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Corporations

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CORPORATIONS

DISREGARDING THE CORPORATE ENTITY

Oklahoma. In *Kingkade Hotel Co. v. Keggin*[1] the court held that where one corporation owned a hotel and a separate corporation managed it, it was reversible error to allow the plaintiff to sue the owner corporation for a tort committed by the management corporation. The plaintiff had sued the Kingkade Hotel Company, the owner corporation, for wrongful ejectment from his hotel room and conversion of his baggage. At the trial the plaintiff offered no evidence that the Hotel Kingkade was operated by the defendant. Martin Kingkade testified for the defendant that there were two separate corporations: the Kingkade Hotel Company, the incorporated owner of the hotel and furniture, and the Hotel Kingkade, the corporation which operated the hotel. Kingkade testified that he was the president of the Kingkade Hotel Company, and that he was manager of Hotel Kingkade. He also testified that he owned stock in both corporations. The defendant offered in evidence the separate annual corporation license for each of the corporations, but the trial court sustained an objection to the introduction of these instruments.

Kingkade testified that the Kingkade Hotel Company, the defendant in the suit, had nothing to do with the operation of the hotel. The testimony that there were two separate corporations, one of which owned the building and the other of which operated the hotel, and that this defendant had nothing to do with the operation of the hotel was *uncontradicted.* At the conclusion of the testimony the defendant moved to dismiss on the grounds that the evidence showed that the defendant was not at any time operating the hotel. The motion was overruled. The jury rendered a general verdict for the plaintiff.

The Supreme Court of Oklahoma reversed on the grounds that

[1] 208 Okla. 464, 257 P. 2d 504 (1953).

the burden was on the plaintiff to show that *this defendant* was liable, and that in fact the uncontradicted evidence showed that this defendant was not liable.

The court cited its prior decision in the *Hilliard* case,[2] which said:

> ... it was apparent at the time of plaintiff's injury and at the time of the trial the owner and operator of the Frisco properties was the St. Louis-San Francisco Railway Company, and that it was, at the times referred to, a separate and distinct corporate entity from the St. Louis and San Francisco Railroad Company.

In *Denver & R.G.R. Co. v. Loveland*[3] the headnote accurately states the holding of the Colorado court:

> Where there were *two corporations* ... and on the trial of an action against the former it developed that the acts complained of were committed by the latter, it was error to allow an amendment of the complaint making the latter corporation defendant, on the ground that such amendment was the correction of a misnomer.

The instant case points out the vast distinction between suing the right person under the wrong name, and suing the wrong person.[4] The principal question was whether there were two separate and distinct corporate entities, and if so, whether the plaintiff had sued the wrong one. The court's affirmative answers to these questions were based upon several factors.

In *U.S. v. Milwaukee Refrigerator Transit Company*[5] the court said that a corporation will be looked on as a separate legal entity "until sufficient reason to the contrary appears." In the present case the plaintiff alleged that the defendant coporation, Kingkade Hotel Company, was operating the hotel when the incident occurred. Thus, the burden was on the plaintiff to prove that this defendant was liable, and this burden was not met. The uncontradicted testimony showed that the Kingkade Hotel Company had

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[2] Hilliard v. St. Louis and S. F. Rr., 98 Okla. 22, 223 Pac. 877, 878 (1924).
[3] 16 Colo. App. 146, 64 Pac. 381 (1901).
[4] See cases cited in 2 McDONALD, TEXAS CIVIL PRACTICE (1st ed. 1950) § 8.09 n. 63.
[5] 142 Fed. 247, 255 (C.C. E.D. Wis. 1905).

nothing to do with the operation of the hotel, and that the hotel was operated by a separate and distinct corporation, the Hotel Kingkade. There were several factors tending to show that the corporations were separate and distinct.

One of the main factors in determining whether two corporations are separate is the question of ownership.[6] Where one corporation is completely owned by another, this is evidence of merger of the corporate entities; however, this is definitely not conclusive evidence. Since the main purpose of incorporation is to separate the entity of the business from its owners, this can be true for one owner just as much as for several owners. It is the purpose of incorporation, and not the number of incorporators, that determines whether the corporation was organized in good faith. As was said in *Security Savings and Trust Co. v. Portland Flour Mills Co.*,

> "The reason for the application of the rule [i.e., disregarding the corporate entity] is to prevent fraud and not because all the capital stock is owned by one person."[7]

Thus, the fact in the present case that Mr. Kingkade owned some, but not all, of the stock in both corporations would certainly not be strong enough evidence to require that the corporations be regarded as one entity.

A second factor in determining whether a corporation is a seprate entity is management.[8] One cannot lay down an ironclad rule as to when one corporation is under the management of another corporation, for it is quite possible that one may, in good faith, be an officer or agent of two distinct corporations at the same time. This is really a question of fact, depending upon such factors as separate office space, accounting procedures, separa-

[6] See BALLANTINE, CORPORATIONS (Rev. ed. 1946) § 128; also cases cited in 1 FLETCHER, CYCLOPEDIA CORPORATIONS (Perm. ed. 1931) § 41 n. 3.

[7] 124 Ore. 276, 261 Pac. 432, 436 (1927).

[8] 1 FLETCHER, CYCLOPEDIA CORPORATIONS (Perm. ed. 1931) § 43.

tion of assets, same officers, method of payment of agents, same directors meetings, etc.

A third factor in determining whether a corporation is a separate legal entity is the purpose of incorporation.[9] Ballantine has said, "As the separate personality or capacity of a corporation is a privilege, it must be used for legitimate purposes and must not be perverted into a fraudulent device."[10] For example, in *U.S. v. Milwaukee Refrigerated Transit Company*[11] the Pabst Brewing Company had caused a transit company to be formed as a subsidiary. By contract Pabst gave the transit company exclusive control of the shipping of its freight over the railroads. The transit company received commissions from the railroads for procuring the business for them. The separate corporate entity was there used in an attempt to conceal the crime of rebating. There are many other examples of disregarding the corporate entity to prevent frauds; *e.g.*, to prevent evasion of state revenue laws,[12] to prevent combinations in restraint of trade,[13] to prevent evasion of debts,[14] and to prevent frauds in general.[15]

Mr. Ballantine sums up the problem very well when he says:

> It is submitted that no mechanical rule based on objective facts of control or connection which will furnish a certain test is possible to formulate. Identity of stockholders, identity of officers, the manner of keeping books and records, the methods of conducting the corporate business as a separate concern or as a mere department of the other concern, may be evidential facts to be considered as bearing on the question of juggling of separate capacities and whether the subsidiary is being managed in such a way as to make the controlling corporation justly responsible. But after all it comes down to a question of good faith and honesty in the use of the corporate privilege for legitimate ends.[16]

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[9] BALLANTINE, CORPORATIONS (Rev. ed. 1946) § 122.
[10] *Id.*, § 123.
[11] Cited *supra* note 5.
[12] BALLANTINE, CORPORATIONS (Rev. ed. 1946) § 142.
[13] 1 FLETCHER, CYCLOPEDIA CORPORATIONS (Perm. ed. 1931) § 45.
[14] BALLANTINE, CORPORATIONS (Rev. ed. 1946) § 130.
[15] 1 FLETCHER, CYCLOPEDIA CORPORATIONS (Perm. ed. 1931) § 41.
[16] BALLANTINE, CORPORATIONS (Rev. ed. 1946) § 136.

CONSIDERATION FOR CAPITAL STOCK

Texas. In *Dunagan v. Bushey*[17] the plaintiff had told one of the defendants that he would not subscribe to capital stock of the corporation which the defendants were promoting until the corporation received its charter. In order to secure the charter, the defendants obtained a personal loan of $18,000 from a bank under the representation that they proposed to repay the loan by selling to the corporation, after its organization, certain properties and a franchise worth the amount of the loan. The promoters paid for more than 50 per cent of the authorized stock with the $18,000, and the Secretary of State issued the articles of incorporation. Later the defendants, acting as directors of the corporation, withdrew the $18,000 received for the stock from the corporate account by a check payable to them personally, and repaid the $18,000 they had originally borrowed. Neither the property nor the franchises were ever delivered to the corporation. The Supreme Court of Texas held that the plaintiff could compel the defendants to repay the $18,000 to the corporate account.

The case is noted because of its similarity to a common practice today. Under the present Texas incorporation law, the Secretary of State may require that a proposed corporation seeking a charter file an audit of its books or an appraisal of its properties.[18] This procedure may be both time-consuming and expensive; so incorporators have developed the practice of obtaining a loan upon the security of the property which they ultimately intend to transfer to the corporation. The cash received from the loan is then used to pay for the stock. After incorporation, the incorporators, acting as directors of the corporation, purchase the original property with the money paid for the stock, and so long as the property is purchased at a proper value, the transaction is sound. Then the money received by the incoporators *for the*

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17 ___Tex.___, 263 S.W. 2d 148 (1953).

18 TEX. REV. CIV. STAT. (Vernon, 1948) art. 1309.

property transferred to the corporation is used to repay their personal loan and the transaction is completed.

This is probably what the defendants in the present case had in mind, but failed to do. Under the facts of the principal case, the incorporators paid the money back to themselves, *but gave the corporation nothing in exchange;* thus the corporation was paying for the personal debts of the directors rather than paying for property received, and the transaction was improper.

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