that rather than sharing middle class virtues, joint stock companies were known to share the vices of the ruling elite.\(^6^9\)

In his book, Jefferys also pointed out that “the main driver of reform favouring incorporation was the growing demand of *rentier* investors in London and other commercial centres for new investment outlets. Frustrated investors were the chief instigators of the limited liability legislation”.\(^7^0\) It is clear that the fight for, and support of the limited liability legislation by investors was self-interest, without any concern for its

\(^{67}\) Paddy Ireland, *supra* note 42 at 838.
\(^{68}\) Ibid.
\(^{69}\) James Taylor, *supra* note 44 at 33.
impact on members of the general public. While companies are not generally responsible for the interest of the public as a whole, they should be, as supported by corporate social responsibility and the stakeholder theory, discussed in Chapter 4.

As wealth began to increase in the economy, investors needed to find ways to protect their assets when making lucrative investments. Some wealthy investors took it upon themselves to abuse corporate privileges that were supposed to be properly controlled by the state.\(^ {71} \) These business men acted as though they were entitled to such powers.\(^ {72} \) Perhaps the joint stock company created more than an economic incentive, but provided an avenue by which wealthy investors could conduct fraudulent practices to the detriment of creditors without being personally liable for their actions. James Taylor agreed with this reasoning when he stated that “immoral corporate behaviour was made possible by the absence of the individual responsibility of directors and shareholders for their actions in their corporate capacity.”\(^ {73} \) It is my contention that the law of partnership forced investors to be responsible for their actions. With the development of the limited liability company, responsible investment has been undermined since the personal assets of shareholders are secured.

As the number of joint stock companies in Britain increased, legal, economic, political, and moral issues regarding the growth of the corporate legal form became commonplace.\(^ {74} \) The joint stock company and its limited liability incentive was opposed by many. In 1855, English barrister and publisher, Edward Cox, wrote an article in The Law Times. He stated:

---

\(^{71} \) James Taylor, *supra* not 44 at 8.

\(^{72} \) *Ibid.*

\(^{73} \) James Taylor, *supra* note 44 at 30.

\(^{74} \) *Ibid.* at 8.
The law of partnership had been: … that he who acts through an agent should be responsible for his agent's acts, and that he who shares the profits of an enterprise ought also to be subject to its losses; that there is a moral obligation, which it is the duty of the laws of a civilised nation to enforce, to pay debts, perform contracts and make reparation for wrongs. Limited liability is founded on the opposite principle and permits a man to avail himself of acts if advantageous to him, and not to be responsible for them if they should be disadvantageous; it allows him to speculate for profits without being liable for losses; to make contracts, incur debts, and commit wrongs, it deprives the creditor, the contractor, and the injured of a remedy against the property or person of the wrongdoer, beyond the limit, however small, at which it may please him to determine his own liability.  

Edward Cox was one of many persons who questioned the legitimacy of the limited liability principle as it relates to its impact on stakeholders and society as a whole. The responsibility of transacting fairly with stakeholders such as creditors was the main concern of the development of the limited liability company.  

During the early 1850s, a Royal Commission was established upon which Lord Curriehill, along with Mr Slater, led for the opposition in the debates about partnerships and joint stock companies. While Paddy Ireland posited that the corporate legal form was not really an economic necessity, Lord Curriehill sought to justify unlimited liability on the basis of the natural justice of individual responsibility.  

If an individual, besides making ready money purchases of goods to the extent of input capital, were to make further purchases on credit; and if these goods were received and used and disposed of by him or for his behoof, he could not be permitted without manifest injustice to claim freedom from his personal liability for

---

payment of the goods so purchased by him on credit, unless he had clearly bargained with the creditor for such freedom.\textsuperscript{77}

Despite the benefits it provided for investors, Lord Curriehill realized the implications it transfers to individuals of society. Basically, unlimited liability, because of the responsibility it placed on investors, discouraged improper business practices. Put another way, investors would not take part in illicit activities that would put all of their personal assets at risk.

Joint stock companies were criticized as being very inefficient because they separated ownership and management.\textsuperscript{78} Adam Smith who thought so, however, believed that where the capital required in an industry was beyond what could be collected into a partnership, and where the risks were great, and where there was an identifiable public interest, the privilege of limited liability should be granted to joint stock companies. Certainly, large public companies would generate large amounts of capital because of the large number of individuals who purchase shares in them. However, at some point during the industrial revolution this was not the case, as large amounts of funds were needed for large infrastructure and developments that were taking place. Some investors were not willing to invest large portions of their funds to bear huge risks, and this was a legitimate reason for not doing so. Nonetheless, the changes in infrastructure and the increase in production

\textsuperscript{77} Ibid.

“made necessary the creation of a well-organized” industrial system.\(^7^9\) The joint stock companies generated large amounts of funds from its pooled investments.

With respect to small private companies where the number of persons contributing capital is not so great, and the shareholders would likely form part of management, it is easy to understand why private companies are more prone to capital inadequacy. This is why limited liability was looked upon as a “dangerous, un-English doctrine.”\(^8^0\) Close private corporations, as this paper illustrates, are more likely to be illegitimately utilized than public companies. Empirical evidence can show that the majority of veil piercing cases involve private companies.\(^8^1\)

In 1896 when the House of Lords decided *Salomon*\(^8^2\) it stirred discontent for many. In fact, in 1897 when the Lord Select Committee consisting of three judges involved in the *Salomon* appeal case came together to consider the Companies Bill, Lord Lindley expressed his frustration with the law as it was after *Salomon*.\(^8^3\) His view, which seems logical, is that to allow an individual with complete control over his business to trade with limited liability was a “dangerous idea” given his “enormous power” and very small risk.\(^8^4\)

---


\(^8^0\) James Taylor, *supra* note 44 at 7.


\(^8^2\) *Salomon, supra*, note 2.

\(^8^3\) Geoffrey Kay & James Mott, “Notes on the Law of Capital”, online: [https://kar.kent.ac.uk/1940/1/201305031110.pdf](https://kar.kent.ac.uk/1940/1/201305031110.pdf).

\(^8^4\) Ibid.
The Bill ordered a copy of a Company’s balance sheet to be filed with the Registrar for public inspection.\textsuperscript{85}

At this time, however, those in favour of limited liability opposed public disclosure of the financial affairs of private companies, arguing that this would hinder many small private companies from incorporating. This publicity, according to Kay and Mott, was imposed in the interest of both shareholders and creditors. By 1899, the Companies Bill was amended to no longer require the disclosure of the balance sheets of private companies. Perhaps this was another influence of the \textit{rentier} investors who wanted to keep their corporate activities private.\textsuperscript{86}

Consequently, the Companies Act of 1900 required only public companies to disclose financial information to the Registrar. If private companies then, and now, were obligated to disclose their financial records, more instances of insufficient corporate funds would perhaps be disclosed. History reveals, however, that when private companies became authorised by the Companies Act and when the landmark \textit{Salomon} case legitimised small companies (including one-man companies) based on the legislature’s intention, the number of joint stock public companies existing in Britain decreased dramatically. This is because business investors preferred the privacy of corporate financial statements and other information afforded to private companies.

By the 1900s, limited liability companies became commonplace. It required no obligation or responsibility from shareholders for adequate capital contributions. The exception to this

\textsuperscript{85} \textit{Ibid.}

\textsuperscript{86} Investor privacy can encourage illicit activities and make it difficult to impose personal liability for improper conduct, ie. offshore companies.
was the obligation of some public companies. Shareholders had little financial incentive to ensure that managers behave legally, ethically, or decently since they were viewed as personally untouchable. Lord Curriehill’s reasoning of the ‘worst effect’ of limited liability is the stimulus it can give to excessive speculation. Since capital itself is the source of surplus, the advance of capital, without direct control, is a direct invitation to speculation. His belief as he declared, was that-

Prudent investors might reckon it too dearly bought, by surrendering the right of taking part in the management and control of their own business, to the speculative classes…enabled to acquire this privilege by merely contributing a small portion of their means…and so indulge their spirit of adventure without endangering the remainder of their fortunes, - this would prove an irresistible temptation.

Obviously, due to the small sum contributed as investment, all economic risks shifted to the corporation’s creditors. Regardless of any degree of economic efficiency that limited liability provides for investors and society, this practice, as Lord Curriehill would agree, cannot in any way be justified as morally correct.

In sum, the limited liability company slowly rose to dominance. This was particularly because, before its emergence, the partnership association had taken the stage on the accepted, legitimate form of conducting business. It is clear that the departure from partnership principles was mostly aimed at accommodating and protecting the rentier joint stock company shareholder. The limited liability principle was widely accepted by many,

---

88 Royal Commission, *supra* note 40 at 17.
89 *Ibid*.
90 *Ibid* at 18.
91 Paddy Ireland, *supra* note 42.
as it still is today. However, as history reveals, many others rejected it because of its immoral and unjust nature. For example, James Taylor stated: “It is an unjustifiable redistribution of rights from creditors to shareholders, and prevents businessmen from learning from their mistakes.”\textsuperscript{92} As a result, there is a need to protect the interests of creditors and other corporate stakeholders. The next chapter discusses theoretical concepts in support of the need to protect stakeholder interests, including the recent development of corporate social responsibility. In addition to this, it illustrates the importance of stakeholders and examine the duty that institutions owe to society in general.

\textsuperscript{92} James Taylor, \textit{supra} note 44 at 31
Chapter 4
A Need to Protect Corporate Stakeholders

4.1 Introduction

Put bluntly, conventional shareholder value thinking is a mistake for most firms—and a big mistake at that. Shareholder value thinking causes corporate managers to focus myopically on short-term earnings report at the expense of long term performance; discourages investment and innovation; harms employees, customers, and communities; and causes companies to indulge in reckless, sociopathic, and socially irresponsible behaviours. It threatens the welfare of consumers, employees, communities, and investors alike.93

As explained in Chapter 3, the limited liability company did not rise to dominance without controversy or criticism, and there were legitimate reasons for the criticisms. Nevertheless, it is the most dominant corporate structure today, and remains as criticized as it was then. The selfish desire for wealth gain on the part of corporate investors has led to unfortunate circumstances for stakeholders. This chapter discusses the reasons why corporations and their shareholders and managers must be more concerned for the interests of stakeholders. Understanding the reasons for this facilitate appreciation for why capital deficiency is a critical issue necessitating resort to the equitable remedy of veil piercing. In raising this discussion, a few things must be remembered. First, while both shareholders and debtholders are known to “capitalize” companies, it is the shareholders who participate in unlimited upside risk unlike debtholders, whose upside is generally limited by the contractual terms of the debt.

It is true that corporations obtain their status through the law as summed up by Chief Justice Marshall in *Trustees of Dartmouth College v. Woodward*.94

_The corporation is an artificial being, invisible, intangible, and existing only in contemplation of law._

As a result, justice should not be expected from corporations95 because they have “neither a soul to lose nor a body to kick.”96 It is therefore the shareholders, directors, and managers who ought to be responsible for the interest of stakeholders who are associated with companies. While the status of a corporation is justified by law, it is “flesh and blood people” who “underlie every corporation and are essential to everything a corporation does.”97 This is because corporations have no arms, legs, mouth, or eyes, and shareholders will reap any profits earned by the corporation, while others stakeholders must ultimately bear any loss.98 Any discussion of the duty of corporations must therefore be viewed in the context of its ‘flesh and blood people’.

The discussion below first examines the shareholder wealth maximization theory with the goal of showing how the rights of stakeholders are made insignificant in the face of the belief that the purpose of corporations is to maximize only shareholder wealth. It is often said that the principle of limited liability has moral justification and economic benefits in the fields of corporate law and economics. But at the same time, there must be a way to capture the benefits of limited liability, while curtailing its negative effects on corporate creditors and stakeholders.99 Under the CBCA, principles of corporate governance

---

95 Robert Hamilton, *supra* note 3 at 980.
generally include the duty of directors to act honestly and in good faith with a view to the best interest of the corporation. Another duty of directors is to maximize the wealth of shareholders who transact with companies by making investments in exchange for shares. Understanding the shareholder wealth maximization theory will help to illustrate that there is a lack of concern for corporate stakeholders. It will further illustrate why the interest of stakeholders and society as a whole should be considered as important as the interests of shareholders.

Second, it is argued that the limitation of shareholder liability creates increased incentives for shareholders to externalize risks to stakeholders. The analysis of this point is subsequently followed by showing that corporations do not possess only economic duties, but that they also owe moral, social, and ethical responsibilities to society. Thus, when corporations are unable to fulfil these duties, shareholders and directors ought to be held responsible. To illustrate this point, this chapter will show how shareholders use the limited liability privilege as a way to externalize risks to stakeholders. John Rawls’ theory of justice, along with the underlying principles of corporate social responsibility, are also discussed. These theories build understanding of the notion of stakeholder interest. Particularly, the theories support the need to show concern for both shareholder and non-shareholder constituents of corporations. The discussion then examines the four social responsibilities that have developed.

Lastly, the chapter concludes by showing how subordinating shareholder claims is one way of illustrating the importance of stakeholder protection, specifically where corporations are

---

100 CBCA, *supra* note 1 at s 122.
poorly capitalized. More specifically, it examines the rationale of the ‘Deep Rock Doctrine.’ Overall, this chapter proves that the interests of other corporate stakeholders are just as important as the interests of corporate shareholders. For this reason, shareholders must be mandated to exercise even-handed conduct in their association with corporations.

4.2 The Shareholder Wealth Maximization Theory

Due to the rise in capital markets and investments, and the increased importance of issues regarding corporate governance, the shareholder wealth maximization theory has gained much recognition in the modern corporate world. This theory posits that the purpose of the corporation is to realize the specified ends of shareholders, with the caveat that those ends are legal and basically non-deceptive.\textsuperscript{101} The purpose of those ends are mainly always to maximise profit,\textsuperscript{102} which in turn would generate more dividends for shareholders.

The theory reflects the concept that in carrying out their fiduciary duties, directors ought to act in the best interest of shareholders in a way that will maximize the value of their shares. The relationship between directors and shareholders under this theory can be likened to the relationship between parents and their children. Just as parents consider what would be best for their children when making life decisions, directors ought to consider the effects of their decisions on shareholders. Under this theory, companies are profit making institutions purposed for securing investments and increasing wealth through directors who control their operations.


\textsuperscript{102} Ibid.
Professor Stephen Bainbridge has sought to identify the theory as having two limbs. These are that (1) the object of the corporation should be to maximize shareholder wealth and that (2) shareholders should have ultimate control of the corporation.\(^{103}\) This theory suggests that directors of a corporation are responsible to accomplish only one goal, a financial goal that would benefit share owners. In most cases, however, the directors of private corporations are also shareholders of that corporation. In essence, Bainbridge’s theory posits that shareholders ought to be concerned for one thing, that is, to increase their own finances. This is particularly true in the case of private companies as oppose to public companies.

Shareholder wealth maximization is usually a major concern in the fight for corporate control concerning takeover bids in public companies. However, this core, underlying principle can sometimes lead to problems in private companies, such as the concealment of corporate funds to avoid liability, or even the concern of some shareholders receiving more dividends than they are supposed to. In the landmark Canadian Supreme Court decision of *BCE v 1976 Debentureholders*\(^ {104}\), the court notes that the corporation and shareholders are entitled to maximize profit and the value of shares, but not by treating individual stakeholders unfairly. It said that fair treatment is fundamentally what stakeholders are entitled to reasonably expect.

Although the case concerns the action of debenture holders who sought relief under the oppression remedy of s. 241 of the CBCA, the court was generally concerned for the

---


\(^{104}\) *BCE v 1976 Debentureholders*, 2008 SCC 69. See generally.
interest of stakeholders and not just debenture holders. The Supreme Court asserted that stakeholders must be treated fairly and in line with the corporation’s duties as a responsible corporate citizen. One of the main purposes of the corporate legal form is to financially reward its share owners; the practical and theoretical notion of wealth maximization must not be used to disregard the interest of other stakeholders and the community as a whole.

As a nexus of contracts, a corporation transacts with several classes of patrons, namely shareholders, creditors, employees, customers, and suppliers. These other patrons must not, in fairness, be denied a reasonable level of protection for their engagement with corporations just so that shareholders’ wealth can be increased. This means that shareholders and directors must be more concerned for the interests of corporate stakeholders. Shareholders are often considered the owners of corporations since they make equity investments to the corporation’s capital fund and receive dividends. It is important to remember, however, that a company is, by law, separate and distinct from its shareholders.

The importance of other stakeholders, however, has been downplayed. Some of the reasons put forward as to why the interests of stakeholders ought to be modulated against those of shareholders are questionable. This is because the business corporation is an economic institution that has both a social service and a profit making function. However, as Canadian Professor Joel Bakan has argued, the legal imperative to maximize profits makes...

---

105 Ibid. at paras 82.
106 Mark Van Der Weide, “Against Fiduciary Duties to Other Stakeholders” (1996) 21 Del J Corp L 27 at 34.
107 E. Merrick Dodd, “For Whom Are Corporate Managers Trustees?” (1932) 45 Harv L Rev 1148 at 1148.
corporate actors act like psychopaths,\textsuperscript{108} without any consideration for the needs of other corporate contributors.

Traditionally, the concept of shareholder primacy is often said to be justified because shareholders are the owners of corporations. However, from a legal perspective shareholders are not the owners of corporations.\textsuperscript{109} Professor Bainbridge states:

Contractarians reject the idea that the firm is a thing capable of being owned. . . . Someone owns each of [the various factors of production in the corporation], but no one owns the nexus itself. To be sure, most theories of the firm agree, shareholders own the residual claim on the corporation’s assets and earnings. . . . Yet, ownership of the residual claim is not the same as ownership of the firm itself.\textsuperscript{110}

Shareholders own shares of stock through contractual relations with the corporation.\textsuperscript{111} Since corporations cannot finance themselves to conduct business, shareholders are responsible for doing so. However, they are no different from employees, suppliers, and other stakeholders, as they all have contractual relationships with the corporation.\textsuperscript{112} Because shareholders often defend their actions through their rights under the law, it is important to reinforce that, by law, shareholders do not own corporations.

A corporation is considered a nexus of contracts incapable of being owned.\textsuperscript{113} Progressive law scholars agree that shareholders have no special status in corporations, which lead to

\begin{thebibliography}{9}
\bibitem{109} Lynn Stout, \textit{supra} note 93 at 37.
\bibitem{111} \textit{Ibid}.
\bibitem{112} Lynn Stout, \textit{supra} note 93 at 37.
\bibitem{113} Julian Velasco, \textit{supra} note 110 at 897.
\end{thebibliography}
the conclusion that corporations must not operate in the interests of shareholders alone, but rather in the interests of society as a whole.\textsuperscript{114} As a matter of fact, shareholders do not even control the management of companies, unless they are also directors. The power to direct the corporation and control its assets belongs to the directors.\textsuperscript{115} They contain no special role in the corporation, and their rights, like everyone else, are limited to those provided by contract.\textsuperscript{116} Velasco’s view is contrary to this position. His belief is that, to rely on the nexus of contract theory alone complicates matters.\textsuperscript{117} He states further:

\begin{quote}
If a nexus of contracts is not capable of being owned, and every business is a nexus of contracts, then no business is capable of being owned—not even a sole proprietorship. This is clearly wrong. Thus, we may conclude that the contractarian claim about corporate ownership is wrong (or at least unfounded).\textsuperscript{118}
\end{quote}

Velasco failed to consider that by law, a sole proprietorship has no separate legal personality. The sole owner is fully liable for all debts and liabilities incurred during the operation of business. Limited liability companies, on the other hand, are separate and distinct from the shareholders who invest in them. Of course, however, in small closely held corporations, shareholders, like directors may possess complete control of corporations. Nevertheless, by law companies are identified as legal persons. As a result, there are a number of reasons why it is important to protect the interests of other stakeholders. For one, limited liability encourages shareholders to externalize risks. When

\begin{itemize}
\item \textsuperscript{114} Ibid. at 899.
\item \textsuperscript{115} Ibid. at 908.
\item \textsuperscript{116} Ibid.
\item \textsuperscript{117} Ibid. at 922.
\item \textsuperscript{118} Ibid.
\end{itemize}
this happens, the loss to be incurred from any chances of business failure will fall heavily on stakeholders.

4.3 The Incentive to Externalize Unnecessary Risks to Stakeholders

According to Mark Van Der Weide, equity investments are more vulnerable than the investments of other stakeholders. In his view, the investments of stockholders are completely at risk, unlike those of employees and suppliers. Since equity investments are not tied to specific firm assets, shareholders would find it difficult to devise contractual safeguards to protect their investments.

However, Van Der Weide’s view fails to acknowledge the incentive afforded to shareholders when they invest in companies. Not only do shareholders only risk the amount paid on their shares, there are also no regulations on the amount of equity capital a private company must maintain to commence operation. Their personal assets are secure. With this freedom, shareholders are allowed to risk the least amount of funds in a corporation, with the chances of reaping great benefits, sometimes at the expense of other stakeholders.

Van Der Weide also fails to identify the proportion of assets constituting shareholder equity. For example, it is important to determine how much of the total equity investment was advanced and not risked unconditionally to the corporation, as the risk to corporate

---

119 Mark Van Der Weide, supra note 106 at 36.
120 Ibid.
creditors is greatly increased where there is a relatively high debt to equity ratio.\textsuperscript{123} The following are said to be factors in balancing the debt and equity ratio\textsuperscript{124}:

1. The size of the initial debt burden which must not be so large as to preclude the possibility of obtaining credit in the future;
2. The views of investors as to what constitutes an optimum capitalization; and
3. Generally the current fashion and, more particularly, the economic climate of the time.

In ‘The Economic Structure of Corporate Law’, Easterbrook and Fischel sought to explain the rationale of limited liability and its benefits not only to shareholders, but also to an economy. They admit that while limited liability affords investors great benefits, it also increases the probability that there will be insufficient assets to pay creditors’ claims. \textsuperscript{125}

They stated:

\begin{quote}
\ldots sharehold\textbf{ers} of a firm reap all of the benefits of risky activities but do not bear all of the costs. These are borne in part by creditors. Critics of limited liability have focused on this moral hazard, the incentive created by limited liability to transfer the cost of risky
\end{quote}

\textsuperscript{123} \textit{Ibid} at 843. Robert Dye provided the following example:

\begin{quote}
\ldots suppose a corporation is being formed for which an initial capitalization of $100,000 would be reasonable. If this corporation were financed in such a way that the shareholders advanced $75,000 in equity and $25,000 in the form of loans, corporate creditors would be much safer than if the corporation was working with the same $100,000, but only $25,000 was advanced as equity and $75,000 had been advanced by the shareholders in the form of loans. Even though in both cases the corporation has total assets of $100,000, the capital structure under the latter arrangement provides $50,000 less unencumbered capital for payment of corporate creditors; the shareholder/creditor stands on equal footing with the corporate creditor after the first $25,000 is depleted.
\end{quote}


\textsuperscript{125} Frank Easterbrook & Daniel Fischel, \textit{supra} note 12 at 49.
activities to creditors as a justification for substantial modification of the doctrine.

Easterbrook and Fischel believe that modifying limited liability has costs, and moral hazards would still exist without limited liability. The argument of this thesis is not to abolish limited liability. However, increased moral hazards arise from the privilege of limited liability. The argument is that whether moral hazards would exist without limited liability or not, risk externalities passed from shareholders to other stakeholders cannot be justified. Stakeholders must be protected from risk externalities which have the tendency to impose social costs.\textsuperscript{126}

It is submitted that whether moral hazard would still exist, and whether or not the investments of shareholders are declared vulnerable, risk hazards which should be borne by the shareholders of companies are wrongly transferred to other stakeholders. It seems that stakeholder claimants should not be forced to bear the burden of externalized risk taking, given that the probability that a corporation would not have sufficient funds to compensate for all losses is real, just as it is the case that the liability of shareholders are already limited. Contributions of risk capital to respond to the corporation’s debts are the required consideration for a stockholder’s personal immunity.\textsuperscript{127} As Robert Dye confirms, limited liability must be purchased by corporate shareholders.....the purchase price is

\textsuperscript{126} \textit{Ibid.} at 50. See also Johnathan Landers, \textit{supra} note 121 at 592-593.

adequate risk capital. Shareholders can externalize risks to stakeholders in many ways. One way is by undercapitalizing corporations.

In “Director’s Liability to Creditors-What are the Alternatives?” Helen Anderson considered that the limited liability privilege can be easily stripped from some shareholders, particularly holding companies. She considered whether the privilege of limited liability should be withdrawn from shareholders of small, undercapitalized companies, where the temptation to use the corporate form to defeat the claims of creditors is most prevalent. She highlighted that the directors in these private companies are usually the principal shareholders, who do not fear losing their positions. The problem is that shareholders do not always consider the impact of their actions on creditors and other stakeholders. Maurice Dix explained:

Stockholder contribution of risk capital adequate to make the corporation self-sufficient is the fundamental conception at the basis of the corporate cover for stockholder's individual liability. It is not unreasonable. It is moral.

Whether courts want to admit it or not, adequate capitalization is not only a legal issue, it has ethical connotations as well. Risk externalization is, indeed, a major problem among investors in private companies. This immoral behavior, as Maurice Dix would agree, is unacceptable and demonstrates a lack of financial responsibility to stakeholders. When shareholders are allowed to limit their risks by contributing nominal amount of funds to a corporation in addition to the limited liability privilege already afforded to them, it

---

128 Robert Dye, supra note 122 at 834.
130 Ibid at 17.
131 Maurice Dix, supra note 127 at 483.
demonstrates a lack of corporate ethics toward other corporate stakeholders and society as a whole.\(^{132}\)

Undercapitalization without shareholder responsibility reduces the chances of receiving any compensation from the corporation if serious injuries are incurred on corporate premises. For small creditors transacting in good faith, the chances of receiving the total cost of goods and labour provided to the corporation are also reduced. For these reasons, the law should provide a level of protection to other stakeholders on the grounds of public policy.

4.4 The Social, Moral, and Ethical Responsibility of Companies and Shareholders

Stakeholders are known as persons who hold a stake in a company, and include creditors, employees, suppliers, customers, and the local community.\(^{133}\) Since corporations are social institutions in constant interaction with the general public, this fact alone develops the need to be concerned for stakeholder interest. Institutions become successful because of the investments that are made in it by stakeholders. Without suppliers, employees, creditors, and customers, there can be no successful business corporation, unless such a corporation was established for an illegitimate purpose. Generally, any discussion about the need for corporations to be concerned for the interests of stakeholders actually refers to their

\(^{132}\) Philippe Salomon, “Limited Limited Liability: A Definitive Judicial Standard for the Inadequate Capitalization Problem” (1973) 47:2 Temp L Rev 321 at 341 where Salomon affirmed that when shareholders fail to adequately capitalize their corporation: 

….such a scheme would permit them to gain everything, risking nothing while shifting the entire risk to the innocent, injured party who acquired no benefit whatsoever. This result defeats the inherent concept of the corporate entity and the underlying concept policy of limited liability.

corporate actors (ie. shareholders and directors) to be of such concern. Shareholders are the ones contributing capital to establish the business, and the directors (usually the shareholders in private companies) are the ones directing its management and controlling its finances.

While a legal person by law, a corporation does not have a mind of its own. Therefore, when a corporation is unable to satisfy any claims brought against it, it is important for regulators to examine the conduct of shareholders and managers before allowing the principle of limited liability to prevail. In ‘Business Ethics’, Richard DeGeorge posits a viewpoint with which this thesis agrees:134

The differences between human individuals and corporations…. [are] significant from a moral point of view and from the point of view of moral responsibility. A corporation as such has no conscience, no feelings, no consciousness of its own. It has a conscience only to the extent that those who make it up act for it in such a way to evince something comparable to conscience. Because a corporation only acts through those who act for it, it is the latter who must assume moral responsibility for the corporation.

Whether we want to believe it or not, a corporation has more than a legal obligation to society. The fact that there are laws and regulations that govern society reflects that moral obligations exist. The recent development of corporate social responsibility argues that there is a moral and ethical responsibility that institutions owe to society. The ethical principle of corporate social responsibility is that management of a corporation should give concern to the interests of non-shareholder and shareholder constituencies.135 The law must

be concerned for the interest of corporate stakeholders for the benefit of the social and political structure of a well-organized society.\textsuperscript{136}

The political philosopher, John Rawls, developed a theory of justice known as ‘justice as fairness’. His work has been criticized by many scholars.\textsuperscript{137} Nonetheless, as an advocate of social justice that works to improve societal productivity, Rawls’ work is credible as it helps in many ways to justify corporate social responsibility. This is so, even though parts of Rawls’ theory can result in misconception if a thorough background of philosophy is not held by the reader. This paper will not provide a detailed account of Rawls’ theory of justice, but will generally utilize his account of the basic principles of justice which can be applied in any society.

According to Rawls, principles of justice provide a way of assigning rights and duties in the basic institutions of society and define the appropriate distribution of the benefits and burdens of social cooperation.\textsuperscript{138} He asserts that there are basic principles that free and rational persons concerned to further their own interests would accept in an initial position of equality as defining the fundamental terms of their association.\textsuperscript{139} The first of these principles requires equality in the assignment of basic rights and duties, while the second

\textsuperscript{137} His work is especially criticized for his view that the general consensus of members of society would result in a well-ordered society. For example, see Anthony J. Fejfar, “In Search of Reality: A Critical Realist Critique of John Rawls’ A Theory of Justice” (1990) 9 St Louis U Pub L Rev 227 at 310. Anthony argues that Rawls’ theory is fundamentally flawed because it assumes and promotes an idealist foundation horizon. He states further that the actual development or maintenance of a Rawlism just and well-ordered society is improbable if not impossible, since it would require a large portion of the population to develop and maintain a fully human critical moral conscience.
\textsuperscript{138} Ibid at 4. See also Thomas Scanlon, supra note 136 at 1021.
\textsuperscript{139} John Rawls, \textit{A Theory of Justice} (United States: Belknap, 1971) at 11.
holds that social and economic inequalities are just only if they result in compensating benefits for everyone, and in particular, for the least advantaged members of society.\textsuperscript{140}

Rawls defines a well-ordered society as follows:

Now let us say that a society is well-ordered when it is not only designed to advance the good of its members but when it is also effectively regulated by a public conception of justice. That is, it is a society in which (1) everyone accepts and knows that the others accept the same principles of justice, and (2) the basic social institutions generally satisfy and are generally known to satisfy these principles. In this case while men may put forth excessive demands on one another, they nevertheless acknowledge a common point of view from which their claims may be adjudicated. If men's inclination to self-interest makes their vigilance against one another necessary, their public sense of justice makes their secure association together possible. Among individuals with disparate aims and purposes a shared conception of justice establishes the bonds of civic friendship; the general desire for justice limits the pursuit of other ends. One may think of a public conception of justice as constituting the fundamental charter of a well-ordered human association.\textsuperscript{141}

The idea that social and economic inequalities can be justified only if they result in compensating benefits to individuals is critical. One can assume that the basic institutions referred to by Rawls in which rights and duties are assigned include corporations. This is simply because corporations play a major role in any society not only by contributing to its economic development, but also to its social structure. Economic inequalities are directly linked to the direct and indirect relationship that stakeholders have with corporate institutions. These inequalities are mostly, if not in all cases, due to limited liability and the separate legal structure of the corporation.

\textsuperscript{140} John Rawls, \textit{supra} note 139 at 14-15. See also Thomas Scanlon, \textit{supra} note 136 at 1072.

\textsuperscript{141} John Rawls, \textit{supra} note 139 at 4-5.
Rawls’ conception of a well-ordered society has a moral basis, but the idea is far-fetched. Everyone will never accept the same principles of justice or possess the same moral standards. For instance, when corporations are managed solely in the interest of shareholders, this will seem just to shareholders as an incentive for investing in a company. On the other hand, it will seem unfair to non-shareholders who possess an interest in the corporation. As Rawls highlighted, not only laws, institutions, and social systems are said to be just and unjust, but also particular actions of many kinds. These include decisions, judgments, and imputations.

Nevertheless, the primary subject of justice is the basic structure of society, or more exactly, the way in which the major social institutions distribute fundamental rights and duties, and determine the division of advantages from social cooperation. This is particularly important since the interest of corporate stakeholders, other than shareholders, can easily be overlooked. The justification for Rawls’ theory in general is evidenced in the increase of social awareness on the part of institutions. Corporate social responsibility is therefore a major area in this regard.

There is said to be no single generally accepted definition of corporate social responsibility, but the social element of it relates to the fact that corporations do not only serve as profit maximizing entities for investors. They also owe a level of responsibility to other stakeholders and society in general. Besides shareholders, stakeholders include consumers,

---

142 John Rawls, supra note 139 at 6.
143 Ibid.
144 Ibid. Rawls states further that the justice of a social scheme depends essentially on how fundamental rights and duties are assigned and on the economic opportunities and social conditions in the various sectors of society.
145 David Millon, supra note 135 at 919.
creditors, managers, and employees. Stakeholders have also been defined as affected persons, members, or different spheres of interest whose positions might be affected by the operation of companies from various social spheres, even if they do not exercise ownership rights in such companies. Since stakeholders are a part of the broader community, the stakeholder theory lends support to the notion of corporate social responsibility.

Recent developments in Canadian corporate law reveal that during insolvency, “the only constituency that can have a financially meaningful economic stake in a company is the creditors or, in extreme cases, some stratification of creditor.” Undercapitalization in fact, can increase the risk of corporate insolvency. In the Supreme Court of Quebec decision known as *Peoples Department Stores Ltd. (1992)*, Greenberg J held that when a company becomes insolvent, the creditors replace the shareholders as the true economic stakeholders and hence the directors have a duty under such circumstances to act in the best interest of the creditors. On appeal the Supreme Court of Canada held that directors do not owe a duty to creditors under s. 122 of the CBCA, but to the corporation as a whole. The corporation’s interests are not to be confused with the interests of creditors and other stakeholders. It is necessary to highlight that the court also reasoned that directors are entitled to consider the interests of more than just shareholders when making

---

152 *Peoples Department Stores Inc. (Trustee of) v. Wise*, 224 DLR (4th) 509 (Que CA) (2003).
decisions. The fact that directors do not owe a duty to shareholders but rather to the corporation as a whole, illustrates that the interests of other stakeholders are just as important as those of shareholders. Decisions made on behalf of the corporation affect not only shareholders, but all other corporate stakeholders.

The main concept of the stakeholder theory is that shareholders are not the only group with legal interests in a company.\textsuperscript{153} Since stakeholders collectively contribute to the corporation, they should see returns commensurate with their investments.\textsuperscript{154} This theory does not totally reject the shareholder wealth maximization idea\textsuperscript{155} that the corporation’s purpose is solely to increase shareholder wealth, which is what senior management is said to be responsible for doing. Rather, it attempts to provide a middle ground for the interests of both shareholders and other stakeholders. Stakeholders are classified as those individuals who benefit from and are harmed by corporate actions.\textsuperscript{156} This includes, for instance, judgement creditors who may be faced with an undercapitalized corporation that is unable to satisfy their claims.

Shareholders are said to have no special claim or corporate resources to alleviate human misery at the expense of shareholder interests.\textsuperscript{157} The two core questions that stem from this theory are: (1) what is the purpose of the firm/corporation? and (2) what responsibility

\begin{enumerate}
\item[154] \textit{Ibid} at 287
\item[155] \textit{Ibid} at 922.
\item[157] \textit{Ibid} at 553.
\end{enumerate}
do management/shareholders owe to stakeholders? In the context of this theory, these questions highlight that it is not just the interests of shareholders that are deemed important, but the interest of the corporation as a whole. Shareholders are important constituents and the making of profit is critical for any corporation. However, concern for profit is the result rather than the driver in the process of value creation. This is because although shareholders are the owners of the corporation, the ability to develop and value the relationship between the corporation and its stakeholders is an important aspect of the corporation’s growth and success.

As a social institution, the concern is that since so many persons other than shareholders contribute to the operation and success of a corporation, it is unreasonable and, perhaps, unacceptable to consider only the interests of shareholders. All stakeholders are important and contribute to the success of the corporation in question. For this reason, every legal system should have laws that not only subordinate the claims of shareholders to creditors during the winding up of a company, but also which enforce an ethical obligation on shareholders to acknowledge the interests of other stakeholders.

Similar to the stakeholder theory is a communitarian theory. This theory posits that the corporation owes a duty to a number of stakeholders, including bondholders, shareholders, creditors, suppliers, labourers, customers, the public, and even the environment. The theory conceives the corporation as a community of constituencies with directors owing duties to all stakeholders. This theory argues that corporate obligations should include ethical

---

159 Ibid at 364.
160 Jeffrey Bone, supra note 153 at 291.
aspects of protecting and enhancing the welfare of all corporate constituents. This way, it embraces the ideals of corporate social responsibility. ¹⁶¹

Today, a major theme in corporate social responsibility discussion concerns environmental sustainability, but corporate social responsibility also encompasses employment rights, ethical market issues, and responsible investments,¹⁶² all of which affect stakeholders.

Corporate wrongdoing has the potential to impact on the efficiency and development of the economy, and has repercussions that may be felt by the broader community including employees, creditors, customers and shareholders. In addition it has been suggested that corporate offenders have the tendency to 'erode the moral base of the law and provide an opportunity for other offenders to justify their misconduct'. For these reasons, it is important that corporate law provides appropriate incentives for compliance.¹⁶³

Removing corporate funds from a company for no legitimate purpose, or failing to provide the company with sufficient funds are corporate wrongdoings since they can negatively impact stakeholders. It is difficult to understand the injustice of undercapitalization when the focus is solely on the limited liability privilege and the separate legal form of a company permitted by law. However, the development of corporate social responsibility has at least helped to create awareness for corporate investors and directors to realize the importance of the interest of stakeholders and the general public on grounds of social justice. This is important for many reasons. For instance, among the many issues involved by corporate

¹⁶¹ Ibid at 291.
¹⁶² Helen Anderson, supra note 129 at 96.
¹⁶³ Ibid at 114.
social responsibility, the vulnerability of unsecured creditors at the time of insolvency of a company is often overlooked.\textsuperscript{164}

The development of the stakeholder theory was influenced by the work of R. Edward Freeman.\textsuperscript{165} Freeman’s work provides a moral and ethical basis for the theory. While the work of corporate social responsibility is mostly focused on community development and making impacts on the environment, its underlying rationale can help to identify the ethical duty of care that should be owed to shareholder and non-shareholder constituents of a corporation, as they form part of the wider community.

Similarly, Milton Friedman’s theoretical views on social responsibility have made an enormous impact in the field of corporate law and a huge impact on legal scholars. His views have given rise to numerous debates about shareholders and their duty to exercise social responsibility. According to Schaefer, Friedman implies that shareholders generally do not have a duty to ensure that the management of their corporations are exercising social responsibility\textsuperscript{166} in the nature of expending corporate resources for socially beneficial purposes, regardless of whether those expenditures are designed to help achieve the corporation’s financial ends.\textsuperscript{167} However they should make corporate funds available for community growth and enhancement. This should be so even though it is obvious that if a corporation’s funds are low, it would be more challenging for that corporation to make any contributions to its community. Whether generally accepted or not, shareholders should be

\textsuperscript{165}Edward Freeman, “A Stakeholder Theory of the Modern Corporation” (2001) 3 Perspectives in Business Ethics Sie 144.
\textsuperscript{166}Brian Schaefer, \textit{supra} note 101 at 297.
\textsuperscript{167}\textit{Ibid.}
made accountable to stakeholders in some cases from a moral and ethical standpoint. This thesis does not suggest that shareholders should be clothed with unlimited liability; however courts should be less reluctant to pierce the corporate veil for improper corporate conduct. Corporate social responsibility should, in fact, be an obligation for all corporations both public and private.

In the *Pyramid of Corporate Social Responsibility*, Archie Carroll suggested that there are four kinds of social responsibilities that constitute total corporate social responsibility. These are economic, legal, ethical, and philanthropic responsibilities.\(^{168}\) Section 4.5 will briefly discuss each of these suggested responsibilities in light of corporate social responsibility, and shows why they are important in the light of the interests of stakeholders.

### 4.5 Types of Social Responsibilities

#### 4.5.1 Economic Responsibility

A corporation was not always purposed as an institution designed to provide maximum profit to shareholders.\(^{169}\) Its main purpose was to provide goods and services to members of a society and to make an acceptable profit in the process.\(^{170}\) This view of the corporation has changed tremendously over time, as it is now accepted as a shareholder value maximization institution for protecting shareholder investments. As a result, the law on corporate undercapitalization is unsettled, as courts continue to grapple with this issue.

---


\(^{169}\) *Ibid.* at 40.

\(^{170}\) Archie Carroll, *supra* note 168 at 41.
Ballantine and other economic scholars, such as Easterbrook and Fischel, are of the view that while there are economic justifications for the limited liability privilege, the privilege should be monitored by the law to ensure that risks are not deliberately or unnecessarily passed on to creditors and other stakeholders. Easterbrook and Fischel argue that corporate shareholders tend to reap all the benefits of risky activities but do not bear all of the costs.\(^{171}\)

Ballantine states:

> It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and risks of loss, this is a ground for denying the separate entity privilege.\(^{172}\)

Empirical data confirm that inadequately financing a corporation increases the chances of that corporation’s failure. This also makes the corporation prone to experiencing cash flow deficiencies, as well as the usage of short-term, high-cost credit as funding sources.\(^{173}\)

While short-term credit will help to immediately finance the corporation, the long term effects can work to its disadvantage and the disadvantage of its creditors.

---

\(^{171}\) Easterbrook and Fischel, *supra* note 14 at 104.

\(^{172}\) Henry Ballantine, *Ballantine on Corporations* (Callaghan & Co, 1946). See also CED 4th (online), *Business Corporations* (Ont), “Creation and Issue of Shares” v4 at §339, where it states that “for many years, the prevailing law was that the power of the directors to issue shares was limited, so that it might be used only for a capital-related purpose, such as raising the capital reasonably required by the corporation in order to carry out its objects.”

Ribstein acknowledges three reasons why shareholders may have an incentive to adequately capitalize and insure their corporations\textsuperscript{174} to avoid these long term effects: (1) Owners of closely held firms will have incentives to insure against personal tort liabilities arising from their participation in firm activities; (2) owners will have an incentive to insure to protect their investments from claims of tort creditors of the firm; (3) and certain creditors will have the incentive and the leverage to insist on adequate capitalization and insurance of the firms with which they do business.\textsuperscript{175} These are legitimate reasons for ensuring that a corporation maintains a sufficient level of capital funds.

4.5.2 Legal Responsibility

While corporations possess their own rules and procedures, they must also conform to the rules of the state and local government, and pursue their economic missions within the framework of the law.\textsuperscript{176} Legal responsibilities reflect a view of codified ethics, as they embody notions of fair operation as established by the lawmakers.\textsuperscript{177} This concept of corporate social responsibility reveals that law makers play a critical role in the way that corporations display concern for the interests of stakeholders. For instance, if the law does not prohibit shareholders and directors from abstracting corporate funds for personal use, shareholders will find no issue in doing so, regardless of the impact on stakeholders. Also, as the law in most countries does not require shareholders to contribute adequate levels of


\textsuperscript{175} Ibid. at 478.

\textsuperscript{176} Archie Carroll, 	extit{supra} note 168 at 41.

\textsuperscript{177} Ibid. at 41.
capital funds to private corporations, shareholders ignore the risks that inadequate funding can create for stakeholders.

4.5.3 Ethical and Philanthropic Responsibilities

Carroll’s concept of ethical responsibilities is concerned with standards, norms, or expectations that reflect a concern for what stakeholders regard as just and fair.\(^{178}\) Philanthropic responsibilities refer to corporate actions that are in response to society’s expectation that businesses are good corporate citizens.\(^{179}\) From initial formation of a corporation, stakeholders and the community at large should have a legitimate expectation that companies would have a duty to act in the best interest of stakeholders due to its social structure.

As to the concept of corporate citizenship, Edwin Merick Dodd Jr’s views on companies as corporate citizens, which is also highlighted by Bone, are that if the law views corporations as legal persons, separate and distinct from their shareholders, then corporate managers should be allowed to perform on behalf of the corporation at large, as opposed to acting only in the interest of its shareholders\(^{180}\) (as the shareholder wealth maximization theory posits).

As discussed previously, Lynn Stout agrees with this, arguing that shareholders do not own corporations. Therefore, since shareholders rely on state laws and regulations for every benefit afforded them through their investment in companies, it is fair to emphasize the legal principle that corporations are separate and distinct from shareholders.

\(^{178}\) Ibid. at 41.
\(^{179}\) Ibid. at 42.
\(^{180}\) Jeffrey Bone, supra note 153 at 296.
4.6 Liability for Corporate Wrongs

Corporate social responsibility has developed into a major corporate field and consists of a number of theories. Despite its environmental and ‘support for the community’ purpose, corporate social responsibility encompasses core ethical principles that are relevant to a discussion of stakeholder protection. One legal scholar argued that although shareholders may not always be morally culpable for corporate wrongs,\footnote{C. Kutz, *Complicity: Ethics and Law for a Collective Age* (Cambridge: Cambridge UP, 2000) at 161.} due to the separate legal form of corporations and the limited liability granted to shareholders by law, it is still ethical and just to hold them liable. The reasons given by Kutz for this view is that:

Their intentional participation in the collective endeavour does not make them blameworthy – they have done nothing wrong by purchasing stock, nor have they failed in any way in their duties as shareholders . . . But it does render them accountable in the domain of repair for the company’s accidents, when the company cannot meet its warranted claims.\footnote{Ibid.}

Kutz sees shareholders as persons morally responsible for victims of corporate wrong, but does not find them to be *blameworthy* for those wrongs. Being held morally responsible but not blameworthy is not the same as shareholders engaging in improper conduct. Nevertheless, both situations can result in unfortunate circumstances for stakeholders if the courts do not pierce the veil where corporate funds are insufficient to compensate for loss. After all, corporate wrongs are not conducted by the corporate building but the actors operating the business of the corporation. Also, accidents on corporate premises which cannot be compensated by the company as a result of undercapitalization should be the responsibility of the shareholders. Unless, however, the managers of a company failed to
enforce workplace safety standards which caused the accidents. Even still, the shareholders should still be held accountable for undercapitalizing the corporation.

As discussed in Chapter 2, courts find it necessary to pierce the veil of incorporation in some cases due to corporate wrongs that shareholders (and directors) engage in. Kutz’s reasoning was based solely on corporate torts and not fraud or instances of controlling parent companies. Since torts such as personal injuries incurred by employees on their jobs are not directly inflicted by shareholders, they should not be deemed blameworthy. While for tort matters this concept holds truth, it is not the case where the corporation, by fault of its stockholders, is financially incapable of compensating contract creditors for corporate wrongs.

When corporations engage in activities likely to injure others, shareholders act opportunistically if they have failed to provide a reasonable amount of compensation, either through liability insurance or cash reserves. As to both contract and tort creditors, the key concern is use of limited liability as a device deliberately or recklessly to extract value from third parties without their consent and without compensation; absent the limited liability shield, such practices could not be effective because business owners would bear full responsibility for creditor claims.183

At initial incorporation, and throughout the course of business, shareholders and directors ought to know that the occurrence of injuries on corporate premises is foreseeable. Hence, inadequate contributions of capital or the constant withdrawal of corporate funds for personal use, making it difficult for the injured to be compensated by the company, is a reason to hold the shareholders blameworthy. As Witting stated, shareholders identify

themselves with the companies with which they invest,\textsuperscript{184} and that is enough to make them responsible for corporate wrongs.

A typical example of this is the issue faced in \textit{Minton v Cavaney}\textsuperscript{185} where a child drowned in a swimming pool owned by a company which had never issued stock. Because the corporation had no capital it could not satisfy the judgment. The court held the corporation was undercapitalized and held Cavaney liable to make compensation. As suggested by Crowe, shareholders will normally become morally culpable for corporate wrongs only if they intended, foresaw or should have foreseen them.\textsuperscript{186} For the mere fact that injuries in the workplace are foreseeable and likely to occur to any stakeholder, whether it be an employee, supplier, or customer, there should be an obligation on shareholders’ part to maintain an adequate capital ratio within the corporation. Where there is a failure to do so, and a company becomes liable to a stakeholder, the court should pierce the veil to hold the shareholders personally to make compensation to the injured stakeholder in this regard.

In public corporations, the ordinary (involuntary) shareholders are not responsible for the general issues faced by corporations. This is because they are usually not involved in the day to day operation of the business, which is usually controlled by management and the board of directors. Therefore, the controlling shareholders are the ones who should be held accountable for the corporate wrongs that stakeholders face. It is difficult, however, to identify controlling shareholders in most private corporations where the number of shareholders is not great, and all shareholders are involved in corporate operations.

\begin{flushleft}
\textsuperscript{185} \textit{Minton v Cavaney} 56 Cal (2d) 576 (1961).
\end{flushleft}
Based on Crowe’s principle of the *Priority of Corrective Justice* (PCJ), “the primary liability to compensate victims of wrongdoing should typically fall on those who are morally culpable for the wrongful outcome; therefore, shareholders should have presumptive liability for remedying corporate wrongs when company funds are insufficient to do so.”\(^{187}\) Intentional failures to provide a sufficient level of capital is even more reason to hold shareholders liable.

Crowe argues that where a private company consists of a number of shareholders but its affairs are more closely controlled by one or two shareholders, the primary burden for corporate wrongs should fall on the principal shareholders. He also listed the alternatives to this model as follows:\(^{188}\)

1. If corporate funds are exhausted or inaccessible, both controlling and ordinary shareholders should be held liable for corporate wrongs on a pro rata basis.

2. If corporate funds are exhausted or inaccessible, controlling shareholders should be held liable for corporate wrongs. If controlling shareholders’ funds are exhausted or inaccessible, liability should be extended to ordinary shareholders on a pro rata basis.

3. If corporate funds are exhausted or inaccessible, controlling shareholders should be held liable for corporate wrongs. If controlling shareholders’ funds are exhausted or inaccessible, the remaining part of the loss should be borne by the taxpayers at large, subject to the usual principles of distributive justice with regard to community action.

4. If corporate funds are exhausted or inaccessible, controlling shareholders should be held liable for corporate wrongs. If controlling shareholders’ funds are exhausted or inaccessible, the remaining part of the loss should be borne by the victim of the wrong.

Whether sufficient capital contributions were made by each shareholder can be evaluated based on the nature and size of the business. Corporate investors should be responsible for at least investigating the average amount of capital funds required for business operation.

An in depth discussion regarding the way in which capital is to be measured follows in

---

\(^{187}\) *Ibid* at 161.

\(^{188}\) Jonathan Crowe, *supra* note 186 at 171.
Chapter 5. For a corporation sufficiently capitalized at inception, but whose shareholders later remove funds from it illicitly, there should be no question of liability if the company becomes undercapitalized. In this case, only those shareholders involved in such activity should bear the responsibility. The rationale behind these models, as outlined and discussed by Crowe, makes sense when dealing with an adequately capitalized corporation whose liability for damages in tort exceeds the amount of available funds it has.

Crowe’s fourth alternative is contrary to the principle that controlling shareholders must provide compensation to other stakeholders when corporate funds are insufficient to do so. To say that victims of corporate wrongs should bear the loss of compensation if the assets of the corporation and its shareholders are inaccessible, goes against the theoretical views already discussed regarding the need to protect stakeholders.

The existence of both controlling and ordinary shareholders is common in public and private companies. However, for public companies, the number of passive investors can far outweigh the amount found in private companies where shareholders are more closely involved in managing the corporations. In closely held corporations it is proper to hold the controlling shareholders liable for corporate wrongs, since they are usually familiar with the corporation’s financial status and are closely involved in the management of business.

In most private companies, shareholders are often directors as well, taking part in the management and operation of business. Where there are passive investors of private undercapitalized companies, the determination of liability becomes challenging since passive investors are not always aware of the financial status of the companies they invest in. As a result, controlling shareholders and those involved in the management of private companies are the ones to be accountable to stakeholders of poorly capitalized companies.
The veil piercing cases in Chapter 5 reveal that undercapitalization is common in closely held companies consisting of only one or a few controlling shareholders.

Company law debates in the United Kingdom have also touched on the issue of creditor protection. More specifically, the Company Law Review Steering Group Strategic Framework document seeks to answer the question: “to what extent should the law relating to share capital seek to protect creditors?”¹⁸⁹ In terms of tort creditors, the following observation was made:

The idea is that since they are unable to adjust the terms on which credit is extended, shareholders may be able to profit at their expense by undercapitalising the firm or its subsidiaries.¹⁹⁰

For contract and tort creditors of private companies, it is difficult to know the actual capital contributions being made by shareholders, although contract creditors have the ability to request this information before contracting. This is in contrast to public companies where the value of capital contributions by shareholders is known to the public.¹⁹¹


¹⁹⁰ Company Law Review Steering Group, Ibid.

¹⁹¹ John Armour, supra note 189 at 365 said that while it seems fitting for this rule to apply to both public and private companies, it is also easy for private share investors to sidestep it through the use of non-cash considerations. As a general note, even as far back as 1892 the House of Lords in the early decision of Ooregum (Gold Mines of India) Ltd v Roper¹⁹¹ made a statement relevant to creditor protection. Lord Halsbury stated that “every creditor of the company is entitled to look to that capital as his security.”¹⁹¹ The court was outlining rules regarding the sale price of shares and held that shares should never be issued at a discounted price from the price at which they were originally issued. This same rule was even enshrined in the 2006 UK Companies Act.
The bottom line is that limited liability and its corporate incentives encourage investors to find ways to control the level of financing of a corporation to their advantage. Accordingly, capital maintenance principles (usually applied only to public companies) were developed by nineteenth century judges who viewed it as a means of protecting corporate creditors against the increased risks involved with limited shareholder liability. It is argued that the importance of adequate corporate capital is too often undermined simply because the liability of shareholders is limited. If shareholders’ investments are protected, who will protect the investment and interactions of other stakeholders?

In the early case of *Re Exchange Banking Company, Flitcroft's Case* the late Jessel MR declared:

> The creditor, therefore, I may say, gives credit to th[e] capital, gives credit to the company on the faith of the *representation* that the capital shall be applied only for the purposes of the business, and he therefore has a right to say that the corporation shall keep its capital and not return it to the shareholders. [sic]

Every creditor should be given the security by law that the corporation’s capital will not be returned to its shareholders. Unlike large contract creditors, tort creditors possess no opportunity to understand the nature and finances of the businesses with which they come into contact. In order to provide alternative protection to voluntary and involuntary creditors besides a minimum capital requirement, Armour suggests that companies be required to carry insurance proportionate to their potential risks. Analysing the level of

---

193 *Re Exchange Banking Company, Flitcroft's Case* (1882) 21 Ch D 518.
risks associated with any particular private company is, in fact, equal to analysing the amount of capital contribution required to establish a corporation.196

Another alternative suggested was to grant involuntary claimants priority over other claimants in corporate insolvencies.197 It is argued that this would be difficult to implement as most Companies Acts provide for the protection of voluntary creditors whose transactions are in most cases secured. The hardship with this is that most involuntary tort creditors are often left hurt and uncompensated if the corporation has insufficient funds to cover both secured and unsecured creditor claimants.

A further suggestion was to impose a pro rata unlimited liability on shareholders for corporate torts.198 Armour believes that this would cause the corporation’s shareholders and voluntary creditors to “increase the firm’s cost of finance in proportion to the level of hazardous activity in which it is engaged……and even a rough-and-ready mechanism such as a judicial doctrine of piercing the corporate veil in cases of unreasonably low capitalization would be likely to be cheaper in terms of administrative costs than a general minimum capital requirement.”199

From a moral and social perspective this view may seem logical. However the imposing of unlimited liability on shareholders would reject the purpose of the corporate legal form.

196 David Barber, “Piercing the Corporate Veil” (1981) 17:2 Willamette L Rev 371 at 390-393, said that the task for lawyers in advising a closely held corporation on the amount of capital that is adequate is difficult, but that it is possible to establish guidelines for deciding whether sufficient capitalization exists to avoid piercing.

197 Ibid.

198 John Armour, supra 189 at 372. See also Hansmaan & Kraakman, “Toward Unlimited Shareholder Liability for Corporate Torts” (1991) 100:7 Yale LJ 1879 where it was generally argued that the law should impose unlimited liability on shareholders in matters of tort.

199 Ibid.
The doctrine of limited liability and free incorporation is deeply fixed within corporate legal systems all over the world, and is said to be economically justified by so many judges, solicitors, legislatures, scholars, and commentators, that the imposition of unlimited liability on shareholders for tort creditors seems almost unreal. Even the landmark Salomon case has made clear that even the shareholder of a one man company will not be liable for the debts of the company; but as a secured creditor of his own company, he can have priority over unsecured creditors.\footnote{Salomon, supra note 2. See generally William Hackney & Tracy Benson, supra note 26.} The doctrine of veil piercing, therefore, becomes important as a means of protecting stakeholder interests.

Nevertheless, imposing personal liability on shareholders must only apply where the circumstances of a given case calls for a court to pierce the veil. In Hackney and Benson’s view, general principles of equity and justice are not very helpful in resolving undercapitalization issues, since it seems unfair for shareholders to be held personally liable if the law is supposed to have accorded them the privilege of limited liability as an incentive to invest.\footnote{Ibid. Willian and Hackney also quoted Professor Conard in A. Conard, Corporations in Perspective (Foundation Press, 1976) at§ 277, where he stated that the privilege of limited liability “presupposes a course of conduct that is prudent and socially acceptable in ways that the legislature may not have articulated.”} Yet, they also concede it might be unfair for creditors to bear the loss of certain shareholder activity. In their view, the whole conception stems from the basic question of whether a shareholder must contribute adequate capital in order to “earn” the “shield” of limited liability.\footnote{Ibid.}
What Hackney and Benson failed to consider is that it is the limited liability incentive afforded to shareholders that encourages corporate abuse. Without limited liability and corporate personality, there would be no need for the courts to develop the equitable remedy of veil piercing in order to protect contract and tort creditors. For that matter, a line should be drawn between corporate incentives and what is deemed unjust on the part of unsecured corporate stakeholders. For Hackney and Benson to argue that general principles of equity and justice seem unfair on the part of shareholders is quite irrational and contradicts their own argument. It must be remembered that while shareholders contribute to the financial status of companies, they are not the only stakeholders who invest in those companies. Neither are shareholders the only stakeholders affected if a corporation goes bankrupt. On the other hand, a shareholder may bring claim against the corporation that it invests in, and in order to uphold equity and justice the court may rule in favour of that shareholder.

Elvin Latty comes to the defence of the need to extend fairness and justice to unsecured corporate stakeholders in the following terms:

The corporation is meant to be a device whereby, among other things, one may do business with the risk of losing not all of one's possessions but only that portion thereof which one invests in the business in question. This is of itself, on the part of those persons who may be adversely affected by the limited liability privilege, a considerable forced concession—a compromise in the interests of business and presumably of society. But it is a compromise, a mutual give and take, not a license to the owners of a business to take all and give nothing. When the law substitutes a special fund, as a source from which creditors are to be paid, in place of a general fund (i.e., unlimited responsibility), it presupposes not only that the special fund exists, but that it is such a fund as normally answers the requirements of the business, and that those who create the fund have not the unrestricted power arbitrarily to fix the fund at practically zero……. The question is one of degree. In other words, the corporation is not meant to be a device by
which one can engage in business with no risk at all or with a risk wholly disproportionate to the normal risks of such a business. The privilege of acquiring limited liability through such a device is a valuable one; and now that incorporation is available to all by simply filing a few papers, it is not unreasonable to attach as a condition to the use of that device the requirement that the users thereof take some reasonable risk themselves, and do not attempt to pass on all the risks of the business to those who may subsequently have claims against it.\(^\text{203}\)

Latty understood the challenges faced by many corporate creditors, particularly unsecured tort creditors. Although subsidiary and affiliated corporations were the focus of his book, the concept also applies to individual shareholders. Ballantine confirms that the relationship between a parent and subsidiary, and that of a sole shareholder and his corporation is similar, and their problems are analogous in cases where undercapitalization is alleged.\(^\text{204}\)

### 4.7 Equitable Subordination for Undercapitalization

Regardless of form or intention, the acquisition of claims by the promoters and managing, dominant and controlling stockholders cannot be asserted on a parity with those claims held by the public, and are instead subordinated to public claims.\(^\text{205}\)

Equitable subordination is a legitimate form of protecting the interest of creditors. It relies on courts’ peering behind the veil of formally unimpeachable legal arrangements to detect

---


\(^{204}\) Henry Ballantine, *supra* note 172 at §§ 139.

the economic reality beneath. This task by nature requires the court to make extremely subjective judgments as to whether a party has acted opportunistically. Undercapitalization is characterized as an important factor of misuse of the corporate form, which can result in subordination of shareholders claims. Under the doctrine of equitable subordination, a bankruptcy court has the power to subordinate the claim of one creditor to those of other creditors where the claimant has engaged in some type of inequitable conduct which has resulted in an unfair advantage to the claimant or an injury to other creditors. Hence, when shareholders (whether parent companies or natural persons) have loaned funds to their corporations which have operated on very little capital, the courts must determine whether the claims of shareholders, as creditors of their corporations, should be subordinated to the claims of other creditors (even if these shareholders are secured creditors).

207 William Hackney & Tracy Benson, supra note 26 at 880.
209 Equitable subordination applies to both parent corporations and natural persons. In his article called “Initial Capitalization and Financing of Corporations” (1959) 13 Vand L Rev 197 at 201, Chester Rohrlich took the same position when he stated: Although the "Deep Rock Doctrine" has thus far been most commonly applied in the corporate parent-subsidiary relationship and there may be reasons of social policy for distinguishing between a corporate parent and individual shareholders, it should not be assumed that the underlying principles are not also applicable to individual shareholders in one-man or close corporations.
210 In an early Maryland case called Dollar Cleansers v McGregor 163 Md 105, 161 A 159 (1932), the court confirmed at para 109 that a valid loan by a shareholder can be made but stated the following: But its [a shareholder’s loan] bona fides is always open to inquiry. This court does not think the law contemplates that one may
The landmark case of *Salomon*\(^{211}\) provides an excellent example of moral hazard which tends to invite corporate irresponsibility to the detriment of corporate creditors.\(^{212}\) It was in this case that the courts allowed the claim of the controlling secured shareholder of the closely held corporation to trump the claims of the creditors of the corporation.

The early case that dealt with the equitable subordination of claims in undercapitalized companies was *Taylor v Standard Gas & Elec Co.*\(^{213}\) This famous US case is commonly known as the “Deep Rock Case.”\(^{214}\) Here the courts used the ‘fairness’ approach to determine whether stockholder loans should be subordinated on the basis of the settled principle that bankruptcy courts are courts of equity.\(^{215}\) It is argued that this approach which has been consistently followed by courts is most preferred since it stresses the realities of the problem of undercapitalization, rather than the artificial niceties of corporate form. In *Taylor*, undercapitalization and improper conduct were the basis for subordinating the parent corporation’s loans.

---

\(^{211}\) *Salomon v Salomon*, *supra* note 2

\(^{212}\) Ali Imanalin, *supra* note 18. In closely held corporations like the one in *Salomon*, *supra* note 2, the owner is usually the manager of the corporation and have the ability to secure his finances by subscribing for debentures and as Ali notes, this makes him a secured creditor taking priority over unsecured creditors in insolvency.


The well-known ‘Deep Rock Doctrine’ posits that the claims of shareholders who are creditors of a corporation will be subordinated to the claims of other creditors of the corporation during bankruptcy proceedings. Therefore, if there are no available funds left over after external creditors have been paid off, the internal creditors of the undercapitalized corporation will receive nothing. In *Taylor*, the undercapitalization of the subsidiary, along with improper activities, led the courts to subordinate the parent corporation’s claim as a creditor. But based on the court’s reasoning, it is believed that if undercapitalization was the only factor, the courts would still have subordinated the parent company’s claim if it was found that undercapitalizing the subsidiary was intended.

Interestingly, the test for determining undercapitalization in this case was said to be whether an average businessman, in establishing such a corporation would consider the amount contributed as adequate capital. While the question arises whether the fairness approach to determine whether loans in these instances should be subordinated is a fit and proper approach to take, a ‘reasonable businessman test’\(^{216}\) approach in determining undercapitalization, as was done in *Taylor*, is questionable. The most effective way to determine undercapitalization is by the size and nature of the corporation with the help of a financial expert for verification.\(^{217}\) Any average business person considering what ‘adequate capital’ means for a corporation would consider this amount based on his financial position or simply what the person is willing to contribute. As economically beneficial as limited liability is to every economy, it has encouraged the development of


\(^{217}\) *Re Mobile Steel Co.*, 563 F (2d) 692 (5th Cir 1977) at 703.
selfish motives. This test of the ‘reasonable businessman’ in the context of determining adequate corporate capital is rather difficult to quantify and can lead to inequitable results.

Courts lean heavily on the principle that limited liability encourages the financing of capital markets and that the law provides for the protection of share investors from personal liability. But one of the inefficiencies that limited liability creates is the incentive it provides for shareholders to direct the corporation to spend too little on precautions to avoid accidents.\textsuperscript{218} As Milton argued, however beneficial the limited liability subsidy may be to corporate shareholders and to society more generally, it should not be so broad as to protect illegitimate behaviour.\textsuperscript{219}

4.8 Conclusion

The unjust end of undercapitalization is the impact felt by creditors and other external stakeholders of a corporation. For a very long time the corporation was an entity only concerned about the interest of its shareholders. This was until courts realized the injustice this causes to stakeholders. As Lynn Stout argues, shareholders do not own corporations and so they are no more important than customers, employees, suppliers, creditors, or the community as a whole. The development of corporate social responsibility has legitimized this argument. Corporate social responsibility helps to increase the level of concern and interest for stakeholders and the wider community against the selfish motives of investors. Theories involving shareholder wealth maximization are now challenged by stakeholder and communitarian theories. As was discussed, supporters of the stakeholder and communitarian theories seek to explain that while there ought to be a concern for the

\textsuperscript{218} Hansmaan & Kraakman, \textit{supra} note 198.
\textsuperscript{219} David Milton, \textit{supra} note 183 at 1307.
interests of corporate shareholders, other constituents hold a stake in the corporation. As a result of their contribution, their interests should also be sought. One way of displaying concern for the interest of other stakeholders is to ensure that unnecessary risks are not being transferred to them, such that the reason for their inability to be compensated is not due from a failure to adequately finance the corporation.

Corporations and their controllers ought to be held equally responsible for the wrongs imposed on stakeholders. While a corporation is given legal personality, its legal functions cannot be fulfilled in the absence of natural human beings responsible for managing and supplying it with capital funds. The only way to understand why properly capitalizing a corporation is critical is to understand that corporations owe a duty to stakeholders. However, when that duty can no longer be fulfilled, those controlling investors and directors who are responsible for capitalizing the company ought to be held personally liable.
Chapter 5
Justified or Unjustified: Undercapitalization as an Independent Factor for Corporate Veil Piercing?

5.1 Introduction

The rise of the limited liability company and separate legal personality presented the need for courts to develop the veil piercing doctrine. The list of veil piercing factors outlined in chapter one is non-exhaustive. As already stated, this paper gives concern for only one of those factors which is undercapitalization. The law provides no obligation for shareholders of private companies to adequately capitalize corporations. As one scholar noted, “the most influential and significant corporate Acts in North America……the Revisited Model Business Corporation Act, 1984, and the Canada Business Corporation Act, R.S.C., 1985, c. C-44 do not require a minimum stated capital to incorporate a business.” 220 It is argued

220 The Model Business Corporation Act did require a minimum paid-in capital before it was removed from the 1970 version. See Garrett, History, Purpose and Summary of the Model Business Corporation ACT, 6 Bus. Law. 1 (1950) at pg. 3 where Garrett stated the following:

Many states will require the payment of a certain amount on shares before incorporation, even though there is no corporation to receive it. As a concession to the tradition that creditors look to such funds as a source of collection, the Model Act requires the receipt of at least $1,000 in payment of shares, not before incorporation, but before a corporation begins business. The sole excuse for this provision is that a corporation should have some funds before it actually starts the business for which it is organized.

Now, as Landers points out (supra note 121 at 592):

State corporation statutes clearly do not require corporate entities to be adequately capitalized as a prerequisite to engaging in most types of business activities: no states have more than a minimal capitalization requirement and none impose sanctions on companies that are inadequately capitalized.
in this chapter that undercapitalization should be an independent basis for shareholder liability.

Section 5.2 defines and presents a typical scenario of its consequences. The problems that corporate undercapitalization create for stakeholders are highlighted and discussed. Canadian courts have no substantial record of cases for dealing with undercapitalization. For this reason Canadian legal commentators are known for examining American jurisprudence on liability for undercapitalization, in regards to the doctrine of piercing corporate veil piercing.

Consequently, section 5.3 examines how undercapitalization is to be measured. This is important in order to establish whether or not a company is in fact undercapitalized. Sections 4.4 and 4.5 will then explore the critical nature of undercapitalization along with cases from several American states where the issue has arisen. The cases show that US courts have grappled with whether or not undercapitalization alone is a sufficient ground to impose personal liability on shareholders. In most of the cases, the courts concluded that undercapitalization is not a sufficient ground to disregard the corporate form and hold shareholders liable, but that undercapitalization, along with other factors must exist in order to pierce the corporate veil.

This chapter argues that US courts have provided no clear justification for not holding inadequate capitalization as an independent ground for liability. The additional factors some courts took into account were of little significance for determining liability for the sake of justice and fairness to stakeholders. In view of this, this chapter argues that though limited liability can be justified on economic grounds, there is no justification for failure
to adequately capitalize corporations, and courts should be more proactive in search of both legal and ethical grounds to pierce the corporate veil in this instance.

5.2 What is Undercapitalization?

A and B enter the laundromat business. They incorporate, obtain permission to issue stock, and each purchases ten shares at $10 par. The total capital of the corporation is $200, although $5,000 is reasonably required capital for a business of this size and nature. The corporation then leases premises on which it locates its new business. It employs a man to work as a janitor, guard, and cashier at a salary of $75 per week. The two shareholders lease to the corporation ten washers and ten dryers. During its first week of operation a woman is seriously injured on the premises, and is awarded a tort judgment in the amount of $5,000. Soon thereafter the business fails. The lessor, employee, and judgment creditor remain unpaid. The $200 capital was paid to the attorney who incorporated the business. There is no doubt but that all corporate formalities were met and that A and B did not treat the corporation as a mere conduit through which they operated as individuals. A and B have sufficient personal assets to meet these obligations. Should the limited liability which ordinarily attaches to the corporate form of doing business prevent the creditors of this corporation from reaching the personal assets of A and B?221

The above scenario illustrates the consequences of incorporating a company with insufficient capital funds. A company may not only fail, but stakeholders can be left in very unfortunate situations like the lessor, employee, and judgment creditor in the scenario. Generally, where the appropriate amount of capital to operate a particular business is known, or can be obtained, but the corporation was deliberately undercapitalized, shareholders should be made responsible to stakeholder claimants if the corporation is unable to compensate them. While corporate directors have a level of control over the assets of a corporation, empirical data shows that mainly only shareholders have been held liable for the inadequate capitalization of companies. This is particularly since the

221 Robert E. Dye, supra note 122 at 823.
shareholders of private companies (mostly closely held companies) are often directors as well. Although they do not own the company, shareholders are the ones who invest corporate capital into the business establishment and benefit from the limited liability privilege. Hence, there must be a level of accountability from shareholders, particularly controlling shareholders, to other stakeholders of the corporation.

In its simplest form, undercapitalization can be defined as the circumstances in which a corporation lacks sufficient capital contribution from its shareholders and, as a result, cannot meet its liabilities. In other words, it refers to a situation where a company’s equity amount is unreasonable or insufficient when compared to the obligations and risks that it undertakes during its operation.\textsuperscript{222} When capital is being assessed as to adequacy, it does not refer to total assets, nor stated or legal capital.\textsuperscript{223} It refers to the “cushion of protection afforded to creditors” and other stakeholders. Capital is the economic substance of a corporation and the funds or other property contributed by the stockholders as the basis to conduct the business of the corporation.\textsuperscript{224} Risk capital, then, is defined as equity investments that back up obligations to liability holders including creditors, customers, and contract counterparties.\textsuperscript{225}

Undercapitalization results in an unfair advantage to corporate shareholders because it limits any possible loss to them if the corporation fails. At the outset, this may not seem an

\textsuperscript{223} William Hackney & Tracy Benson, supra note 26 at 890.
\textsuperscript{224} Maurice Dix, supra note 127 at 483.
unfair advantage, since the purpose of limited liability is to limit the personal liability of shareholders. But when consideration is given to corporate creditors and other stakeholders (besides the shareholders) who are likely to be affected by a corporation’s insufficient level of assets, it becomes an issue.

For instance, insufficient capital funding exposes judgment creditors to a “high degree of risks.”226 It may lead to great misfortune for these creditors if they are not compensated for loss or injuries sustained through a company. The scenario at the beginning of this chapter where the corporation was not funded with sufficient capital to operate the laundromat business illustrates the risk. The company failed for insufficient funds, and could not finance its liabilities. As a result, the lessor, employee, and creditor remain uncompensated. Obviously, for courts to uphold the corporate legal form in this situation would result in misfortune for all three parties. American courts have often held that the corporate veil will be lifted and limited liability disregarded when to do so would prevent injustice.227 If courts will not pierce the veil in a circumstance like this, injustice will indeed be the resulting factor.

Robert Dye argued that the state of the law should be that, in order for shareholders to enjoy the benefits of limited liability, it must be purchased and the purchase price should be adequate risk capital.228 Capital must be allocated to assess profitability, to make investment decisions, to price products and services, and to set compensation.229 While it

226 Ibid at 621
227 Dewitt TruckBrokers, supra note 17 at para 2. This principle was set forth by Judge Sanborn in United States v. Milwaukee Refrigerator Transit Co. 142 F. 247 (CCWis1905).
228 Robert E. Dye, supra note 122 at 834.
229 Isil, Stewart, & James, supra note 225 at 621.
is believed that large amounts of capital will increase agency and monitoring costs that shareholders would have to bear (as well as corporate income tax), the advantage of adequate levels of capital is that it reduces possible debt over-hang and risk externalities.\textsuperscript{230}

In defining adequate risk capital, Isil, Stewart and James distinguish it from what they call ‘cash capital’. They identify ‘cash capital’ as funds available to invest, but they do not clarify what the difference is between risk capital and cash capital. Isil, Stewart and James agree that the measurement of capital depends on the nature and size of the enterprise because the amount of risk capital will depend on the risk of the portfolio of businesses.

Lack of sufficient capital funds has been said to encourage courts to reject claims of shareholders against the corporation as claims against \textit{themselves}.\textsuperscript{231} In other words, for shareholders who are creditors of their corporations, any claims brought by them against the corporation is said to be brought against the shareholders themselves. Maurice Dix’s argument in this regard deserves recognition:

\begin{quote}
When a person wishes to engage in business, such person should survey the chances of success and ascertain the average risk capital required for the venture. Should that person lack the ascertained risk capital or decline to provide it alone, such person may invite one or more persons to join in the venture so that together the adequate risk capital will be furnished. But the business risk of failure cannot be shifted to the public. If the person is a natural person and the contributed risk capital is inadequate, his other assets will respond to the business liabilities. The rule should not be different because the person is an artificial person. The courts will look through the association of persons constituting the stockholders, as justice requires.\textsuperscript{232}
\end{quote}

\textsuperscript{230} \textit{Ibid.} It was discussed in the previous chapters that risks can be externalized to corporate creditors by shareholders where there is a lack of sufficient capital.

\textsuperscript{231} Maurice Dix, \textit{supra} note 127 at 486.

\textsuperscript{232} \textit{Ibid.} In making this statement, Maurice referred to the early case of \textit{Wabash Ry. v. American Refrigerator Transit Co.} 7 F (2d) 335 (8th Cir1925)
Two early decisions to which Maurice refers support his view. The first is *Oriental Investment Co. v Barclay*. This case involved a lessee which was a hotel. The hotel was financed with capital amounting to only $10,000 for its business worth a few hundred thousand dollars. The normal risk capital of the business was averaged at about $150,000. An employee of the hotel brought a claim for injuries sustained on premises and the court held the stockholder, Oriental Investing, liable to the employee.

In the second case, *Chesapeake Stone Co. v. Holbrook*, Highland Stone Company (“Highland”) was a subsidiary of Chesapeake Stone Co. (“Chesapeake”). Highland was financed with a capital of only $500 and was leasing premises from Chesapeake at an extremely high rental cost. Due to this cost, it was impossible for Highland to make a profit. As a result, when an injured employee brought a claim for compensation, the court held Chesapeake (the stockholder) liable to make compensation. The courts reasoned that a corporation must be provided with risk capital adequate to respond to the normal risks its venture.

Those who have the power to take all the profits cannot throw the risks and hazards of a business upon the public. The corporate form is not made to be a lawful device for the purpose of stockholders to make all gains and to be secured against loss if the venture meets disaster. It is said that courts will not tolerate an arrangement where the privilege to do business in the corporate form is secured, while the public is deprived of the security upon

---

233 *Oriental Investment Co. v Barclay* 25 Tex Civ App 543 (1901), 64 SW 80.
234 *Chesapeake Stone Co. v. Holbrook*, 181 SW 953 (1916).
235 Maurice Dix, *supra* note 127 at 487.
which the franchise to do business depends. However, the cases discussed below on undercapitalized corporations will show that US courts have taken the contrary position. In essence, undercapitalization arises where investors establish and operate companies with the least amount of working capital, and capital that is inadequate for the nature, size, and foreseeable risks of the corporation.

5.3 How is Undercapitalization Measured?

Companies are structured in all forms and sizes. For this reason, courts have said that the nature of the business a company carries out, and the level of risks it takes will determine the amount of capital it requires for operation. In the US case of J-R Grain Co. v. FAC, the characteristics of undercapitalization were suggested. The court stated that “‘inadequate capitalization’ ... means capitalization very small in relation to the nature of the business of the corporation and the risks the business necessarily entails. As to measurement, the courts said this is done at the time of formation.... a corporation that was adequately capitalized when formed but has suffered losses is not undercapitalized.... undercapitalization presents a question of fact that turns on the nature of the business of the particular corporation.”

In J-R Grain Co., the court pointed out that a company that suffers loss but was adequately capitalized initially is not to be considered undercapitalized. This, however, should only be the case if the losses suffered are not due to the misuse of corporate funds. The loss must

---

237 Maurice Dix, supra note 127 at 488.
238 While debt capital might be required to establish a large private corporation, large amounts of it cannot secure creditors and can prove excessively risky.
239 J-R Grain Co. v. FAC 627 F (2d) 129, 135 (8th Cir. 1980).
240 Ibid. at 135. See also Minton v Cavaney, supra note 185 at para 6.
have occurred in the natural course of business operation for the company to not be held to have been inadequately capitalized.

As the scenario at the beginning of this chapter illustrates, $5,000 might be adequate capital to carry out a laundromat business. However, the capital needed to operate a large electronic store that would sell high end technology products might be a start-up contribution of $20,000 to begin a successful operation and to cover foreseen and unforeseen risks. A foreseeable risk, as the scenario illustrates, would be accidental injuries incurred by customers or employees.

The Civil Practice of Business Litigation of California (“Civil Practice”)\textsuperscript{241} provides a detailed account of circumstances where undercapitalization will arise. These are:

1. Where the corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts;

2. A defendant had attempted to do corporate business without providing any sufficient basis of financial responsibility to creditors;

3. Shareholders have failed to put at the risk of the business unencumbered capital reasonably adequate for prospective liabilities, or;

4. The corporation’s capital is illusory or trifling compared with the business to be done and the risk of loss.

The circumstances outlined in number 2 of the list provide the most illustrative example of what undercapitalization does. Financial irresponsibility demonstrates a lack of care for stakeholders. The Civil Practice also outlines the methods that can be used to determine whether a corporation is undercapitalized or not. These are:

1. Financial analysis, pursuant to which the capitalization of the corporation is compared to the capitalization of companies in the same industry;

2. The insurance approach, pursuant to which the corporation is required to either maintain sufficient assets or purchase liability insurance in sufficient amounts;  

3. A statutory minimum capital requirement.

If a case calls for questioning whether a corporation’s capital is sufficient, and a judge has to decide what constitutes adequate capital for the size and nature of a business, the advice of a financial expert may prove critical. It is more reliable for a financial expert to examine the business market to inquire about the average amount of capital appropriate for the business in question. For example, in Re Mobile Steel Co. the court, relying on Latty in ‘Subsidiaries and Affiliated Corporations’, stated that:

Capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized.

---

242 See generally Walkovzky v Carlton 18 NY (2d) 414 (1966). The statutory minimum requirement of insurance was taken out which was $10,000. However $10,000 was not a ‘sufficient amount’ to cover the losses sustained. It may be beneficial for all companies to take out liability insurance but this should be in addition to other means of corporate funding.

243 Minimum capital requirements are in most countries only required from public companies.

244 See Harvey Gelb, “Piercing the Corporate Veil-The Undercapitalization Factor” 1982 59:1 Chicago-Kent L Rev 1 at 14, Marisa Petrella, “Piercing the Corporate Veil in Michigan” (1883) 61 U Det J Urb L 81 where it was said that what constitutes a reasonable debt to capital ration given business volume is outside the court’s expertise.; Steven Chiodini et al., Organizing Corporations in California, 3d (California: CEB, 2006) at §1A.18 where it was said that to determine whether a corporation is adequately capitalized, courts have relied on the testimony of financial experts (Costello v Fazio 256 F (2d) 903 at 908); and Robert Dye, supra note 122 at 840 said that “the answer can be only an educated approximation of the amount reasonably necessary to the operation of the business but not so small as to shift the risks of loss unfairly onto creditors.”

245 Re Mobile Steel Co, supra note 217 at 703.

246 Elvin Latty, supra note 203 at 119 to 128 & 133 to 138.
Insurance coverage is usually measured by the amount carried by analogous businesses.\textsuperscript{247} If implementing mandatory insurance was not a difficult process, it would be an effective alternative to ensuring capital adequacy. However beneficial, "compulsory insurance does not offer an unmixed blessing."\textsuperscript{248} The amount and type of insurance will vary from company to company\textsuperscript{249} since they all differ in size and structure. The development of a mandatory scheme of insurance requirement would be costly, and government officials will have to make continuous decisions on business risks for companies occupying the entire private sector of an economy.\textsuperscript{250} This type of regulation can financially drain an economy. Instead of imposing a statutory requirement for liability insurance, corporations should decide to insure their business in order to help reduce the chances of business failure.

In relation to capital requirements, it may be difficult for legislatures in countries like the United States and Canada to implement a minimum capital requirement for private companies. The reasons for not supporting the implementation of a minimum capital requirement are discussed further below. Even so, doing it may be advantageous to both investors and creditors. As for creditors, particularly judgment creditors, they stand a better chance of being fully compensated for their losses. As a result, a minimum capital requirement would reduce the risks that would ordinarily be transferred to creditors and other stakeholders in cases of capital inadequacy.

\textsuperscript{247} Harvey Gelb, \textit{supra} note 244 at 14.
\textsuperscript{248} “Should Shareholders be Personally Liable for the Torts of Their Corporations?” Comment, (1967) 76:6 Yale LJ 1190 at 1202.
\textsuperscript{249} \textit{Ibid.}
\textsuperscript{250} \textit{Ibid.} at 1202.
Some academic writers have debated whether legislatures should implement a minimum capital requirement for private companies to ensure that they are adequately capitalized for their business operation. It is believed that such a requirement can help to internalize risk taking, rather than to externalize those risks to stakeholders. Despite this, these writers also believe that this regulatory requirement can also create legislative problems.\textsuperscript{251} Perhaps the most obvious legislative issue concerns what amount of capital should be considered adequate for a business of a particular nature and size. Due to the variations in companies, it has been suggested that instead of a minimum capital requirement to be imposed by legislatures, courts should determine\textsuperscript{252} whether a corporation has been adequately capitalized or not, based in the advice of a financial expert.

As for shareholders, once the minimum capital requirement is met, it reduces the chances of any of them becoming personally liable for undercapitalization, even if the corporation’s funds are still insufficient to cover a creditor’s claim. Once minimum capital is available and any decrease in corporate funds is due solely to the natural course of business or market structures (rather than siphoning or comingling of corporate assets), the liability of shareholders should remain limited to the amount paid on their shares.

\textsuperscript{251} Easterbrook and Fischel, \textit{supra} note 12 at 60.  
\textsuperscript{252} Harvey Gelb, \textit{supra} note 244. See also, Rembar highlighted that there are three tests of determining inadequate capitalization (1) Comparisons with other corporations of similar size and nature. Contributions up to the point where the capital approximates the norm of other like businesses will be regarded as capital. (2) Advances would be viewed as capital if the subsidiary could not have borrowed from outside sources. (3) The parent's non-capital contributions should not be too great as contrasted with capital contributions, Rembar, “Claims Against Affiliated Companies in Reorganization” (1939) 39:6 Colum L Rev 907 at 915-16.
Many countries require a minimum capital amount for public companies to be established. This is not the case for private companies.\textsuperscript{253} There are no minimum capital requirements for shareholders of private companies in the US and Canada, forcing the courts to adjudicate on the matter. On this, Dignam and Lowry explain that the law presumes that in private companies, investment is largely provided by the founding members either through their personal savings or through bank loans, and that in public companies, the intention is to raise large amounts of funds from the general public.\textsuperscript{254}

Regarding private companies, the details of their financial statements are not disclosed, and their shares are not issued to the public. Since the contributions from the public make up a large pool of capital funds, the belief is that they are entitled to know the company’s information, financial statements, and plan of operation. Dignam and Lowry assert that “public companies are in fact subject to more arduous regulatory regime than private companies,”\textsuperscript{255} since the general public is involved and their investments need to be protected. So, while private companies can have a nominal share capital, public companies must meet a greater number of requirements.\textsuperscript{256}

One area where regulation of private companies is most needed concerns the relationship between parent and subsidiary corporations. Easterbrook and Fischel argue that moral hazard problems are greater in parent-subsidiary situations because subsidiaries have less incentive to insure.\textsuperscript{257} Two situations have been identified in which the capitalization of a

\textsuperscript{253} Alan Dignam & John Lowry, \textit{Company Law} 7\textsuperscript{th} Ed (Oxford: Oxford University Press, 2012) at 66.
\textsuperscript{254} \textit{Ibid}. at 66.
\textsuperscript{255} \textit{Ibid} at 66.
\textsuperscript{256} Alan Dignam & John Lowry, \textit{supra} note 253.
\textsuperscript{257} Easterbrook and Fischel, \textit{supra} note 12 at 57.
subsidiary can be inadequate. One situation is where a nominal amount is paid in as equity, and the corporation is financed by loans and cash advances from the parent corporation and the parent receives the earnings of the subsidiary. The second is where the subsidiary is primarily formed for the sole purpose of being milked by the parent corporation.\textsuperscript{258}

Jonathan Macey and Joshua Mitts argue that there are three real justifications for veil piercing.\textsuperscript{259} One of those justifications is to avoid the mistaken extension of credit by shareholders who, for instance, can misrepresent their active involvement in a subsidiary’s affairs.\textsuperscript{260} They argued that undercapitalization is a “poor predictor of veil piercing outcomes,”\textsuperscript{261} highlighting that it rarely provides an independent basis for piercing the corporate veil.\textsuperscript{262} Yet, they clearly admit that “creditors are often harmed when a firm is insufficiently capitalized.”\textsuperscript{263} One limitation of Macey and Mitts’ argument is the failure to provide reasons as to why they believe undercapitalization hardly provides an independent basis for veil piercing. As already discussed, this lack of sufficient reasoning for the argument against undercapitalization seems to be the major weakness among legal scholars and judges.

\begin{flushright}
\textsuperscript{258} “Inadequately Capitalized Subsidiaries” Comments, (1952) 29:4 U Chicago L Rev 872 at 875.  
\textsuperscript{260} Ibid. at 123.  
\textsuperscript{261} Ibid. at 103.  
\textsuperscript{262} Ibid. at 99.  
\textsuperscript{263} Ibid. at 123.  
\end{flushright}
5.4 The Critical Nature of Undercapitalization

Before discussing the main problems that undercapitalization creates, it is important to reinforce and make clear the court’s point in *J-R Grain Co. v. FAC*\(^{264}\), that inadequate capitalization is measured when a business is formed. Initial capitalizing of a company followed by bankruptcy due to market forces or through the normal course of business, is not undercapitalization. If it were so, bankruptcy rules, laws, and regulations would be of no effect. However, if a corporation is adequately capitalized at initial incorporation, but throughout the course of business shareholders siphoned corporate funds or comingle corporate assets\(^{265}\) to the point where the company could not cover its liabilities, this would be considered undercapitalization.

In his article, Harvey Gelb adopted the view of a US judge who stated that initial capital is not entirely important to decide whether the veil of incorporation should be pierced.\(^{266}\) In his view, increased hazards or changes can render the requirement for initial capital irrelevant.\(^{267}\) The judge failed to consider that from the moment a corporation is formed, various unforeseen things might happen under its name. There is no timing for when injuries on corporate premises and difficulties in business transactions will occur. Hence,

\(^{264}\) *J-R Grain Co. v. FAC.*, supra note 239. See also Ballantine & Sterling, *California Corporation Law* 4th ed (California: Mathew Bender, 1962) at §298.02 where it states: Although courts frequently cite inadequate capital or capitalization as an important factor, they seldom define the term. Generally, adequacy of capital implies corporate assets sufficient for the conduct of the business. In Inadequate assets or excessive debt or liability financing at the time of formation may suggest insufficient protection of creditors or tort victims….


\(^{267}\) *Ibid.*
from inception a company must be adequately supplied with the funds needed to carry out the business of the corporation, and failure of investors to make adequate supply should not prevent fair compensation to stakeholders. A typical example can again be seen in the scenario at the beginning of this Chapter, where injuries were incurred during the first week of operation but the corporation’s funds were insufficient to compensate the stakeholders. The unpredictability of when business problems will arise makes initial capital investment important.

A corporation must be equipped to deal with employee or consumer accidents on its premises, along with foreseen and unforeseen debts that it may encounter, even from the first day of operation. As a legal fiction, a corporation cannot finance itself. It is the duty of shareholders to do so. The need to contribute adequate capital to private companies at initial formation reflects the reasons legislation may impose minimum capital requirements on public companies. These reasons illustrate that undercapitalization is a critical issue.

Easterbrook and Fischel describe undercapitalization as a moral hazard that can exist with groups of companies. Moral hazard refers to the opportunity for organizational and individual actors to reap rewards of risky behaviour without bearing associated costs. A corporation possesses its status only through the eyes of the law. This encourages investors to take advantage of the corporate form by incorporating parent companies, and through those parent companies, to incorporate subsidiary companies. This chain of corporations can, sometimes, make it more challenging to determine liability, while making it much


269 Helen Anderson, supra note 265 at 15.
easier for shareholders to manipulate the corporate form for illicit purposes. Indeed, as Helen Anderson points out, “the lifting of the corporate veil in order to impose liability on the parent company, which is, after all, a shareholder in the subsidiary, is doubtlessly justified by the frequent reality of control of the subsidiary by the parent company.”270 Companies can avoid liability for debts by incorporating undercapitalized subsidiaries for the mere purpose of shielding the parent corporation from liability.271

There are countless ways in which the corporate form has been manipulated because of its limited liability privilege. Anthea Nolan affirms this when she highlighted that there may be powerful commercial or fiscal incentives for a parent company to either allow one or more group members (companies) to operate at a loss, to deny those companies economic opportunities, to undercapitalize those companies, or to adopt integrated financing techniques characterised by the shuffling of assets (particularly funds) and liabilities between those companies as the need arises.272

Despite some disagreement, undercapitalization alone is grave enough to pierce the corporate veil. Courts possess the discretionary powers to determine whether to pierce the veil of incorporation in particular cases. Undercapitalization will mostly exist in subsidiary companies controlled by parent companies for reasons explained above. The idea of countries establishing minimum capital requirements for private companies would be in

---

270 Helen Anderson, *supra* note 265 at 11.
271 *Ibid*.
the interest of all stakeholders; however, the courts would be the appropriate institutions to
determine situations of capital adequacy.

On this issue, the Court of Appeal of New York follows a line of decisions that developed
from the guidelines of Judge Cardozo in *Berkey v Third Ave. Ry.*,273 a relatively early New
York Court of Appeal decision. Judge Cardozo ruled in *Berkey* that “the corporate entity
will be ignored when the parent corporation operates a business through a subsidiary which
is characterized as an ‘alias’ or ‘dummy.’ …the essential term to be defined is the act of
operation. Dominion may be so complete, interference so obtrusive that by the general
rules of agency the parent will be a principal and the subsidiary an agent.”274

It has been observed that New York courts have consistently adhered to this general
principle laid down by Judge Cardozo. The rule applies equally to individual shareholders
and their corporations. In situations of agency, a company’s funds can be tampered with or
insufficient from initial incorporation. The fundamentals of limited liability and separate
legal personality are, indeed, beneficial to any economy and provide a ‘shield of protection’
for investors by making them liable only to the amount unpaid on their shares. Since
stakeholders are also risking their funds, their labour, and the chances of being injured on
Corporate premises, they should also be afforded a ‘shield of protection’, which is adequate
risk capital.

273 *Ibid.* at 981, 244 NY 602 (1927).
274 Frederick Lenz & Andrew Newman, “Corporations- Stockholders’ Personal Liability-
Application of Agency or Undercapitalization Theory to “Pierce Corporate Veil.”-
5.5 Undercapitalization: The Underlying Problem

It is necessary to reiterate that empirical evidence shows that veil piercing cases do not involve public corporations, but only close private corporations or corporate groups.\textsuperscript{275} Robert Thompson gave the following explanation why this is the case:

In the entire data set, piercing did not occur in a publicly held corporation.... Limited liability performs the additional function in larger corporations of facilitating the transferability of shares and making possible organized securities markets with the increased liquidity and diversification benefits that these markets make possible. The absence of these market-related benefits for close corporations explains, in part, why courts are more willing to pierce the veil of close corporations....\textsuperscript{276}

The lack of regulation of close corporations has resulted in the thin capitalization issues faced of some private corporations. This fact has led to the problems created when a corporation’s financial status make it unable to satisfy its debts. Undercapitalization is a concern because of the injustice it causes to stakeholders. It is often said that "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."\textsuperscript{277} This association of persons includes shareholders of a corporation who act in their own interest, and are not separate and distinct from the corporation as the law permits.

\textsuperscript{275} Robert Thompson, \textit{supra} note 80 at 1039. Again on page 1070, Robert said that "piercing the corporate veil is a doctrine exclusively directed at close corporations and corporate groups. The total absence of piercing in publicly held corporations indicates the presence of factors in the public corporation setting that make the presumption of limited liability unassailable.”

\textsuperscript{276} \textit{Ibid.} at 1047-1048.

\textsuperscript{277} \textit{United States v. Milwaukee Refrigerator Transit Co.}, 142 F 247 (C.C.E.D. Wis. 1905) at 255.
One of the major issues of undercapitalization is the incentive it creates for shareholders to deliberately abuse the corporate form.\textsuperscript{278} If shareholders are allowed to provide inadequate amounts of capital to a corporation, this will encourage risky activities. When too many risks are taken, the result is the externalizing of those risks to other stakeholders. Easterbrook and Fischel agree that the lower a firm’s capitalization, the higher the probability that it will engage in excessively risky activities.\textsuperscript{279} They further explained:

If limited liability is absolute, a parent can form a subsidiary with minimum capitalisation for the purposes of engaging in risky activities. If things go well, the parent captures the benefits. If things go poorly, the subsidiary declares bankruptcy [to the detriment of its outstanding unsecured creditors] and the parent creates another with the same managers to engage in the same activities. The asymmetry between benefits and cost, if limited liability is absolute, would create incentives to engage in a socially excessive amount of risk activities.\textsuperscript{280}

In addition to externalizing risks to stakeholders, undercapitalization increases the chance that stakeholders will not be compensated for loss or injuries incurred and for which they make legitimate claims against the corporation and/or its shareholders.\textsuperscript{281} There is no justification for externalizing risks to other stakeholders if shareholders are already

\textsuperscript{279} Frank Easterbrook and Daniel Fischel, supra note 12 at 60. See also Solomon Castro, supra note 278 at 650, where he states that shareholders who enjoy limited liability and, at the same time, contribute only minimal capital have greater incentives to engage in overly risky activities since they have hedged their positions against huge losses if things go bad but have placed themselves strategically to receive the highest returns possible if the business does well.
\textsuperscript{280} Frank Easterbrook and Daniel Fischel, supra note 14 at 111.
\textsuperscript{281} See Robert Dye, supra note 122 at 841, where it was explained that sufficient total assets protect the creditor by increasing the chances that the infant business will not fail for lack of funds. A high proportion of equity protects the creditor by increasing the amount of loss the shareholders must absorb before the creditor’s interests are impaired.
afforded the privilege of limited liability. As Robert Dye explained, the purpose of limited liability is to encourage risk capital investment.\textsuperscript{282} In other words, it allows shareholders to invest only a portion of their personal assets in a company with the hope of gaining greater returns, and without fear of losing any more than the amount invested. Since they are afforded this privilege, it is suggested that limited liability be purchased by corporate shareholders, and the purchase price is adequate risk capital. An examination of the cases in the next section illustrates the types of risks caused by corporate undercapitalization.

5.6 The Case for Independence: A Critical Analysis of the Undercapitalization Factor

Most courts consider undercapitalization to be one of the most important factors for imposing personal liability on shareholders,\textsuperscript{283} and yet, they are still reluctant to pierce the veil for inadequate capitalization.\textsuperscript{284} Since it is considered so important, there should be legitimate reasons why courts do not regard undercapitalization as an independent ground for holding shareholders personally liable to claimants when corporate funds are insufficient. This section critically analyses a number of US cases that dealt with undercapitalization, and evaluates the rationale behind each court’s decision from the facts of each case.

\textsuperscript{282}Robert Dye, supra note 122 at 833.  
\textsuperscript{283}William Hackney & Tracy Benson, supra note 26 at 859. According to William and Hackney, “there is no question today but that inadequate capital is considered by all courts to be one of the most important factors in cases imposing liability on shareholders for corporate obligations.” Although it is acknowledged as an important factor, in their view, inadequate capitalization cannot be the sole determining factor for establishing liability.  
\textsuperscript{284}This position is confirmed by one judge who stated that “this power to pierce the corporate veil, though, is to be exercised "reluctantly" and "cautiously" and the burden of establishing a basis for the disregard of the corporate fiction rests on the party asserting such claim”- DeWitt Truck Brothers, supra note 17.
The position that most courts take is that undercapitalization in and of itself is not a sufficient ground to pierce the corporate veil, but, that it should be a factor to consider. This chapter concludes that no coherent explanation is provided as to why

285 There are many other factors that the courts will consider along with undercapitalization to determine whether to pierce the veil. Although some factors were listed in chapter 1, the case of *Laya v. Erin Homes, Inc.*, 352 SE (2d) 93 (W Va 1986) as quoted in Harvey Gelb’s article (note 244 above) perhaps provides the most exhaustive list of factors. These factors are: "(1) commingling of funds and other assets of the corporation with those of the individual stockholders; (2) diversion of the corporation's funds or assets to non-corporate uses (to the personal uses of the corporation's shareholders); (3) failure to maintain the corporate formalities necessary for the issuance of or subscription to the corporation's stock, such as formal approval of the stock issue by the board of directors; (4) an individual shareholder representing to persons outside the corporation that he or she is personally liable for the debts or other obligations of the corporation; (5) failure to maintain corporate minutes or adequate capital records; (6) identical equitable ownership in two entities; (7) identity of the directors and officers of two entities who are responsible for supervision and management (a partnership or sole proprietorship and a corporation owned and managed by the same parties); (8) failure to adequately capitalize a corporation for the reasonable risks of the corporate undertaking; (9) absence of separately held corporate assets; (10) use of a corporation as a mere shell or conduit to operate a single venture or some particular aspect of the business of an individual or another corporation; (11) sole ownership of all the stock by one individual or members of a single family; (12) use of the same office or business location by the corporation and its individual shareholder(s); (13) employment of the same employees or attorney by the corporation and its shareholder(s); (14) concealment or misrepresentation of the identity of the ownership, management or financial interests in the corporation, and concealment of personal business activities of the shareholders (sole shareholders do not reveal the association with a corporation, which makes loans to them without adequate security); (15) disregard of legal formalities and failure to maintain proper arm's length relationships among related entities; (16) use of a corporate entity as a conduit to procure labor, services or merchandise - for another person or entity; (17) diversion of corporate assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors, or the manipulation of assets and liabilities between entities to concentrate the assets in one and the liabilities in another; (18) contracting by the corporation with another person with the intent to avoid risk of nonperformance by use of the corporate entity, or the use of a corporation as a subterfuge for illegal transactions; (19) the formation and use of the corporation to assume existing liabilities of another person or entity." It is highly unlikely that the courts will consider all of these factors in any given case; however because veil piercing is such a discretionary remedy, there is no telling what all factors courts will consider in making a decision whether to pierce or not.
undercapitalization, *in and of itself*, cannot be a sufficient ground to pierce the veil of incorporation if the facts of the case demonstrate injustice to stakeholders.

California judges have dealt considerably with undercapitalized corporations. In 1951 an interesting case was brought to the Supreme Court of California called *Automotriz Del Golfo De California v. Resnick.* Automotriz, a Mexican corporation sued the defendants for funds owed to it for the sale of automobiles. The court found that Erbel Inc., the defendants’ company, operated a business that generated a volume of motor sales between $100,000 and $150,000. The corporation, however, never issued stock nor received any permission to issue stock. In addition, there was no bank account maintained in the name of Erbel Inc. The court found that the company was never supplied with any amount of capital. Instead, the defendants personally supplied the funds needed for the transactions of Erbel Inc.

This fact scenario is typical of how shareholders would use the limited liability privilege of corporations to their advantage, regardless whether this affects other stakeholders that conduct business with a company. The company was established for the purpose of limiting risk of financial loss.

When business began to fail, Erbel Inc. filed a voluntary petition in bankruptcy. The company listed liabilities at $146,000 but only held assets at $16,000. The plaintiff sued on two cheques that were drawn on the corporation’s checking account by one of its shareholders. The cheques were given to the plaintiff but were dishonoured by the bank. The court held that the shareholders were personally liable for the corporation’s debts. The

---

286 *Automotriz Del Golfo De California v. Resnick* 47 Cal (2d) 792 at 306 P (2d) 1 (1957).
reasons for the decision were failure to issue stock where the defendants were doing business as individuals, and to adequately capitalize Erbel Inc. The court reasoned as follows:

Another factor to be considered in determining whether individuals dealing through a corporation should be held personally responsible for the corporate obligations is whether there was an attempt to provide adequate capitalization for the corporation. The proper rule is that inadequate capitalization, where such appears, is a factor, and an important factor, in determining whether to remove the insulation to stockholders normally created by the corporate method of operation. 287

From the court’s reasoning, it is clear that inadequate capitalization was not considered an independent ground for piercing the corporate veil. Besides the failure to issue stock, which indicated that the defendants were doing business as individuals, undercapitalization was the only major issue that the courts needed to consider. However, for both reasons, the court rightly found a need to pierce the corporate veil.

Adequate capital is measured according to the size and nature of the corporation in question. 288 Before arriving at a decision, the court went to great lengths to explain that the shareholders were doing business as individuals. However, very little was said about the corporation’s capital, although the court did find it necessary to quote Henry Ballantine in ‘Ballantine on Corporations’. It stated that “if a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no

287 Ibid at para 7.
288 J-R Grain Co. v. FAC, supra note 237.
sufficient assets available to meet its debts, it is inequitable for shareholders to set up such a flimsy organization to escape personal liability.\textsuperscript{289}  

Judge Gibson pronounced that in view of the volume of business conducted by the shareholders, even $5,000 which the shareholders alleged they contributed to the company’s capital was insufficient for the type of business in question. Despite this, the court ruled that undercapitalization is an \textit{important factor} to consider in determining whether to hold shareholders personally liable to claimants. The use of the word \textit{factor} indicates that the court did not consider undercapitalization to be so critical that it should stand as an independent ground for personal liability.

Since the court considered undercapitalization as such an \textit{important factor}, its failure to explain why it cannot be an independent ground for liability is questionable. The court concluded:

\begin{quote}
In determining whether the defendants should be allowed to escape personal liability for the debts due plaintiff, the trial court was entitled to consider the failure to issue any stock……and the creation and operation of Erbel Inc. with little or no capital….\textsuperscript{290}
\end{quote}

Let us imagine that the corporation had issued stock and the defendant did \textit{not} operate through the corporation as individuals. The fact that stock was issued should not be a sufficient ground to free the defendants from personal liability. An inequitable result would still exist to the plaintiff, since Erbel Inc. would still be operating a large automobile

\begin{flushright}
\textsuperscript{289} Automotriz Del Golfo De California v. Resnick, \textit{supra} note 284 at para 7; Henry Ballantine, \textit{supra} note 172,\S\S\ 129 at 139.

\textsuperscript{290} Automotriz Del Golfo De California v. Resnick, \textit{supra} note 286 at para 8.
\end{flushright}
business “without substantial capital,”\textsuperscript{291} or capital adequate for the nature of the automobile business.

It is submitted that the court came to the proper conclusion by holding the defendant shareholders liable to compensate the plaintiff. However, the court’s reason for holding that undercapitalization cannot be an independent ground for liability is unclear.

In 1961, shortly after Automotriz, the Supreme Court of California decided Minton v Cavaney.\textsuperscript{292} The case involved the drowning of a little girl in a swimming pool that was operated by a company called Seminole Hot Springs Corporation. The company never issued stock and the only form of assets was a lease on the pool. The parents of the deceased received a judgement against the corporation in the amount of $10,000 but the judgement remained unsatisfied. They then brought an action to hold the defendant Cavaney liable to satisfy the judgment. Cavaney was found to be the equitable owner of the Seminole corporation.

The reason for suing Cavaney was that he operated Seminole as equitable owner. The court said:

\begin{quote}
In the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. Seminole never had any substantial assets. It leased the pool that it operated, and the
\end{quote}

\textsuperscript{291} Ibid.
\textsuperscript{292} Minton v Cavaney supra note 185; Automotriz, supra note 286. See also Stone v Eacho, 127 F (2d) 284 (4\textsuperscript{th} Cir 1942). Here the parent corporation’s claim was made subordinate to other creditors because the subsidiary was capitalized with only 3 shares at $1 par value each. Also, a similar case scenario to Minton v Cavaney was Dixie Coal Min & Mig Co v Williams, 221 Ala 331 where the shareholders of the corporation were held liable to compensate the plaintiff for the death of her husband arising out of his employment since the corporation in that case had no assets. These cases help to demonstrate that undercapitalization can be an independent ground for shareholder liability.
lease was forfeited for failure to pay the rent. Its capital was trifling compared with the business to be done and the risks of loss…

The court found that the defendant Cavaney was actually the alter ego of the corporation and held:

The equitable owners of a corporation, for example, are personally liable when they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will; when they hold themselves out as being personally liable for the debts of the corporation; OR when they provide inadequate capitalization and actively participate in the conduct of corporate affairs.

It could not be found that the defendant treated the assets of Seminole as his own. He admitted and the court found that Seminole had no assets, and there was no attempt made to “provide adequate capitalization.” In this case the court acknowledged that out of the three reasons it gave for determining when equitable owners are personally liable, only

---

293 Ibid. (Minton v Cavaney) at
294 The figurative terminology ‘alter ego’ and ‘disregard of the corporate entity’ is generally used to refer to the various situations that are an abuse of the corporate privilege (See Minton v Cavaney, supra note 185, quoting Ballantine, supra note 171 at 292-293; Latty, “The Corporate Entity as a Solvent of Legal Problems” (1936) 34 Mich L Rev 597 at).
295 Ibid.
296 Minton v Cavaney, supra note 185 at 580. See also Robert E. Dye, supra note 122 at 828 [footnote] where he stated the following:

The court had the opportunity to hold Cavaney liable without basing its decision solely on inadequate capitalization. Here, as in Automotriz, no stock was ever issued. However, this fact was not mentioned in the holding—inadequate capitalization alone was sufficient to place liability on a stockholder who participated in corporate affairs. The court answered defendant’s challenge that the evidence did not support the trial court’s determination that Cavaney was personally liable for Seminole’s debts, saying:

In the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. Seminole never had any substantial assets. It leased the pool that it operated, and the lease forfeited for failure to pay the rent. Its capital was “trifling” compared with the business to be done and the risks of loss…
undercapitalization was present. Undercapitalization alone resulted in the court’s decision to pierce the corporate veil.

In this case the Supreme Court of California, the same court that decided Automotriz Del Golfo De California v. Resnick, took the position that undercapitalization can be an independent ground to pierce the corporate veil. The court concluded in Minton that the company’s capital was trifling compared to the business to be done and the likely risk of loss.

If there is evidence that no attempt was ever made to adequately capitalize a company, it is difficult to understand why that is not sufficient ground to hold shareholders personally liable. In Minton, the plaintiffs suffered the loss of their child through a company that was never capitalized. Nor was there any intention to ever finance the corporation. The nature of the business of Seminole included the operation of a public swimming pool. For that fact alone, there were risks involved and the Supreme Court’s decision to pierce the veil on the independent ground of inadequate capitalization was reasonable.

The court’s decision to extend the principle in Automotriz that undercapitalization is only a factor, to ruling in Minton that undercapitalization alone is sufficient to pierce the veil, reveals that there are inconsistencies in dealing with the issue. The creditors in both cases would have suffered major losses if the equitable owners were not made liable. In fact, the judgment creditors in Minton had already suffered the loss of their daughter as a result of the equitable owner’s financial irresponsibility.
In 1970, the California appellate court decided *Harris v Curtis*. A motel corporation and its stockholders were sued by the appellants for funds they had advanced to the corporation. The corporation issued 1000 shares at a dollar per share. Out of the $1000 paid in capital, $811 was used for incorporation fees. The corporation’s equity capital was only $189, while its total debt averaged $355,000.

At the trial court, judgment was entered in the plaintiff’s favour against the corporation, but also in the defendant stockholders’ favour against the plaintiffs. The plaintiffs therefore appealed. The court highlighted one issue on appeal, that is, “……whether or not lack of capital contribution to the corporation is sufficient to make the individual shareholders liable and to pierce the corporate veil.” The court distinguished this case from *Automotriz Del Golfo De California v. Resnick*, saying that in *Automotriz* no application to issue stock was ever made and no permit was ever issued. However, in this case, an application was made and a permit was granted.

There is no question that the corporation was underfinanced, a condition not uncommon among new small businesses, including small corporations privately financed. It is common knowledge that many such corporations have been highly successful, that others have prospered but without legendary success, and that still others have failed to part, at least, because of inadequate capital…..[sic]

The court acknowledged that undercapitalization has led to the failure of many new small businesses. *Wheeler v Superior Mortgage Co.* was one of the cases cited by the

---


appellants, but Justice Coakley asserted that *Wheeler* does not hold that where there is undercapitalization the corporate veil must be pierced. However, in *Wheeler*, it was said:

> The court may also consider that the corporate entity or entities are not adequately capitalized. If the capital is *illusory* or *trifling* compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege. [Emphasis added]

In *Wheeler*, the corporations were determined by the court to be significantly undercapitalized and the court pierced the veil solely on the ground of undercapitalization. In *Wheeler* and *Harris v Curtis*, stock was properly issued and undercapitalization was the only ground for decision, as all other factors were properly met. As the court stated, and as Judge Coakely in *Harris v Curtis* declared, if the capital is trifling, this is ground to pierce the veil.

The court in *Harris v Curtis* held, nevertheless, that undercapitalization is only a factor to be considered, along with all other factors present in the case to determine liability. Interestingly, the court made the following statement:

Appellants would have us declare that, per se, inadequate capitalization renders the shareholders, officers and directors liable for the obligations of the corporation. They cite no case so holding, and we know of none.

The Supreme Court in *Harris v Curtis* made no reference to *Minton v Cavaney* where inadequate capital was held to be sufficient ground for shareholder liability. No consideration was given by the courts in *Curtis* for the steps taken to advance the capital of the motel corporation. For instance, large amounts of funds were borrowed to finance the corporation.
Although it is common for most businesses to operate from debt capital, a much larger ratio of debt capital over equity capital results in a considerable amount of externalized risks. As it stands for this case, a debt to equity ratio of $80,000 to $1,000 provides no security for stakeholders and, economically, does not put the company in an attractive position. Such a high debt to equity ratio leads to inequitable results for other stakeholders involved with the corporation. Again, besides pointing out that inadequate capitalization was only one of many factors to consider in *Automotriz*, the court provided no substantial explanation or outline of the reasons why undercapitalization cannot be an independent ground for liability.

The issue was raised again in the famous case of *Dewitt Truck Brothers v Ray Flemming Fruit Company*. Ray Flemming Fruit Company was a commission agent and sold fruits for growers of farm products. The company was operated solely by Flemming. The plaintiffs, Dewitt Truck Brothers, brought action against Flemming personally to recover funds owed to it from Ray Flemming Fruit Company. It was observed at the beginning of this chapter that failure to observe corporate formalities is another factor the courts consider for veil piercing. In this case, it was stressed that no corporate formalities were ever observed over the span of the corporation’s existence, and there were no records of any Board meetings.

Beyond the absence of corporate formalities the corporation was operated in a purely personal manner. No other stockholder, besides Flemming, ever received salaries or dividends from the company. In addition, the corporation was significantly

---

300 *Dewitt, supra* note 17.
301 *Laya v. Erin Homes, Inc.*, *supra* note 283.
undercapitalized and, in the court’s words, “had no working capital.” Flemming was the sole beneficiary of the company and received a considerable amount of money each year from the corporation which showed no profit. In making the decision to pierce the veil and hold Flemming personally liable, the court considered the lack of formalities and the lack of capital contribution made to the company. The court said:

The conclusion to disregard the corporate entity may not, however, rest on a single factor, whether undercapitalization, disregard of corporation's formalities, or what-not, but must involve a number of such factors; in addition, it must present an element of injustice or fundamental unfairness. But undercapitalization, coupled with disregard of corporate formalities, lack of participation on the part of the other stockholders, and the failure to pay dividends while paying substantial sums, whether by way of salary or otherwise, to the dominant stockholder, all fitting into a picture of basic unfairness, has been regarded fairly uniformly to constitute a basis for an imposition of individual liability under the doctrine.

The court provided no explanation why other factors must exist alongside undercapitalization to justify piercing the corporate veil. It highlighted that undercapitalization was significant in the inquiry and relied on the words of the court in *Kirvo Industrial Supp. Co. v National Distill. & Chem. Corp.* The court in *Kirvo* said that fraud is a proper matter of concern in suits to disregard corporate fictions, and it is not a prerequisite to a result, especially when there is gross undercapitalization or complete domination of the corporate entity under scrutiny by shareholders.

It can be inferred from *Kirvo* that the court considers gross undercapitalization to be an independent ground for liability. The issue is that gross undercapitalization has never been

---

measured. It may be inferred that the lack of sufficient funds to make compensation in \textit{Automotriz}, \textit{Minton}, and \textit{Harris}, was due to gross undercapitalization when consideration is given to the small amount of funds the corporations in those cases had. Nonetheless, it is unclear why the court in \textit{Dewitt}\textsuperscript{304} relied on \textit{Kirvo}, when the court in \textit{Kirvo} never said that undercapitalization is the only determining factor for liability. It is clear from earlier discussion that \textit{Kirvo} is not the only case that holds that gross undercapitalization can be an independent basis for imposing liability on shareholders.\textsuperscript{305}

While corporate formalities are important to a corporation’s operation, they have no direct impact on stakeholders, such as creditors, employees and suppliers. As one commentator observed, one of the major weaknesses of the \textit{DeWitt} case was the court’s assertion that other factors, like the disregard of corporate formalities, must be present along with inadequate capitalization to allow for piercing the corporate veil.

With reference to corporate formalities, the court pointed to the lack of shareholder meetings and corporate records of director meetings.\textsuperscript{306} Although Gelb\textsuperscript{307} does not entirely support an independent basis of undercapitalization for veil piercing, his views on the court’s lack of reason for considering corporate formalities is reasonable. As he asserts, it is not quite clear why the courts in \textit{DeWitt} considered corporate formalities. The only situation where it would make sense to consider formalities was if such disregard confused a creditor into believing that he was dealing with the individual shareholder, rather than

\textsuperscript{304} \textit{DeWitt, supra} note 17.  
\textsuperscript{305} \textit{O’Hazza} 431 SE (2d) at 321 (1993).  
\textsuperscript{306} \textit{DeWitt, supra} note 17; see also Harvey Gelb, \textit{supra} note 242 at 7.  
\textsuperscript{307} Harvey Gelb, \textit{supra} note 244.
the corporation itself. Nevertheless, conditioning the doctrine of disregard of the corporate entity upon both inadequate capitalization of a company and the ineffectual maintenance of the statutory formalities is a meaningless standard.

Another observation by Gelb is the court’s decision to also identify *domination* as a factor for classifying disregard of the corporate entity. It is odd to think that a controlling shareholder, in such circumstances, would bring in another person to share in decision making. Gelb did not say that undercapitalization should be an independent ground for veil piercing; his comments are confined to pointing out the weaknesses in the court’s reasoning.

With respect to the interests of creditors, there is no connection between the disregard of corporate formalities and withholding adequate corporate capital. Gelb points out that the court never explained its reasoning. Proper formalities, such as keeping proper records of director meetings cannot, as a factor, reduce the level of *unfairness* and *injustice* felt by creditors dealing with poorly capitalized corporations.

Inadequacy of the capital which is risked by the individuals who avail themselves of the corporate device is of far more vital concern to creditors of the corporation than the failure to observe the many niceties

---

308 Harvey Gelb, *supra* note 244 at 7.
309 Philippe Salomon, “Limited Limited Liability: A Definitive Judicial Standard for the Inadequate Capitalization Problem”, Temp L Rev (1973) 47:2 321 at 341. Solomon states that where a shareholder have ritualistically preserved the statutory obligation, but have failed to capitalize the entity adequately, they have failed to purchase the privilege of limited liability.
310 Harvey Gelb, *supra* note 244 at 8.
311 In *Dewitt* Judge Russell began the case by stating the general principle that “the concept of separate entity is merely a legal theory introduced for purposes of convenience and to subserve the ends of justice, and the courts decline to recognize it whenever recognition of the corporate form would extend the principle of incorporation beyond its legitimate purposes and would produce injustice or inequitable consequences” at 684.
of corporate formalities upon which the courts sometimes appear to base their decisions.\textsuperscript{312}

The elements of injustice or unfairness are necessary for disregarding the corporate veil. It is inequitable for stakeholders to suffer loss where a company is intentionally undercapitalized. There must be a level of concern from shareholders and directors for the public’s interest. The need to show concern for the public’s interest is confirmed in the famous dissenting judgement of Judge Keating in \textit{Walkovszky v Carlton}.\textsuperscript{313} In this New York Court of Appeal case, the plaintiff was seriously injured when he was hit by a taxi cab. The taxi cab was owned by the defendant company, Seon Cab Corporation. It was alleged that the cab was negligently operated by another defendant. Carlton was the stockholder of ten corporations including the corporation in question, each having two taxi cabs registered in its name. The corporations, however, operated as a single entity with regard to financing, supplies, and other resources. Action was brought against the driver of the taxi, Seon Cab Corporation, nine other corporations, and Carlton. The corporations were claimed to be undercapitalized and their assets intermingled.

When the case eventually reached the Court of Appeal, it was held that the allegations fell short of demonstrating a cause of action against the defendant Carlton. The court found no reason to hold Carlton liable for the corporation’s debt. It rejected the claim that Carlton was doing business in his individual capacity as shareholder, but did not deny that the corporation was undercapitalized. However, the majority of the court thought that undercapitalization \textit{alone} was not a sufficient ground to impose personal liability. In the

\textsuperscript{312} Elvin Latty, \textit{supra} note 203 at 119.
\textsuperscript{313} \textit{Walkovszky v Carlton} 18 NY (2d) 414 (1966).
majority’s view, the allegation of fraud could not stand since there was nothing fraudulent about Carlton taking out only the minimum required liability insurance. Meeting the minimum requirement by law will protect shareholders from liability to stakeholder claimants.

However, the nature of the business in question drew a concern. Judge Fuld even found it necessary to restate that the law permits the privilege of limited liability to be disregarded “to prevent fraud or achieve equity.” Nevertheless, as principal shareholder of the corporation, Carlton had met the minimum insurance required by law and this was sufficient for the majority of the court.

Limited liability is protected under statute. But the protected rule has led to the exceptional principle of veil piercing to provide an equitable remedy when the circumstances of a case call for it. The court’s sole reliance on the fact that Carlton satisfied the minimum statutory insurance required by law, is therefore, irrational, given the circumstances of the case and the injuries sustained by the plaintiff. There are foreseeable risks involved in operating a taxi cab company. The adequacy of capital must be determined by the nature of a corporation. Based on the nature of the taxi cab business, the minimum $10,000 insurance coverage is entirely insufficient to cover foreseeable risks, such as injuries to pedestrians.

---

314 Ibid. at 417.
315 In the dissenting judgement of Judge Keating, he cited Minton v Cavaney, stating that “it seems obvious that one of ‘the risks of loss’ referred to” in that case “was the possibility of drowning due to the negligence of the corporation. And the defendant’s failure to provide such assets or any fund for recovery resulted in his being held personally liable”, at 593. The risk of accidents occurring due to the nature of the taxi cab business is clearly foreseeable.
The insurance coverage was not only small in the context of the risks associated with the taxi cab business, but the only assets the company possessed were two mortgaged taxi cabs.

A significant part of Walkowszky was the dissenting judgement of Judge Keating who, along Judge Bergan, dissented from the majority’s decision to not pierce the veil and hold Carlton personally liable. Judge Keating’s judgement has gained much recognition from legal scholars and writers.316 He reasoned that Carlton was the principal shareholder of the corporations which were intentionally undercapitalized from inception for the purpose of avoiding responsibility for acts which were, according to Judge Keating, bound to arise as a result of the operation of a large fleet of taxi cars engaged in daily public transportation.317 He stated:

The issue presented by this action is whether the policy of this State, which affords those desiring to engage in a business enterprise the privilege of limited liability through the use of the corporate device, is so strong that it will permit that privilege to continue no matter how much it is abused, no matter how irresponsibly the corporation is operated, no matter what the cost to the public. I do not believe that it is.318 [Emphasis added]

316 See David Parker, “The Undercapitalisation of a Company: Can this be the Basis for Piercing the Corporate Veil?”, Australasian Law Teacher’s Association 2006 Refereed Conference Papers, ALTA Secretariat online: http://s3-ap-southeast-2.amazonaws.com/resources.farm1.mycms.me/alta-edu-au/Resources/PDFs/Published%20Conference%20Papers%202006%20and%202007/2006%20Papers/Parker%20D%20-%20The%20Undercapitalisation%20of%20a%20Company%20-%20Final.pdf; see also Stephen Bainbridge, Corporate Law (Thomson Reuters Foundation Press, 2009) at 67. (Although Bainbridge acknowledges Judge Keating’s position in Walkoszky v Carlton, he asserts that Judge Keating’s view regarding undercapitalization only sounds sensible at first blush, and goes on to criticize it as he draws a scenario and poses questions he believe one would need to answer for shareholders. According to Bainbridge, some wrong beyond a creditor’s inability to collect must be shown before the veil can be pierced. However, the inability of creditors to collect due to inadequate capital is wrong in itself, as it shows an abuse of the corporate form, by making it unable to meet its liabilities).

317 Ibid.

318 Walkowszky v Carlton, supra note 242 at 592.
Judge Keating also turned to *Minton v Cavaney*\(^{319}\) and *Ballantine on Corporations*\(^{320}\) to support his view that it is not equitable for shareholders to set up companies with insufficient funds and to be afforded the privilege of limited liability, when to do so would result in inequitable consequences to stakeholders. And, referring to *Anderson v Abbott*\(^{321}\) Judge Keating said it provides an example of the Court’s duty to deny the principle of limited liability “when the sacrifice is so essential to the end, that some accepted public policy may be defended or upheld.”\(^{322}\)

It must be noted that in *Walkovzsky*, Walkovszky suffered a double fracture of the pelvis, a possible skull fracture, and was probably partially disabled for the rest of his life.\(^{323}\)

Carlton owned nine other cab corporations and no evidence was presented that he could not compensate Walkovszky. Like in *Walkovzsky*, in *Anderson*, the governing statutes provided that the shareholders in certain banks were liable to the extent of the amount of their stock. The shareholders had made transfers to a holding company that they organized, all in good faith. Nevertheless, the court pierced the veil and held all the shareholders, both

\(^{319}\) It is inferred that Judge Keating is of the view that undercapitalization can be an independent ground for liability when he quoted Justice Roger Traynor in *Minton v Cavaney*. The portion quoted was the following:

> The equitable owners of a corporation are personally liable when they treat the assets of the corporation as their own......when they hold themselves out as being personally liable for the debts of the corporation, OR when they provide inadequate capitalization......

\(^{320}\) *Ballantine*, *supra* note 172.


\(^{322}\) *Walkovszky*, *supra* note 242 at 424.

\(^{323}\) Comment, *supra* note 246.
voluntary and involuntary, liable for the obligations of the impecunious holding company.

In the words of Judge Cardozo:

> An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in cases denying stockholders their defense of limited liability.….That rule has been invoked even in the absence of legislative policy which undercapitalization would defeat. [Emphasis added]

Legislative policy has been denied by the court on many occasions in order to prevent injustice to creditors. In *Walkovzsky* the majority decision was certainly not in the interest of justice and fairness. The majority favored more the shareholder’s adherence to the statutory minimum insurance requirement. Speaking to the allegation of undercapitalization, Judge Fuld saw no need to provide his reasoning on the issue. Judge Keating, however, in the final conclusions of his dissenting judgment, said the following:

> What I would merely hold is that a participating shareholder of a corporation vested with a public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of the corporation's business, may be held personally responsible for such liabilities. Where corporate income is not sufficient to cover the cost of insurance premiums above the statutory minimum or where initially adequate finances dwindle under the pressure of competition, bad times or extraordinary and unexpected liability, obviously the shareholder will not be held liable.324

Basically, the attempt to carry on business in corporate form, without providing a sufficient financial base, is an abuse of the corporate process justifying a piercing of the corporate

324 *Walkovzsky supra* note 242.
veil. Though a dissenting judgement, Judge Keating’s argument has gained much recognition particularly because of its public interest focus.

Most corporations constantly engage with the general public, which includes external stakeholders and other persons who come into contact with the corporation. For that matter, consideration must be given to foreseeable risks, and a corporation should be adequately funded to meet those risks. As Judge Keating asserted, there are some liabilities of a corporation that are certain to arise, and in no way should it be acceptable for shareholders to ignore the importance of a corporation’s risks and responsibilities, simply because liability is limited to them.

Undercapitalization is undoubtedly a very critical issue and courts do not undermine its significance. In all the cases discussed in this chapter, the courts identified undercapitalization to be either a significant factor, or an important factor in veil piercing cases. Prior to the case of Dana v 313 Freemason, the Supreme Court of Virginia refused to pierce the corporate veil for what they thought were even more compelling matters than

---

325 Stephen Bainbridge, Corporate Law, (Thomson Reuters Foundation Press, 2009). Inadequate capitalization, in an economic sense, is one of the principal factors looked to by the courts as a sign of misuse of the corporate privilege-Willliam Hackney & Tracy Benson, supra note 26 at 1981-1982.

326 See Guanares Bros. & Co. v United States, 185 F Supp 794; Minton v Cavaney, supra note 184; Kilpatrick Bros Inc v Poynter, 205 Kan 787 P (2d) 33 (1970); Contra, Critzer v Oban Wash. (2d) 446; 326 P (2d) 53 (1958).

327 This view is also supported by Frederick Lenz & Andrew Newman, “Corporations-Stockholders’ Personal Liability-Application of Agency or Undercapitalization Theory to “Pierce Corporate Veil.”-Walkovszky v Carlton”, (1967) 8:4 Boston College L Rev 981 at 984.

328 Dana v 313 Freemason 266 Va 491 at 2003.
just undercapitalization.\textsuperscript{329} The deliberate undercapitalization in that case, however, led the court to pierce the veil.

The case involved a close private corporation called Freemason that was grossly undercapitalized. It was believed that the sole purpose of the corporation was for the investor to avoid liability. There were no liquid assets of the company and the investor transferred all the income of the corporation to his personal account. Condominium units that were being sold to the plaintiff were in poor condition and this was known to the shareholder. Nevertheless, the defendant shareholder thought to cover himself from liability by hiding behind the corporation. In their reasoning and discussion whether the trial court erred in piercing the corporate veil of a close corporation to impose liability against the corporation’s stockholders,\textsuperscript{330} the court quoted its previous judgement in \textit{O’Hazza}, to say that:

\begin{quote}
One of the principal factors we look to in resolving the issue of piercing the veil of a corporation, and pertinent here, is whether the inability of the corporation to satisfy the judgement against it is the result of the deliberate undercapitalization by the incorporating shareholders. If from its inception, a corporation is unable to pay its costs of doing business because of grossly inadequate capitalization, its legitimacy of suspect. Under such circumstances, stockholder may not be entitled to the corporate shield.\textsuperscript{331}
\end{quote}

Again, the inference is made that shareholders cannot inadequately capitalize a corporation to avoid liability, or they will be held liable for that fact alone, especially where to do so

\textsuperscript{329} Wendy Davis and Serdar Hizir, “Dance of the Corporate Veils: Shareholder Liability in the United States of America and in the Republic of Turkey” (2008) 1 Ankara B Rev 76.
\textsuperscript{330} Ibid.
\textsuperscript{331} \textit{O’Hazza}, supra note 305 at 321.
would cause injustice. The court distinguished that decision from the present case in that Freemason was never adequately capitalized. The court stated further—

The apparent inability of Freemason to satisfy the judgment against it in this case was not the result of poor business decisions, mismanagement, or unexpected liabilities such that an expected profit never materialized. Rather, because of the deliberate acts of the incorporating shareholders, Freemason suffered from non-existent capitalization from its inception.\textsuperscript{332}

In this case, undercapitalization was not the only issue present. There was unity of interest between the shareholders and the corporation. Even so, the court viewed gross undercapitalization as sufficient to allow it to pierce the veil. Although the Supreme Court of Virginia generally supports the view that undercapitalization is but one factor to consider, the court found that \textit{deliberate} acts of undercapitalization are sufficient ground for holding shareholders personally liable.\textsuperscript{333}

In \textit{Remme v Herzog},\textsuperscript{334} Remme, a former employee, brought action against his former employer, Herzog Builders Supply Company, Inc. He sought to recover a percentage of profits that were due to him from the corporation under his contract of employment, under which he was entitled to one-third of the net profits of the business. About a year and a half after being employed, Remme terminated his employment and this action followed.

The court rendered judgement not only against Herzog Builders Supply, but also against the stockholders. This was because the corporation began business with an invested capital of $7700.\textsuperscript{335} The court found evidence that in operating the business through the corporate

\textsuperscript{332} \textit{Ibid.}
\textsuperscript{333} \textit{Ibid.}
\textsuperscript{334} \textit{Remme v Herzog} 222 Cal App (2d) 863.
\textsuperscript{335} \textit{Ibid} at 589.
entity, the stockholders themselves disregarded that entity. It was clear that the company was undercapitalized and in its conclusions, the court said that “undercapitalization is a factor to be considered in determining whether the corporate veil should be pierced.”

The court held that shareholders should not be allowed to set up organizations with capital so small that the corporation cannot meet its debts. In those circumstances, the shareholders should not be allowed to escape liability.

On grounds of undercapitalization alone, the court held the shareholders responsible to compensate Remme as a stakeholder of the corporation. Although it held undercapitalization to be sufficient ground to pierce the corporate veil in this case, the court seem to contradict itself by stating that undercapitalization is only a factor to consider. The general principle, as followed in Automotriz, Harris, Dewitt and Walkovzsky is that other factors must be present with undercapitalization to allow for veil piercing. In Remme, undercapitalization was held as a factor to consider, but the Court of Appeal pierced the veil on the basis of undercapitalization alone in order to uphold justice.

5.7 Conclusion
The scenario at the beginning of this chapter provided a basic example of an undercapitalized corporation and the resulting circumstances that unfold when stakeholders cannot be compensated for losses. A number of US cases where courts have grappled with the issue were then examined. Three things are clear from the cases. The courts accept that limited liability, although an established legislative policy, cannot be upheld in every case when to do so would result in injustice to stakeholders. Secondly, no

---

336 Ibid. at 589.
case has denied that undercapitalization is a significant or important factor for determining whether to hold shareholders personally liable for a corporation’s debt. If it stands alone as being important or significant, it is difficult to understand how the absence of other factors can make it any less important for holding shareholders liable. Thirdly, most of the US cases that do not favour undercapitalization as an independent factor for veil piercing, or which see it as only one of the deciding factors for determining such an outcome, lack justification and clear reasoning as to why a deliberate failure to adequately fund a corporation cannot make their shareholders personally liable. Judge Keating in Walkovszky, at least, attempted to provide some rationale for veil piercing for undercapitalization on grounds of public interest.

Limited liability is a privilege granted to corporate shareholders. While it is a legitimate corporate privilege, deliberate undercapitalization should never be shielded by it. The cases reveal that the US courts find inadequate capitalization to be a pressing issue weighing heavily on the grounds of fairness and financial irresponsibility. However there exists a lack of consistency in the courts’ views regarding undercapitalization. The general principle which the majority holds is that inadequate capitalization is only a factor to consider, but the few cases in which the courts have pierced the veil for undercapitalization have helped to illustrate its critical nature. Judges and legal scholars have all provided their views on the issue and while some take an independent stand, attempting to provide reasoning for undercapitalization as an independent ground for veil piercing, others merely state, with no sufficient reasoning, that undercapitalization has never been accepted as an independent basis for liability.
Chapter 6
Tort Creditors vs Contract Creditors – Should It Matter for Veil Piercing?

6.1 Introduction
The cases explored in chapter 5 not only exposed the inconsistency in the law regarding undercapitalization, they also demonstrate a lack of reasoning on the part of some judges in their decision making. The cases explored involved both contract and tort stakeholders. Legal scholars have grappled with the issue of determining where liability for tort and contract cases should rest where a corporation has been inadequately financed. There are two lines of argument that have developed.

The first is that the veil piercing doctrine cannot protect tort creditors since they do not rely on any financial information of a company as contract creditors do, nor are they deceived by their association with the company.\textsuperscript{337} The second is that contract creditors should not be allowed to benefit from the veil piercing doctrine since they would have had the opportunity to inquire about the financial status of a corporation before entering into a contract with it. In regards to the legal implications of the relationship between tort and contract creditors, the goal is to examine whether the type of stakeholder involved in a particular case should determine liability, as some scholars argue.

\textsuperscript{337} Comment, supra note 248 at 1966-1967. The author further commented that courts cannot focus solely on initial capital or assets in deciding whether inadequacy of assets warrants a decision to pierce because subsequent changes such as increased hazards or reduced assets may render a determination as to initial inadequacy irrelevant. However the author failed to consider that the level of initial capital often times determine the increased hazards that companies would face such as cash flow deficiencies.
It is concluded in chapter 5 that as a matter of public policy and in the interest of justice, undercapitalization should be an independent ground for veil piercing. Such a conclusion demands a discussion of both tort and contract cases since the corporate veil can only be pierced in either of these types of cases. Such a discussion will seek to show why it is necessary to hold both tort and trade creditors vulnerable to undercapitalized corporations. The chapter begins with a discussion about tort creditors and demonstrates why they are classified as helpless victims to corporate misconduct such as undercapitalization. Subsequent to this is a discussion regarding contract creditors which proves they are no better off than tort creditors, although circumstances may show that their financial status places them in a better position to secure their investment and inquire about the financial standing of corporations. This chapter then concludes that both tort and trade creditors are vulnerable to inadequate capitalizing of companies by shareholders, and the type of creditor or stakeholder in question should not determine whether to pierce the veil or not, unless such creditor is a financial institution.

6.2 Undercapitalization in Tort Cases
It is generally accepted that tort creditors, as opposed to contract creditors do not have the advantage of negotiating with a corporation before accepting the risks implicated by their dealing with the company. In view of this, it is socially undesirable for firms to shift these risks, and costly for tort claimants to internalize those risks. In economic terms, tort

338 Salmon Castro, supra note 278. The view was confirmed in Secon Service System, Inc. v St. Joseph Bank and Trust Co. 855 F.2d 406 (7th Cir. 1988) where Judge Easterbrook stated thus at 413:

Analysis of the scope of these exceptions [to limited liability] sometimes appears dominated by metaphor or epithet rather than by logic. [But] [s]ome points stand out, among them that it is a lot
creditors cannot be identified \textit{ex ante} and cannot engage in \textit{ex ante} risk allocation to protect themselves.\textsuperscript{339} In other words, injured employees or customers do not plan their accident. While injury in the work place is foreseeable when an accident will occur cannot be predicted. Judge Frank Easterbrook made the following observation in \textit{Secon Service System, Inc. v St. Joseph Bank & Trust Co.}:\textsuperscript{340}

\begin{quote}
It is a lot harder to hold investors personally liable in contract disputes than for tort judgments. The reason is simple: contract creditors have entered into a voluntary arrangement with the corporation, which gave them an opportunity to negotiate terms reflecting any enhanced risk to which doing business with an entity enjoying limited liability exposed them. If they wanted guarantees from the investors, they could have negotiated for them. Tort creditors [on the other hand] had no chance to obtain compensation \textit{ex ante} for exposure to increased risk, so to cut off all liability might encourage excessively risky behavior.
\end{quote}

See also Robert Hamilton, \textit{supra} note 3 at 988 where it is said that courts are much more likely to hold shareholders liable in tort cases when the element of inadequate capitalization is present.


\textsuperscript{340} \textit{Secon Service System, Inc. v St. Joseph Bank & Trust Co} 855 F (2d) 406 at 413-14 (7th Cir. 1988).
Tort creditors must, therefore, be able to assume that the corporation in question is financially stable. This would help to discourage investors from indulging in risky behavior while encouraging corporate responsibility.

Limited liability encourages shareholders to externalize risks to tort creditors. This is why Tung argues that corporations will under-invest for their safety, and engage in excessively risky activities. The result is that limited liability encourages corporate irresponsibility toward tort creditors as we have seen in the Walkovszky case discussed in chapter 5. Tort creditors do not assume risks of insolvency or inadequacy of capital. They ordinarily have no choice in the selection of their debtors, and no opportunity to examine financial conditions. They are entirely involuntary risk bearers of undercapitalized corporations. Where a company has been undercapitalized, a manifestation of bad faith is already present, as Judge Keating pointed out in Walkovszky. Failure to impose personal liability on the shareholders of undercapitalized corporations in tort cases undermines court enforcement of the corporate privilege and, ultimately, engenders inequitable outcomes.

6.3 Undercapitalization in Contract Cases
The general idea in contract cases is that creditors voluntarily choose to deal with corporations and, therefore, have the opportunity to inquire about credit risks before entering into contractual agreements. Based on the enquiry, they can determine whether it is fitting to contract with the corporation or not. If it turns out that the corporation is

341 See generally Frederick Tung, supra note 339.
342 As discussed in Chapter 5.
343 Philippe Salomon, supra note 132 at 342.
344 Ibid. at 344.
345 Ibid.
346 Solomon Castro, supra note 278 at 644.
unable to make contractual payments, the contract creditor is said to have considered that risk and should not be entitled to pierce the corporate veil.\textsuperscript{347}

In the \textit{DeWitt}\textsuperscript{348} case discussed earlier which involved a contractual arrangement for a corporation to sell farm products, the following declaration was made by the court in determining whether to pierce the veil:

\begin{quote}
The reasoning is that when one extends credit or makes any other contractual arrangement with a corporation, it is to be assumed he acquaints himself with the corporation's capitalization and contracts on such basis, and not on the individual credit of the dominant stockholder.\textsuperscript{349}
\end{quote}

The position of the court in this regard was discussed by Harvey Gelb in his article.\textsuperscript{350} Gelb is of the view that despite the assurance given to the plaintiff creditor that payments will be made, no weight should be given to the undercapitalization factor. Hence, undercapitalization should not play a part in determining whether to pierce the veil. If, however, the failure to pierce would present the court with an unjust result in light of the shareholder’s personal assurance, then such assurance may well be an element contributing to a decision to pierce.\textsuperscript{351}

It should be pointed out that while the stockholder’s personal assurance carries much weight in determining liability, undercapitalization weighs heavily for two reasons. Without such an assurance, there would still exist an undercapitalized corporation, and the dominant stockholder would know this. Unless it is evident that the undercapitalized or

\begin{flushright}
\textsuperscript{347} \textit{Ibid.}.
\textsuperscript{348} As discussed in Chapter 5.
\textsuperscript{349} See note 274, footnote 13.
\textsuperscript{350} Harvey Gelb, \textit{supra} note 244.
\textsuperscript{351} \textit{Ibid.}
\end{flushright}
generally poor financial condition of a corporation is not due to the intentional acts of its stockholders, undercapitalization should always be a sufficient ground for piercing the veil.

Secondly, in Dewitt, the court referred to the presence of injustice or fundamental unfairness in order to disregard the corporate entity and pierce the veil. If one was to subtract all other factors except inadequate corporate capital that the court took into consideration, such as proper formalities, there would still exist an injustice to the contract creditor: no compensation. Common factors, such as the failure to observe formalities and the exercise of shareholder control and dominance, have no apparent causal connection to claims of either contract or tort creditors.\(^\text{352}\)

Gelb rightly argues that contract creditors who are able to protect themselves should not be allowed the equitable remedy of veil piercing for a corporation’s inadequate capital level. But those contract creditors who are unable to protect themselves when dealing with corporations should arguably be able to win piercing cases \textit{solely} on the ground of undercapitalization.\(^\text{353}\) This argument recognizes two types of contract creditors: Financial creditors, such as banks and other financial institutions, have high professional portfolios and the financial expertise needed to examine the financial status of companies with which they transact. In most cases, these financial creditors secure their transactions with high

\(^{352}\) Solomon Castro, \textit{supra} note 278 at 639.

\(^{353}\) Harvey Gelb, \textit{supra} note 244 at 13. It was argued in \textit{Moore & Moore Drilling Co. v White} 345 SW (2d) 550 (Tex Civ App (1961) that a person dealing with a corporation should investigate the financial position of the corporation with which he is dealing. It is also said that this principle applies to small trade creditors who do not make elaborate investigations of their customers because of the size of the transactions or the competitive nature of their business. However, most small trade creditors are not in the position to make elaborate investigations of companies like financial institutions would be able to do. Even financial institutions should have a legitimate expectation that a company would be able to meet its liabilities and that its failure to do so is not the result of inadequate capitalization.
interest rates, personal guarantees from shareholders, and other forms of security. On the other hand, small contract creditors, such as employees and other middle level suppliers, do not possess the level of expertise by which to competently evaluate the financial status and credit risk of a company.\footnote{See John Hudson, “The Case Against Secured Lending” (1995) 15 Intl L & Econ 47 at 56, where it was explained that banks contain superior ability to determine their financial position and monitor firms as compared to trade creditors. See also Solomon Castro, supra note 5 at 648 where the following view regarding different types of contract creditors was discussed. Solomon stated that “transactions may be too small to warrant either a full investigation into the firm's financial condition or a detailed negotiation regarding risk and return. This amounts to what may be termed as a "sophisticated" creditor requirement since only those creditors who have access to company information (either actual access or bargaining power or relationship to gain access) and are able to use them in making credit decisions, would be barred from invoking undercapitalization to tear the corporate fiction. In the case of small creditors, it is argued that it would be more efficient for the company to disclose any "unusual capitalization" than for the unsophisticated creditor to investigate.” A further argument that can be raised is that all creditors, in both contract and tort cases, should have a reasonable expectation that the corporation in which they are engaged is adequately capitalized to make returns and compensation unless the company declares bankruptcy. See also “Piercing the Corporate Veil: A Comparison of Contract Versus Tort Claimants under Oregon Law” (1999) 78 Or L Rev 347 at 349 where it is stated that “contract creditors who deal with the corporation on a voluntary basis through the extension of loans and financing bear much….risk; however they are able to adjust their credit terms to compensate for any risk that limited liability will impose on them.” They are also more skilled to evaluate the financial status of corporations. See also Harvey Gelb, Limited Liability Policy and Veil Piercing (2009) 9:2 Wyo L Rev 551 at 566 where he stated:}

Those contract creditors who are in a position to do so, like banks, may obtain personal guarantees and/or security from privately held businesses as a matter of course. But the vast majority of contract creditors or potential contract creditors, such as wage earners, consumers, trade creditors and small suppliers, have probably been in no position competitively or economically to insist on guarantees or other protections or to incur the expenses of investigating whether they should be seeking such protections. These contract creditors should not lose the opportunity to pierce corporate veils or be disadvantaged in their efforts to do so simply because they are classified as contract creditors.
corporation and a financial institution will, in most cases, far outweigh the contractual amount involved with the average trade creditor. It is not good practice for any creditor to engage in business transactions with companies without knowledge of its capital structure.\(^{355}\) But this does not mean that the creditor should bear the loss if the corporation was initially underfinanced.\(^{356}\) Robert Dye’s cogent argument affirms at \(^{838}\) of his article, \((supra\: note\: 122)\):

> Shareholders in inadequately capitalized corporations should not be allowed to shift speculation risks to contract creditors, specifically, because (1) there is no reason in terms of the justification for limited liability to hold otherwise, and (2) it is reasonable for creditors to rely on initial adequate capitalization. First, since the reason for granting limited liability is encouragement of investment, there is no justification for limited liability accruing to the corporate entity until such time as it becomes adequately capitalized. If the corporation with which a creditor deals remains inadequately capitalized, the creditor should be allowed to recover against the shareholders because the corporation never paid the price for limited liability which, therefore, should never attach.

The belief that courts are more willing to pierce the corporate veil in tort cases than in contract cases\(^{357}\) has been challenged by a 1991 study.\(^{358}\) A nationwide study in the United States revealed that courts have disregarded the corporate entity in 42% of contract cases and only 31% in tort cases.\(^{359}\) These statistics provide support for the view that trade and other small contract creditors are in no better position than tort creditors for evaluating the financial standing of a corporation.

\(^{355}\) Robert Dye, \textit{supra} note 122 at 837.
\(^{356}\) \textit{Ibid}.
\(^{357}\) Easterbrook and Fischel, \textit{supra} note 12 at 112.
\(^{358}\) Robert B. Thompson, \textit{supra} note 80.
\(^{359}\) \textit{Ibid} at 1039.
Dye recommends that corporations need merely disclose their financial status to all future creditors, which will remove the “ignorant creditor” problem completely.\(^\text{360}\) It is also argued that the cost of providing such information would be less for the corporation than for the creditor, since the corporation, presumably, has the necessary information to make available to creditors.\(^\text{361}\) Disclosing such information can be beneficial to small contract creditors who can then determine whether they want to negotiate with an undercapitalized corporation. Such information, however, cannot be provided beforehand to tort creditors, as they are involuntary creditors.

### 6.4 Conclusion

None of the cases examined in chapter 5 involves financial creditors. These institutions often secure their investments and contain the resources to obtain any financial information and security they desire. The cases mostly involved tort creditors of closely held corporations, and small and medium sized contract creditors. There should be no distinction between tort and small/medium sized contract creditors and their right to receive the court’s equitable remedy of veil piercing when the facts of a case clearly illustrate the intentional undercapitalization of a company against which they have a claim to be satisfied. The consideration for wrongful corporate actions which are not in the best interest of stakeholders should not be determined on the basis of the type of creditor involved. The focus must be the actions of the debtors not the form. Thus, whether the court is dealing with a contract or tort creditor, the veil should be pierced for undercapitalization, unless

\(^{360}\) Robert Dye, *supra* note 122 at 845.

\(^{361}\) *Ibid.*
the court determines that the contract creditor is secured and in a position to investigate the financial status of the corporation in question.
Chapter 7
Recommendations and Conclusion

This thesis argues that undercapitalization of private companies should be an *independent* ground for piercing the corporate veil. Undercapitalization in private companies exists for two reasons: minimum capital requirements are not imposed across the board for shareholders of private companies, and courts do not consider undercapitalization significant enough to be an independent ground for shareholder liability. However, undercapitalization is, in fact, an issue affecting corporate stakeholders, as the US cases discussed has shown. Minimum capital requirements within a standard range are set for public corporations by way of contributions to a large corporate fund, but such a requirement may not prove effective for private companies. Indeed, for them, it may prove inefficient and rather costly.

In view of the foregoing, it is recommended that adequate capital maintenance be regulated by the courts. This is a more effective method, because the adequacy of capital must be determined by the nature and form of the business in question. Secondly, as this thesis has argued, the nature and structure of corporations vary in many ways. For this reason, to decide whether a corporation is undercapitalized or not, it is recommended that the courts examine factual details and the circumstances surrounding the particular case. When it cannot easily determine if a particular corporation is undercapitalized, the court must utilize the skills of financial analysts to come to a conclusion on capital adequacy.
The limited liability company developed as an incentive for investment in society. Even so, the development of its separate legal personality was influenced by rentier investors who sought effective avenues to secure their investments. Lord Curriehill was right in explaining the repercussions of such change in the law relating to investment. While he did not deny the benefits of limited liability he argued against the effects the limited liability company would have on creditors. His view was that those enjoying the benefits of liability must also feel its burden.

Before the rise of the limited liability company, the law of partnership allowed for those committing wrongful acts to be responsible for those acts. Subsequent to its development, judges began to speak of the immoral acts limited liability encouraged in investors. As a result, they were forced to develop exceptional principles to make investors personally liable for corporate actions which, if not punished, could result in unfair dealing with stakeholders. Despite this, courts seldom exercise this jurisdiction for fear that businessmen would stop investing in companies and, thus, adversely affect the economic growth and development of society.

Partnership associations never discouraged investors to invest. But this form also led to illicit business conduct by investors who were afraid to be fully liable for their company’s debt. Limited liability, therefore only legitimized illicit activity, even from initial incorporation. The economic advantages a limited liability company brings to an economy are important for continued growth and development. However, it is also arguable whether their operations bring with them the level of justice and transactional fairness in the social relations those operations necessitate.
Institutions must therefore owe a duty to stakeholders, since without stakeholders there can be no successful operation of a company. As this thesis has shown, empirical evidence reveals that courts have found the need to pierce the veil only in privately held companies. Investors of these companies are usually afforded the privilege of funding their organization for their own benefit. Hence, undercapitalization has become prevalent among closely held corporations, as well as parent and subsidiary companies.

As shareholders enjoy limited liability, stakeholders should also enjoy the assurance of fair dealing by investors of an adequately capitalized company. Although acknowledged as a significant factor, the importance of adequate capitalization is undermined when courts refuse to pierce the veil on that ground alone. Its critical depth cannot be fathomed unless the reasons for why it is important to protect stakeholders are understood. While it is important for shareholders to see returns in their investment, the sole purpose of companies cannot be to maximization wealth. Stakeholders are the reason for the continued growth and success of companies. As a result there should be a legitimate expectation that risks will not be externalized unnecessarily.

This thesis has sought to demonstrate that undercapitalization unnecessarily externalizes risks to stakeholders as it increases the chances that stakeholders will not be fully compensated by corporations. This should not prevent stakeholders from reaching the assets of shareholders especially where corporations are intentionally undercapitalized. The development of corporate social responsibility has demonstrated that institutions have economic, legal, and moral responsibilities to society. Often times these moral responsibilities are overlooked as a result of selfish ends and the desire for wealth maximization.
As Judge Keating argued in *Walkovzsky*, the veil should be pierced for undercapitalization on grounds of public policy. Public policy therefore informs the ethical duties owed to society. It is only through law that corporations possess the characteristics that they have. Hence their investors are the operators and should be obliged to finance them adequately before they are allowed to operate business. They cannot commit treason, they cannot be outlawed, and they cannot be excommunicated, for they have no souls.  

Courts are institutions designed to enforce justice in every society. The facts of the cases discussed all revealed a level of injustice that the courts have not denied. In all of the cases explored in chapter 5, no judge has denied that the corporations in question were inadequately capitalized. For those cases in which the courts refused to pierce the corporate veil, the only reasoning was that in following previous decisions, undercapitalization alone has not been considered sufficient grounds to hold shareholders personally liable. The courts’ lack of reasoning and failure to consider the interests of stakeholders is questionable. As Judge Keating would agree, as institutions of justice, the courts have a duty to hold investors responsible for their actions on grounds of public policy.

---

Bibliography

LEGISLATION

Canada Business Corporations Act, RSC 1985, c. C-44, s 15 (1) [CBCA].

Bubble Act 1720 (UK), 6 Geo 1, c 18.

JURISPRUDENCE


Arnold v. Phillips, 117 F (2d) 497 (5th Cir 1941).

Automotriz Del Golfo De Cal. v. Resnick, 47 Cal (2d) 792 (1957), 306 P (2d) 1, 63 ALR (2d) 1042.

BCE v 1976 Debentureholders, 2008 SCC 69.


Burns v Pennell, 2 HL 520.

Contra, Critzer v Oban Wash. (2d) 446; 326 P (2d) 53 (1958).

Costello v Fazio 256 F (2d) 903 at 908.

Dana v 313 Freemason 266 Va 491 at 2003.


Dixie Coal Min & Mig Co v Williams, 221 Ala 331.


Guanaires Bros. & Co. v United States, 185 F Supp 794.


In re V. Loewer's Gambrinus Brewery Co., 167 F (2d) 318 (2d Cir. 1948).

J-R Grain Co. v. FAC 627 F (2d) 129, 135 (8th Cir. 1980).


Kilpatrick Bros., Inc. v. Poynter, 205 Kan 787 (1970), 473 P (2d) 33 at 40


Moore & Moore Drilling Co. v White 345 SW (2d) 550 (Tex Civ App (1961).


Oriental Investment Co. v Barclay 25 Tex Civ App 543 (1901), 64 SW 80.

People v Coleman, 133 NY 279, 31 NE 96.

Petrodel Resources Ltd. v Prest [2013] 2 AC 415.


Re Mobile Steel Co. 563 F (2d) 692 (5th Cir 1977).

Remme v Herzog 222 Cal App (2d) 863.

Salmon v The Hamborough (1671), 1 Ch 204.

Salomon v Salomon [1897] AC 22, 66 L.J. Ch. 35 (HL (Eng).

Secom Service System, Inc. v St. Joseph Bank and Trust Co. 855 F.2d 406 (7th Cir. 1988).


Stone v Eacho, 127 F (2d) 284 (4th Cir 1942).


Wabash Ry. v. American Refrigerator Transit Co. 7 F (2d) 335 (8th Cir. 1925).


Wildman v Wildman, 2006 ONCA 82 OR (3d) 401.

Willis v Chapman, 68 Vt 459, 35 Atl 459.

SECONDARY MATERIAL: BOOKS


Conard, *Corporations in Perspective* (Foundation Press, 1976).


SECONDARY MATERIAL: PRACTICE BOOKS

SECONDARY MATERIAL: ARTICLES


Petrella, Marisa. “Piercing the Corporate Veil in Michigan” (1883) 61 U Det J Urb L 81.


SECONDARY MATERIAL: ENCYCLOPEDIC DIGESTS
CED 4th Business Corporations (Ont), “Characteristics of Corporation” (ll.2.(b).(i) at §18.
SECONDARY MATERIAL: ONLINE

“The Industrial Revolution and the Changing Face of Britain”, British Museum Online Search Catalogue, online:

http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2575&context=lcp.

Company Law Review Steering Group, “Company Formation and Capital Maintenance” (London: DTI, 1999), online:


Kay, Geoffrey & James Mott, “Notes on the Law of Capital”, online:

https://kar.kent.ac.uk/1940/1/201305031110.pdf.

Company Law Review Steering Group, “Company Formation and Capital Maintenance” (London: DTI, 1999), online:


L.C.B. Gower, “The English Private Company”, online:

Ireland, Paddy, “Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility” (2010) 34 Cambridge J of Economics 837 at 840, online:


Barnes, Paul. “The Origins of Limited Liability in Great Britain, the First ‘Panic’, and Their Implications for Limited Liability and Corporate Governance Today”, online:


Parker, David. “The Undercapitalization of a Company: Can this be the Basis for Piercing the Corporate Veil?”, Australasian Law Teacher’s Association 2006 Refereed Conference Papers, ALTA Secretariat online:

http://s3-ap-southeast-2.amazonaws.com/resources.farm1.mycms.me/alta-edu-au/Resources/PDFs/Published%20Conference%20Papers%202006%20and%202007/200
SECONDARY MATERIAL: WORKING PAPERS

“Royal Commission on Assimilation of Mercantile Laws in United Kingdom and Amendment in Law of Partnership, as Regards Question of Limited or Unlimited Responsibility First Report”, Cm 1791 in *Sessional Papers* (1854) 15.