DISREGARDING THE CORPORATE ENTITY

The general doctrine is well established, and obtains both in law and equity that a corporation is an entity distinct and apart from the individuals who compose it, and is not affected by the personal rights, liabilities, and transactions of its stockholders,[1] so that ordinarily, the acts of the corporation are the acts of the legal entity, and not the acts of the individual members composing it, while the acts of the members cannot be considered as those of the corporation. This rule prevails merely because the courts recognize the legal fiction that a corporation is a body distinct from the persons who compose it—a fiction or policy which the law has adopted the better to deal with corporations, but when this fiction is urged for a purpose not within its reason, the courts will ignore the distinct corporate entity, and recognize the acts of the members as acts of the corporation, or those of the corporation as the acts of the members.[2]

Perhaps the leading case on this subject is *State v. Standard Oil Co.*,[3] where *quo warranto* proceedings were brought against the Standard Oil Co. to deprive it of its right to be a corporation, on the grounds that it had abused its franchises by becoming a party to an illegal trust agreement. The agreement complained of had been entered into between its stockholders and the stockholders of other companies, and the proceeding was defended on the ground that the agreement was made by the individual stockholders of the corporation in their individual capacity, and was not the agreement of the corporation. The arguments for the defense were based upon the assumption that the corporation was a legal entity, distinct from its stockholders, and that it could only be bound by such acts of its corporate agents as fell within the apparent scope of their authority. The court, however, said, in holding that the agreement of the stockholders was the agreement of the corporation: "Now, so long as a proper use is made of the fiction that a corporation is an entity apart from its shareholders, it is harmless, and, because convenient should not be called into question; but where it is urged to an end subversive of its policy, or such is the issue, the fiction must be ignored, and the question determined, whether the act in question, though done by shareholders, that is to say, by the

---

[1] Morawetz on Private Corporations, par. 227.
[2] State vs. Standard Oil Co., 49 O. St. 137.
[3] *Supra.*

persons united in one body, was done simply as individuals, and with respect to their individual interests as shareholders, or was done ostensibly as such, but, as a matter of fact, to control the corporation, and affect the transaction of its business, in the same manner as if the act had been clothed with all the formalities of a corporate act."

"The doctrine of corporate entity is not so sacred that a court of equity, looking through forms to the substance of things, may not in a proper case ignore it to preserve the rights of innocent parties or to circumvent fraud."[4]

This fiction, as the court said in *Bank v. Trebein Co.*,[5] "is limited to the uses and purposes for which it was adopted—convenience in the transaction of business, and in suing or being sued in its corporate name, and the continuance of its rights and liabilities, unaffected by changes in its corporate members. But the fiction cannot be abused. A corporation cannot be formed for the purpose of accomplishing a fraud or other illegal act under the disguise of the fiction; and when this is made to appear the fiction will be disregarded by the courts, and the acts of the real parties dealt with as though no such corporation had been formed, on the ground that fraud vitiates everything into which it enters, including the most solemn acts of men. The good faith of the parties to such a transaction must be determined by its legal effect on the rights of others. If its legal effect works a fraud on their rights, the finding of a court that the parties acted in good faith is simply an erroneous conclusion of law from the facts."

Thus in a recent case,[6] a pulp company caused the incorporation of another company, The Great Western Oil Co., and transferred to it its gas and oil wells and lands. The president and treasurer of the pulp company owned all the stock of the second corporation, except a few shares, put in the name of a third party for the purpose of having a resident director in Indiana. The Great Western Co. was treated as an agent of the pulp company for the development of its business, especially for the supplying of cheap motor power. The pulp company, having become bankrupt, the receiver demanded the delivery to him of the property held by the second corporation as a part of the assets of the pulp company. The demand was resisted, but the court held that The Great Western Company had no shadow of claim

---

[4] *In re* Rieger, Kapner & Altmark, 157 Fed. 609.
[5] 59 O. St. 316; 52 N. E. 834.
[6] *In re* Muncie Pulp Co., 139 Fed. 546.

to the property in controversy, and to permit it, or its president or shareholders, to dispose of such property would be a fraud on the creditors of the pulp company—"the new oil company was the old company under another name."

Thus where the same body of stockholders controlled two corporations, and the business of the corporations was so conducted as to make one the mere instrumentality of the other, the corporate entity was disregarded, and the corporations held identical, so as to render the property of the one liable for the debts of the other.[7] However, the mere fact that the stockholders of one corporation are the stockholders of another, and that the two corporations have mutual dealings will not of itself justify a disregard of the separate corporate entities of the two companies.[8] Similarly, attempts to evade the anti-trust statutes have been frustrated by the disregarding of the corporate entity, and the recognition by the court of the acts and contracts of the shareholders as those of the corporation.[9] For the same reason "holding companies" have been declared illegal, the veil of corporate entity stripped from them, and the transaction considered in its true light—a combination of several corporations in restrain of trade.[10] The courts have uniformily held that a "dummy" corporation, formed in order to defraud creditors, or for other illegal purposes, has the same identity as the defrauding company.[11] In an early Michigan case,[12] the corporation was restrained from carrying on a particular

---

[7] Donovan vs. Purtell, 216 Ill. 629; *In re* Muncie Pulp Co., *supra.*

[8] *In re* Watertown Paper Co., 169 Fed. 252; see also Lange vs. Burke, 69 Ark. 85, holding that "a corporation is an artificial being, separate and distinct from its agents, officers, and stockholders. Its dealings with another corporation, although it may be composed in part of persons who own the majority stock in each company, and may be managed by the same officers, if they be in good faith and free from fraud, stand upon the same basis and affect it and the other corporation in the same manner and to the same extent, that they would if each had been composed of different stockholders and controlled by different officers."

[9] State vs. Creamery Package Co., 110 Minn. 415; Unckles vs. Colgate, 148 N. Y. 529; State vs. Standard Oil Co., 490 O. St. 137; Cook on Corporations (6th Ed.) par. 663, 664.

[10] Northern Securities Co. vs. U. S., 193 U. S. 197.

[11] Brundred vs. Rice, 49 O. St. 640; U. S. vs. Milwaukee Transit Co., 142 Fed. 247, per Sanborn, J., "If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but 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."

[12] Beal vs. Chase, 31 Mich. 490.

business in violation of a contract entered into by one who subsequently became its principal stockholder and president, by the terms of which contract, such stockholder in selling his printing business to plaintiff, had agreed not to engage in the business in the state. So where a vendor, in selling his business, made a valid contract not to continue in business, but subsequently formed a corporation with other persons, who knew of the sale, the court restrained the corporation from violating the contract.[13]

A recent Missouri case[14] shows a very rigid application of the rule as to when the corporate entity shall be disregarded. The defendants were the directors and sole stockholders of an ice company. This corporation borrowed $25,000.00 from plaintiff, and defendants indorsed a note given by the company to the plaintiff as collateral security. A warehouse receipt covering 8500 tons of ice belonging to the ice company, was also given as collateral security. Later the plaintiff released the warehouse receipt to the ice company. The defendants claimed that they were released *pro tanto,* assuming that they were liable as sureties and had not consented to the surrender. As regards this the court says: "Now, in equity and good conscience, should the plaintiff, who loaned this $25,000.00 to the defendant's creature, the Ice Company, be required to lose it through the technical rules of suretyship, when, as previously shown, the defendants were the real beneficiaries thereof? Clearly the answer should be in the negative, for there is no equity in such a proposition. And this answer should not be changed, even though it be considered that the plaintiff surrendered the warehouse receipt for the 8500 tons of ice to the Ice Company, for the reason that the defendants as owners of that company, have received the entire proceeds of that ice. The defendants have been the recipients of every dollar borrowed and the proceeds of this 8500 tons of ice, and have not lost a cent of it, while the plaintiff has received nothing except its interest." This appears to be contrary to the general line of authority, for the corporation was duly organized for a legitimate purpose, and no misuse of the corporate entity, or element of fraud enters into the case. The equities of the case do not seem to be such as to justify such a conclusion, for the defendants might not have been able to obtain indemnity from the corporation; it is by no means clear that the corporate entity should be

---

[13] Booth & Co. vs. Seibold, 74 N. Y. Supp. 776.
[14] Mercantile Trust Co. vs. Donk, 178 S. W. 113.

disregarded in this case so as to deprive the defendants of the defense ordinarily available to sureties.[15]

In *Barrie v. United Railways Co.*,[16] the rule as to the disregarding of the corporate entity when it would otherwise result in a fraud on creditors was laid down, the court citing with approval *In Re Muncie Pulp Co., supra.* The case arose from an action against a corporation (United Railways Co.) owning a street railway system which had leased all its property to another corporation (Transit Co.) for the purpose of operating the system and where the directors and officers of both corporations were the same and equally interested in both corporations, and where the lessee on incurring financial embarrassment, transferred all its property to the lessor for the purpose of avoiding the liabilities of the lessee. The lessor was held liable in a creditor's bill for the debt against the lessee. "Equity does not sanction the creation of dummy corporations so as to exonerate the main corporation from liabilities of the one it causes to be organized."[17]

Clearly, therefore, the authorities justify the statement of Judge Noyes in *In Re Watertown Paper Co.*:[18] "Unless, therefore, it can be shown that some exception to the general rule of separate existence and liability applies in this case, it must follow that the claim of the Pulp Co. should have been allowed. The only exceptions to that rule possibly applicable here are: (1) The legal fiction of distinct corporate existence will be disregarded, when necessary to circumvent fraud. (2) It may also be disregarded in a case where a corporation is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality or adjunct of another corporation."

M. C. J.

---

[15] It should be stated that in deciding the case the court did not rely entirely upon this theory, but held the defendants liable as indorsers.

[16] 138 Mo. App. 558.

[17] Barrie vs. United Railways, *supra, l. c.*, 689.

[18] 167 Fed. 252, *l. c.*, 256.