PART III – Advanced Law

CHAPTER 11 – BUSINESS ORGANIZATIONS

**A. Chapter Introduction**

Chapter 11 is the first chapter for Unit III of *Introduction to Law*, which covers many of the advanced substantive areas of the law in which the paralegal may be called to practice. Chapter 11 discusses business organizations, including sole proprietorships, partnerships, limited partnerships, limited liability companies, and corporations.

After completion of this chapter, students should be able to:

* Define a sole proprietorship and the liability of a sole proprietor.
* Describe how a business files for a d.b.a.—a fictitious business name.
* Define general partnership and describe how general partnerships are formed.
* Define a limited partnership and distinguish between limited and general partners.
* Define a limited liability partnership (LLP) and describe the limited liability of partners of an LLP.
* Define a limited liability company (LLC) and describe the process of organizing an LLC.
* Define a corporation and list the major characteristics of a corporation.
* Describe the process of forming a corporation.
* Describe the functions of shareholders, directors, and officers in managing the affairs of a corporation.
* Describe multinational corporations and their role in international trade.

B. Instructional Ideas

1. At the beginning of discussing this chapter, ask the class to vote on what they think is the best business form. Note what the students choose, and then revisit that at the end of the chapter to see if the opinions have changed.

2. Discuss the advantages and disadvantages of sole proprietorships. Advantages include ease of start-up, and disadvantages include unlimited liability.

3. Discuss the advantages and disadvantages of general partnerships. Advantages include single taxation, and disadvantages include unlimited liability.

4. To help the class understand the significance of the partners’ liability for business torts committed by individual partners, create an example of a three-partner partnership, with one partner on vacation, one partner in the hospital, and one partner who committed a huge act of negligence in the course of partnership business. Assume the negligence results in liability greater than the partnership assets, and assume the negligent partner has left the country and can’t be found.   
Explain to the class who is liable.

5. Create a fictitious partnership and put the class into groups to work on drafting a partnership agreement that would cover a sufficient number of the issues mentioned in the section on partnerships. For instance, consider whether the death of a partner should allow that partner’s executor to choose an independent accountant to examine the partnership’s books.

6. Explain to the class what distinguishes a limited partnership from a general partnership, and how one could be both a general and limited partner.

7. Distinguish between a limited partnership (LP) and a limited liability partnership (LLP).

8. Explain the advantages of a limited liability company (LLC). How is it different from a limited partnership or a limited liability partnership?

9. Explain the advantages and disadvantages of a traditional business corporation. Advantages include limited liability for shareholders, and disadvantages include double taxation. Discuss some of the corporate scandals of the recent years (Enron, Tyco, and Global Crossings, for instance). Ask the class for suggestions on whether the boards of directors of those companies were derelict in their fiduciary duties and, if so, whether they should be personally liable. Use this topic as a springboard into the doctrine of piercing the corporate veil.

10. Discuss S corporations and how they are different from C corporations, including some of the limitations that apply to S corporations.

**C. Video Recommendation(s)**

Insight Media has on its web site (insight-media.com) a few videos for sale that relate to this chapter, including the following: *Forming a Business*, which is about proprietorships, partnerships, and corporations; and, *Illegal, Immoral, and Ill-Advised: Business Crimes and Corporate Social Responsibility*, whose title makes the content obvious.

*Barbarians at the Gate*, the HBO movie adapted from the famous book of the same title, is about the corporate buyout orgies of the 1980s that culminated in F. Ross Johnson, CEO of RJR Nabisco—whose rise to the top of that company is a corporate merger-mania story all in itself—attempting to buy the RJR in a leveraged buyout. In addition to being informative and relevant to this chapter’s material, *Barbarians at the Gate* is highly entertaining.

**D. Chapter Outline**

**I. Sole Proprietorship**

A. **Definition**: A form of business in which the owner and the business are one; the business is not a separate legal entity.

B. **Business Name**: A sole proprietorship can operate under the name of the sole proprietor or a trade name. Operating under a trade name is commonly designated as a d.b.a. (doing business as). If a trade name is used, a fictitious business name statement must be filed with the appropriate government office.

C. **Liability**: The sole proprietor is personally liable for the debts and obligations of the sole proprietorship.

**II. General Partnership**

A. **Definition**: An association of two or more persons to carry on as co-owners a business for profit.

B. **Uniform Partnership Act (UPA)**: Model act that codifies partnership law; most states have adopted all or part of the UPA.

C. **Entity Theory of Partnerships**: A theory that holds that partnerships are separate legal entities that can hold title to personal and real property, transact business in the partnership name, and the like.

D. **Taxation of Partnerships**: Partnerships do not pay federal income taxes; the income and losses of partnerships flow onto individual partners’ federal income tax returns.

E. **Partnership Agreement**: Agreement establishing a general partnership; sets forth terms of the partnership. It is good practice to have a written partnership agreement that partners sign.

F. **Partners’ Contract Authority**: A contract entered into by a partner with a third party on behalf of a partnership is binding on the partnership.

G. **Tort Liability**:

1. **Tort**. Occurs when a partner causes injury to a third party by his or her negligent act, breach of trust, breach of fiduciary duty, or intentional tort.

2. **Partnership liability**. The partnership is liable to third persons who are injured by torts committed by a partner while he or she is acting within the ordinary course of partnership business.

3. **Joint and several liability of partners**. Partners are personally liable for torts committed by partners acting on partnership business. This liability is joint and several, which means that the plaintiff can sue one or more or the partners separately. If successful, the plaintiff can recover the entire amount of the judgment from any or all of the defendant-partners.

H. **Dissolution of Partnerships**: Change in the relation of the partners caused by any partner ceasing to be associated in carrying on the business.

I. **Wrongful Dissolution**: Occurs when a partner withdraws from a partnership without having the right to do so at the time. The partner is liable for damages caused by the wrongful dissolution of the partnership.

# III. Limited Partnership

A. **Uniform Limited Partnership Act (ULPA)**: A 1916 model act that contains a uniform set of provisions for the formation, operation, and dissolution of limited partnerships.

B. **Revised Uniform Limited Partnership Act (RULPA)**: A 1976 revision of the ULPA that provides a more modern comprehensive law for the formation, operation, and dissolution of limited partnerships.

C. **Limited Partnership**: A special form of partnership that has both limited and general partners.

1. **General partners**: Partners in a limited partnership who invest capital, manage the business, and are personally liable for partnership debts.

2. **Limited partners**: Partners in a limited partnership who invest capital but do not participate in management and are not personally liable for partnership debts beyond their capital contributions.

D. **Formation of Limited Partnerships**:

1. **Certificate of limited partnership**: A document that two or more persons must execute and sign that establishes a limited partnership. The certificate of limited partnership must be filed with the secretary of state of the appropriate state.

2. **Limited partnership agreement**: A document that sets forth the rights and duties of general and limited partners, the terms and conditions regarding the operation, termination, and dissolution of the partnerships and so on.

E. **Liability of General and Limited Partners**

1. **General partners**: General partners of a limited partnership have unlimited personal liability for the debts and obligations of the limited partnership.

2. **Limited partners**: Limited partners of a limited partnership are liable only for the debts and obligations of the limited partnership up to their capital contributions.

3. **Limited partners and management**: Limited partners have no right to participate in the management of the partnership. A limited partner is liable as a general partner if his or her participation in the control of the business is substantially the same as that of a general partner, but the limited partner is liable only to persons who reasonably believed him or her to be a general partner.

**IV. Limited Liability Partnership (LLP)**

A. **Definition**: A new form of business in which there does not have to be a general partner who is personally liable for debts and obligations of the partnership. All partners are limited partners and stand to lose only their capital contribution should the partnership fail. LLPs are formed by accountants and other professionals, as allowed by LLP law.

B. **Partners**: Owners of an LLP.

C. **Articles of Partnerships**: A document that the partners of an LLP must execute, sign, and file with the secretary of state of the appropriate state to form an LLP.

D. **Taxation**: An LLP does not pay federal income taxes unless it elects to do so. If an LLP is taxed as a partnership, the income and losses of the LLP flow onto individual partners’ federal income tax returns.

**V. Limited Liability Company (LLC)**

A. **Definition**: A special form of unincorporated business entity that combines the tax benefits of a partnership with the limited personal liability attribute of a corporation.

B. **Members**: Owners of an LLC.

C. **Articles of Organization**: A document that owners of an LLC must execute, sign, and file with the secretary of state of the appropriate state to form an LLC.

D. **Operating Agreement**: An agreement entered into among members that governs the affairs and business of the LLC and the relations among partners, managers, and the LLC.

E. **Taxation**: An LLC does not pay federal income taxes unless it elects to do so. If an LLC is taxed as a partnership, the income and losses of the LLC flow onto individual members’ federal income tax returns.

**VI. Corporation**

A. **Definition**: A legal entity created pursuant to the laws of the state of incorporation. A corporation is a separate legal entity—an artificial person—that can own property, sue and be sued, enter into contracts, and such.

B. **Characteristics of Corporations**:

1. **Limited liability of shareholders**. Shareholders are liable for the debts and obligations of the corporation only to the extent of their capital contributions.

2. **Free transferability of shares**. Unless they are expressly restricted, shares of a corporation are freely transferable by the shareholders.

3. **Perpetual existence**. Corporations exist in perpetuity unless a specific duration is stated in the corporation’s articles of incorporation.

4. **Centralized management**. Board of directors of the corporation makes policy decisions of the corporation. Corporate officers appointed by the board of directors run the corporation’s day-to-day operations. Together, the directors and officers form the corporation’s management.

C. **Business Corporations Acts**:

1. **Model Business Corporation Act (MBCA)**. A model act drafted in 1950 that was intended to provide a uniform law for the regulation of corporations.

2. **Revised Model Business Corporation Act (RMBCA)**. A revision of the MBCA promulgated in 1984 that arranged the provisions of the model act more logically, revised the language to be more consistent, and made substantial changes that modernized the provisions of the act.

D. **Classifications of Corporations**:

1. **Domestic corporation**. A corporation in the state in which it is incorporated.

2. **Foreign corporation**. A corporation in any state other than the one in which it is incorporated. A domestic corporation often transacts business in states other than its state of incorporation; hence, it is a foreign corporation in these other states. A foreign corporation must obtain a certificate of authority from these other states in order to transact intrastate business in those states.

3. **Alien corporation**. A corporation that is incorporated in another country. Alien corporations are treated as foreign corporations for most purposes.

E. **Procedure**: Incorporation. The process of incorporating (forming) a new corporation.

F. **Selecting a State of Incorporation**: A corporation can be incorporated in only one state, although it can conduct business in other states.

G. **Articles of Incorporation**:

1. The basic governing document of a corporation; must be filed with the secretary of state of the state of incorporation. It is a public document, also called the corporate charter.

2. The Corporation Code of each state sets out the information that must be included in the articles of incorporation. Additional information may be included in the articles of incorporation as deemed necessary or desirable by the incorporators.

H. **Corporate Bylaws**: A detailed set of rules adopted by the board of directors after the corporation is formed, containing provisions for managing the business and affairs of the corporation. This document does not have to be filed with the secretary of state.

I. **Organizational Meeting**: A meeting that must be held by the initial directors of the corporation after articles of incorporation are filed. At this meeting, the directors adopt the bylaws, elect corporate officers, ratify promoters’ contracts, adopt a corporate seal, and transact such other business as may come before the meeting.

J. **Common Stock**: A type of equity security that represents the residual value of the corporation. Common stock has no preferences, and its shareholders are paid dividends and assets upon liquidation only after creditors and preferred shareholders have been paid.

K. **Liability of Shareholders**: Shareholders of corporations generally have limited liability; that is, they are liable for the debts and obligations of the corporation only to the extent of their capital contribution to the corporation.

L. **Liability**: Shareholders may be found personally liable for the debts and obligations of the corporation under the doctrine called piercing the corporate veil. Courts can disregard the corporate entity and hold shareholders personally liable for the debts and obligations of the corporation if (a) the corporation has been formed without sufficient capital (thin capitalization) or (b) separateness has not been maintained between the corporation and its shareholder (*e.g.*, commingling of personal and corporate assets, failure to hold required shareholders’ meetings, and such). Also called the alter-ego doctrine.

M. **Board of Directors**: A panel of decision makers for the corporation, the members of which are elected by the shareholders.

1. The directors of a corporation are responsible for formulating the policy decisions affecting the corporation, such as deciding in what businesses to engage, determining the capital structure of the corporation, selecting and removing top officers of the corporation, and the like.

2. Inside director: A member of the board of directors who is also an officer of the corporation.

3. Outside director: A member of the board of directors who is not an officer of the corporation.

N. **Meeting of the Board of Directors**:

1. **Regular meeting**. A meeting of the board of directors held at the time and place scheduled in the bylaws.

2. **Special meeting**. A meeting of the board of directors, convened to discuss an important or emergency matter, such as a proposed merger, a hostile takeover attempt, and such.

3. **Written consents**. The board of directors may act without a meeting if all of the directors sign written consents that set forth the action taken.

O. **Officers**: Employees of the corporation who are appointed by the board of directors to manage the day-to-day operations of the corporation.

P. **Duty of Loyalty**: A duty that directors and officers have not to act adversely to the interests of the corporation and to subordinate their personal interests to those of the corporation and its shareholders.

Q. **Duty of Care**: A duty that corporate directors and officers have to use care and diligence when acting on behalf of the corporation. This duty is discharged if they perform their duties (a) in good faith, (b) with the care that an ordinary prudent person in a like position would use under similar circumstances, and (c) in a manner they reasonably believe to be in the best interests of the corporation.

1. **Negligence**. Failure of a corporate director or officer to exercise this duty of care when conducting the corporation’s business.

2. **Business judgment rule**. A rule that says directors and officers are not liable to the corporation’s shareholders for honest mistakes of judgment.

**VII. Franchise**

A. **Definition**: Established when one party licenses another party to use the franchisor’s trade name, trademarks, commercial symbols, patents, copyrights, and other property in the distribution and selling of goods and services.

1. **Franchisor**. The party who does the licensing in a franchise arrangement. Also called the licensor.

2. **Franchisee**. The party who is licensed by the franchisor in a franchise arrangement. Also called the licensee.

**E. Critical Legal Thinking Questions**

**1. Define a sole proprietorship. Describe the tort and contract liability of a sole proprietorship for the debts and obligations of the sole proprietorship.**

A sole proprietorship is an unincorporated business with one owner, the proprietor. The proprietor of the sole proprietorship is personally liable for the tort and contractual liabilities of the business, since there is no legal distinction between the business and the owner.

**2. Define a general partnership. Describe the liability of general partners for the debts and obligations of the general partnership.**

A general partnership is a voluntary association of two or more persons carrying on a business as co-owners for profit. General partners are personally liable for the debts and obligations of the partnership—jointly liable for contractual obligations, and jointly and severally liable for tort damages.

**3. Define a limited partnership. Describe the liability of general partners versus limited partners for the debts and obligations of the limited partnership.**

A limited partnership is a statutorily created partnership in which there is at least one general partner and at least one limited partner. General partners have full authority over the partnership and unlimited liability. Limited partners have no decision making power, but have limited liability that is capped at their investment.

**4. Define a limited liability partnership (LLP). What is the liability exposure of partners of an LLP?**

A limited liability partnership is a statutorily created partnership that doesn’t require that the partnership have a general partner. All partners in an LLP are limited partners. The liability for such partners extends only to their capital contribution.

**5. Define a limited liability company (LLC). What is the liability exposure of the member-owners of an LLC?**

A limited liability company is another statutorily created unincorporated business entity that combines the most favorable attributes of general partnerships, limited partnerships, and corporations. An LLC may elect to be taxed as a partnership, the owners can manage the business, and the owners have limited liability.

**6. Define a corporation. What are the major attributes of a corporation? What is the liability exposure of shareholders for the debts and obligations of the corporation?**

A corporation is a separate legal entity (or legal person) for most purposes. Owners of corporations are called shareholders. The major attributes of a corporation include limited liability of shareholders (limited to their investment), free transferability of shares, perpetual existence, and centralized management.

**7. Describe the articles of incorporation, bylaws, and minutes of a corporation.**

The articles of incorporation are the basic governing document of the corporation and are filed with the state of incorporation of the promoters’ choice. The articles of incorporation are similar to a state’s constitution. The bylaws are the rules that govern the corporation and are much more detailed than the articles of incorporation. Bylaws may contain any provision for managing the business and affairs of the corporation that are not inconsistent with law or the articles of incorporation. The minutes of a corporation consist of the written record of what occurred at board meetings.

**8. Define an S corporation. What requirements must be met for a corporation to qualify to be an S corporation?**

An S corporation is one that is allowed to come into existence as a result of a 1982 federal statute. The primary benefit of an S corporation is that it can avoid double taxation. There are seven requirements that must be met for a corporation to be taxed as an S corporation, including the following: being a domestic corporation; having no more than 75 shareholders, all of whom must be individuals, estates, or certain trusts; and not having more than one class of stock.

**9. Explain an officer’s and director’s duty of care to the corporation. Explain how the business judgment rule protects officers and directors from liability.**

Officers and directors are required to use care and diligence when acting on behalf of the corporation. To meet this duty, they must discharge their duties (1) in good faith, (2) with the care that an ordinary person in a like position would use under similar circumstances, and (3) in a manner they reasonably believe to be in the best interests of the corporation. The business judgment rule protects officers and directors from liability by measuring the directors’ and officers’ decisions at the time decisions are made, not by exercising hindsight judgment. This means that such decision makers are not liable for honest mistakes of judgment.

**10. Define a franchise. Describe the tort and contract liability of the franchisor and franchisee.**

A franchise is established when one party (the franchisor or licensor) licenses anther party (the franchisee or licensee) to use the fanchisor’s trade name, etc., and other property in the distribution and selling of goods and services. Franchisors and franchisees are liable for their own contracts. The same is true of tort liability. For example, if a person is injured by a fanchisee’s negligence, the franchisee is liable.

**F. Cases for Discussion**

***Kinney Shoe Corp. v. Polan***, 939 F.2d 209 (4th Cir. 1991), concerned a corporation named Industrial Realty, formed by Mr. Polan, that rented commercial space from Kinney, and then breached the sublease agreement. After Kinney obtained a $64,000 dollar judgment against Industrial, Kinney sued Polan, attempting to pierce the corporate veil and make him personally liable for his company’s debts. The evidence was that after the certificate of incorporation was issued, no organizational meetings were ever held, no officers were ever elected, and no capital was ever contributed to Industrial. The only rent payment made to Kinney came from Polan’s personal funds. The Fourth Circuit Court of Appeals agreed with Kinney that Polan should be personally liable. Under the test for piercing the corporate veil, Industrial had no capital and was just a paper curtain, and holding Polan personally liable would result in an equitable result.

QUESTIONS

1. *Is the doctrine of piercing the corporate veil needed? Should parties like Kinney bear the risk of dealing with corporations like Industrial?*

To some extent, this is an opinion question, but one could make a strong argument that without the corporate veil being able to be pierced, unscrupulous incorporators, such as Polan, would be able to use the corporate form to fraudulently walk away from their own messes. Kinney might have insisted on a personal guarantee from Polan before leasing the space to Industrial. Since it didn’t, Kinney did bear the risk of dealing with Industrial by having to go through this litigation and appeal to get paid.

2. *Is it ethical for persons to form corporations to avoid personal liability? Should this be allowed?*

Abstractly, this is an opinion question. However, avoiding personal liability is the primary reason why business corporations are formed, and this has been allowed for centuries.

3. *What is the risk if corporate formalities are not observed? Explain.*

The risk is that if the corporation incurs a loss or debt it can’t pay, the owners of the corporation are likely to be personally responsible for the debt or judgment because of skirting the corporate rules.

***Martin v. McDonald’s Corporation***, 572 N.E.2d 1073 (1991), concerned the tragedy of a robbery and murder that occurred at an Illinois McDonald’s owned by a McDonald’s franchisee, McDonald’s Restaurants of Illinois. Three teenage girls working at closing were robbed by an armed gunman who used the back door of the restaurant to gain entrance. In the course of the robbery, he shot and killed one of the girls and assaulted the other two. Prior to the crime, the McDonald’s Corporation (the franchisor) had sent its regional security manager to that franchise to discuss security issues. Finding the security procedures to be inadequate, the security manager discussed with the franchisee the security improvements that needed to be made, including installing an alarm system, changing the locks, instructing employees never to use the back door after dark, and to use the side door at least one hour prior to closing. The evidence showed that McDonald’s regional security manager never followed up with the restaurant to see if the security improvements were implemented, that the employees hadn’t been instructed about the use of the back door after dark and never received the security manual that was given to franchisees and required to be followed, and that the required warning about not using the back door after dark had not been posted at the restaurant. The parents of the dead girl and the other two girls sued McDonald’s Corporation (the franchisor) and won a large judgment. In affirming the judgment, the appellate court concluded that McDonald’s Corporation voluntarily assumed a duty to provide security to the girls and that, once it assumed that duty, it had to see that the obligation was carried out with competence. By failing to follow up on the initial visit and instructions for improvement, McDonald’s breached its duty and was liable.

QUESTIONS

1. *Should businesses be held liable for the criminal actions of others? Why or why not?*

Although an opinion-type question, the answer relates to foreseeability and the failure to exercise care. If the business is in a position of foreseeing the likelihood of crime and the need to prevent that occurrence, then it will be liable when the crime that occurs can be connected to the business’s failure to act.

2. *Should McDonald’s have denied liability in this case?*

This is an opinion question. It certainly could have acknowledged liability and settled the case with the families without putting them through the stress of a trial and appeal. But, it might have sincerely believed that liability rested with franchisee for failing to carry out the security improvements.

3. *What are the benefits to a franchisor to establish and require its franchisees to adhere to security rules? Is there any potential detriment? Explain.*

The benefits would be to establish uniformity throughout the franchisees and to help to ensure a higher level of safety for all employees. The potential detriment, as evidenced in this case, is that by getting involved in the security of its franchisees’ employees, the franchisor opens itself up to liability that otherwise might not have existed.

**11.1**

***National Lumber Company v. Advance Development***, 732 S.W.2d 840 (Ark. 1987), concerned a limited partnership formed for real estate development purposes that had three general partners. One of the general partners and his company, Advance Development Corp., were appointed to manage the business affairs of the limited partnership. Upon discovering that suppliers hadn’t been paid, the two other general partners removed the managing general partner and took over the operations. The suppliers sued the partnership to recover unpaid bills, but the partnerships assets were insufficient to pay all of their claims.

ISSUE: *Who is liable to the suppliers?*

The individual partners are liable to the suppliers. The court followed general partnership doctrine and found that the derelict managing partner incurred those expenses as partnership expenses, since his actions were made in the course of partnership business. As a general rule, a partnership is bound by the acts of a partner acting within the scope or apparent scope of authority, and general partners have personal liability for the limited partnership’s debts.

**11.2**

(This can’t be answered since the citation was not given.)

**11.3**

***Billy v. Consolidated Mach. Tool Corp.***, 412 N.E.2d 934, (N.Y.App. 1980), concerned a lawsuit by the widow of an employee of USM Corporation, a publicly held corporation, who was killed when a two-ton ram from a vertical boring mill broke loose and crushed him. The widow’s suit alleged that her husband’s death was caused by negligent design and manufacture of the boring mill and in the two moving parts directly involved in the accident, a metal lifting arm and the two-ton ram.

ISSUE: *If Mrs. Billy’s suit is successful, can the shareholders of USM Corporation be held personally liable for any judgment against USM?*

Mrs. Billy’s suit was successful because the Court of Appeals found that the exclusive statutory remedy of worker’s compensation didn’t preclude a common law action against an employer who independently assumed the obligations and liabilities of a third-party tort-feasor. That occurred when the company that made the boring mill was merged with the decedent’s employer. However, the Court found that USM’s parent, Emhart Corporation, wasn’t liable as the shareholder of USM, because there was no showing that Emhart disregarded the separate identity of USM and involved itself directly in the affairs of USM.

**11.4**

***Chelsea Industries, Inc. v. Gaffney***, 449 N.E.2d 320 (Mass. Sup. 1983), concerned a suit over a competing business, Action Manufacturing Co., that sprang from Ideal Tape Co., a subsidiary of Chelsea Industries. Gaffney was the president of Ideal Tape and recruited three other Ideal executives to join him in starting a tape-manufacturing business. They remained at Ideal for the two years it took them to plan their venture, at which time they traveled for Ideal across the country, while at the same time built a customer base, etc. When Action Manufacturing was formed, Chelsea sued the four former executives for damages.

ISSUE: *Who wins?*

Chelsea wins. The court agreed with the master’s findings that, by being disloyal, the Ideal executives breached their fiduciary duties to act in the best interest of their employer. Their actions in surreptitiously planning a competing business while working for Ideal as employees who occupied positions of trust and confidence made them liable to repay the compensation they were paid during the time of their disloyalty.

**G. Case for Briefing**

**1. Case Name**

*United States v. WRW Corporation*, 986 F.2d 138 (6th Cir. 1983)

**2. Key Facts**

A. WRW Corporation (WRW), a Kentucky coal mining corporation, was fined $90,350 because of federal safety violations that resulted in two miners’ deaths.

B. Three men, Richardson, Woolum, and Woolum, who were the sole shareholders, officers, and directors of WRW, went to prison for criminal violations of the federal safety laws.

C. Upon their release from prison, Richardson filed a Chapter 7 bankruptcy petition. The federal government brought an action against the three men to recover the civil penalties that WRW never paid, since it was liquidated.

D. The district court found that piercing the corporate veil was appropriate here under either theory: the equity theory or the alter-ego theory.

E. The evidence showed that WRW was capitalized with only $3,000, that no corporate formalities were observed and no bylaws were ever created, that all corporate actions were carried out by the three men without any corporate authorization, and that WRW operated at a loss for its two-year existence.

**3. Issue**

May the corporate veil be pierced against shareholders who owned and ran a coal mining corporation that was significantly undercapitalized, and had no indicia of separation between the corporation’s acts and the shareholders’ acts?

**4. Holding**

The Sixth Circuit Court of Appeals affirmed the district court’s holding that it was appropriate to pierce the corporate veil under either an equity or alter-ego theory.

**5. Court’s Reasoning**

A. The Sixth Circuit agreed with the district court that the facts support making the three shareholders/officers/directors personally liable for WRW’s unpaid civil fines.

B. Under the alter-ego theory, there was no distinction between WRW and its shareholders; they did not have separate “personalities” as evidenced by the lack of bylaws, meetings, or other corporate formalities.

C. $3,000 in capital is woefully inadequate for a coal mining company.

D. All the evidence pointed to a complete merger of ownership and control of WRW with its owners.