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## One-Man Corporate Entity in Torts

James A. Thomas\*

THIS ARTICLE IS CONFINED to a summary of the liability of a sole shareowner for the torts of his employees or of himself in the execution of the corporate business.<sup>1</sup>

In ascertaining the tort liability of the owner of a one-man corporation, the first step is to determine whether or not the jurisdiction in question recognizes one-man corporations. For even though throughout most of the United States today corporations in which one person owns all of the stock, directly or indirectly, are prevalent, only three states specifically by statute provide for one-man corporations.<sup>2</sup> Of the remaining states, many have judicially recognized one-man corporations,<sup>3</sup> others have not ruled on the matter, and a few have specifically refused to recognize the validity of the one-man corporation.<sup>4</sup>

A good example of what could happen in a jurisdiction that has not ruled on the validity of a one-man corporation occurred recently in North Carolina. The North Carolina Supreme Court refused to recognize this device and held that when all of the stock of a corporation is acquired by one individual, the corporation ceases to exist.<sup>5</sup> The court had given no earlier reason

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<sup>1</sup> For a more comprehensive treatment of one-man corporations and close corporations, see: 1 Oleck, *Modern Corporation Law*, § 177 et seq. (1958); O'Neal, *Close Corporations*, § 105 et passim (1958); Fuller, *The Incorporated Individual: A Study of the One-Man Corporation*, 51 *Harv. L. Rev.* 1373 (1938); Ballantine, *Corporations*, § 129 (rev. ed. 1946); Cataldo, *Limited Liability With One-Man Companies and Subsidiary Corporations*, 18 *Law & Contemp. Prop.*, 473 (1953).

<sup>2</sup> *Wis. Stat.* (1953) § 180.44; *Code of Iowa* (1954), § 491.2; *Mich. Genl. Corp. Act* § 3, as amended by L. 1949, Act 229.

<sup>3</sup> *Garvin v. Matthews*, 193 *Wash.* 152, 74 P. 2d 990 (1938); *Keokuk Electric R & Power Co. v. Weisman*, 146 *Ia.* 679, 126 N. W. 60 (1910); *Webber v. Knox*, 97 *F. 2d* 921 (8 *Cir.* 1938); *Norins Realty Co. v. Consolidated Abstract & Title Guaranty Co.*, 80 *Cal. App. 2d* 879, 182 P. 2d 593 (1947); *State v. Miner*, 233 *Mo.* 312, 135 *S. W.* 483 (1911); *Donovan v. Purtell*, 216 *Ill.* 629, 75 *N. E.* 334 (1905); *United Banking & Trust Co. v. Russel*, 38 *Ohio App.* 275, 176 *N. E.* 166 (1931). This list is not intended to include all states that have recognized one-man corporations.

<sup>4</sup> *Louisville Banking Co. v. Eisenman*, 94 *Ky.* 83, 21 *S. W.* 531 (1893); *Geo. T. Stagg Co. v. Taylor*, 95 *Ky.* 651, 27 *S. W.* 247 (1894); *Swift v. Smith*, 65 *Md.* 428, 5 *A.* 534 (1886); *First Nat. Bank v. Winchester*, 119 *Ala.* 168, 24 *S.* 351 (1898).

<sup>5</sup> *Park Terrace, Inc. v. Phoenix Indemnity Co.*, 241 *N. C.* 473, 85 *S. E.* 2d 677 (1955); on rehearing, 243 *N. C.* 595, 91 *S. E.* 2d 584 (1956).

to anticipate such a decision.<sup>6</sup> The decision created quite an uproar, for there were thousands of such corporations in the state at the time. Immediately thereafter, the legislature amended the law so as to provide for one-man corporations. The court refused to retreat, and on a case whose facts occurred prior to the amendment but which was tried after the amendment, the court again refused to recognize a one-man corporation.<sup>7</sup>

The North Carolina incident stands as a bleak reminder of what can happen in states in which there is no express judicial or legislative sanction of the one-man corporation.

### **Tort Liability of Owner for Unintentional Torts of His Employees**

In states which recognize the one-man corporation, it is generally agreed that an individual may incorporate his business for the sole purpose of escaping individual liability for the debts of the corporation.<sup>8</sup> This insulation is predicated on the separate entity concept, whereby the corporation is treated as a legal entity separate and distinct in identity from its shareholders.

But incorporation does not cut off personal liability at all times and in all circumstances.<sup>9</sup> Courts frequently "pierce the corporate veil" and hold the sole shareholder liable for both contractual and tort liability of "his" corporation. Usually this result has been reached by saying that the corporation has been the *alter ego*, *simulacrum*, "normal identity," or "instrumentality" of the sole shareholder.<sup>10</sup> Of course, these terms are not self-defining and become meaningful only when considered in the light of the facts of the case in which they are employed. This is simply a judicial technique employed to accomplish results which would not logically flow from the popular dogma that a corporation is an entity separate and distinct from its shareholders.

<sup>6</sup> Latty, *A Conceptualistic Tangle and the One- or Two-Man Corporation*, 34 N. Car. L. Rev. 471-480 (1956).

<sup>7</sup> *Lester Brothers, Inc. v. Pope Realty & Insurance Co.*, 250 N. C. 565, 109 S. E. 2d 263 (1959).

<sup>8</sup> *Elenkrieg v. Siebrecht*, 238 N. Y. 254, 144 N. E. 519, 34 A. L. R. 592 (1924); *National Hotel Co. v. Motley*, 123 S. W. 2d 461 (Tex. Civ. App. 1938); *Grapico Bottling Co. v. Ennis*, 140 Miss. 502, 106 S. 97, 44 A. L. R. 124 (1925).

<sup>9</sup> Ballantine, *Corporations* (rev. ed. 1946) § 122, pp. 292-293; Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 Mich. L. Rev. 597 (1936).

<sup>10</sup> Note, 51 Harv. L. Rev. 1373, 1377 (1938).

Actually, it appears that the courts have been guided more by what they consider to be legitimate uses of the corporate form, the separate entity concept being set aside whenever asserted for a purpose which the particular court considers inconsistent with the policy of law for which the concept was developed.<sup>11</sup> Thus, the power to disregard the corporate entity appears to be a discretionary or equitable power used to obtain a just result according to the circumstances of the case and the conflicting rights and liabilities of the parties.<sup>12</sup>

### Factors Leading to Personal Liability

While the power to pierce the corporate veil is a sweeping one, courts for the most part have exercised judicial restraint, generally invoking the power only in cases of gross misuse of the corporate form. The courts have placed special significance on the manner in which the business was operated and the amount of capital dedicated to the business.<sup>13</sup>

*Manner in Which Business is Operated*—Generally, it has been held that mere failure to comply with statutory formalities, such as holding directors' meetings and mailing notices, if not detrimental to insiders or outsiders, will not subject the owner to personal liability.<sup>14</sup> However, the business must be maintained and preserved as a separate entity. For example, personal and business funds must not be commingled,<sup>15</sup> separate records must be maintained,<sup>16</sup> contracts must not be made in the owner's own name instead of corporation's,<sup>17</sup> or creditors told that the corporation is a mere name.<sup>18</sup> If such practices are engaged in, the

<sup>11</sup> Horowitz, *Disregarding the Entity of Private Corporations*, 14 Wash. L. Rev. 285 (1939), 15 Wash. L. Rev. 1 (1940); Note, 34 N. Car. L. Rev. 432 (1956).

<sup>12</sup> R. B. General Trucking, Inc. v. Auto Parts & Service, Inc., 3 Wis. 2d 91, 87 N. W. 2d 863 (1958).

<sup>13</sup> See Note, *One Man Corporations—Scope & Limitations*, 100 U. Pa. L. Rev. 853, 858 (1952); Cataldo, *supra*, n. 1, at 481.

<sup>14</sup> Miller & Dabrin Furniture Company, Inc. v. Camden Fire Insurance Co., 55 N. J. Super. 205, 150 A. 2d 276 (1959).

<sup>15</sup> 1 Fletcher, *Private Corporations*, §§ 41, 44, 165 (perm. ed.); Minahan v. Timm, 210 Wis., 689, 247 N. W. 321 (1932).

<sup>16</sup> Larson v. Western Underwriters, Inc., 87 N. W. 2d 883 (S. D., 1958).

<sup>17</sup> Biscayne Realty & Ins. Co. v. Ostend Realty Co., 109 Fla. 1, 148 S. 560 (1933); Shea v. Leonis, 14 Cal. 2d 666, 96 P. 2d 332 (1939).

<sup>18</sup> Tynes v. Shore, 117 W. Va. 355, 185 S. E. 845 (1936); Rutz v. Obear, 15 Cal. App. 435, 115 P. 67 (1911).

court is likely to disregard the corporate veil and hold the owner personally liable.<sup>19</sup>

A good example of what is likely to happen when the corporation is not conducted as if it were a corporation is the case of *Dixie Mining & Manufacturing Company v. Williams*.<sup>20</sup> In organizing the corporation, defendant did not bother to use dummy incorporators, instead he merely "put down" two names in addition to his own. No stock was ever issued to the two fictitious incorporators, no meeting of stockholders or directors was ever held, and the defendant operated the business as if it was an individual proprietorship. In a suit by the widow of one of the defendant's former employees, the court said that the corporation was a mere sham, and held the owner personally liable.

*Adequate Capital*—If an individual has risked an adequate amount of money on the hazards of the business, and has not attempted to shift the burdens of his doing business to others, the separate corporate entity concept is likely to be applied, regardless of the manner of operations.<sup>21</sup> On the other hand, if the capital of the corporation is illusory or trifling compared to the business to be done and the risks of loss, or if the stockholder has withdrawn corporate assets, the corporate veil is likely to be disregarded.<sup>22</sup>

It is, of course, impossible to establish a standard amount to be deemed adequate capital. The type of business, its locality and its gross business are all relevant factors.

The currently popular "thin" corporation, where the capital investment is kept modest and the working fund is supplemented by a loan so as to enable tax saving, also creates problems.<sup>23</sup> If a substantial amount of capital is risked at the inception, there should be no objection to future financial aid which is not meant to be included in capital. *Arnold v. Phillips*<sup>24</sup> suggested that the

<sup>19</sup> Failure to issue stock may be considered in determining whether the corporate veil should be pierced. *Wheeler v. Superior Mortgage Co.*, 17 Cal. Rep. 291 (1961).

<sup>20</sup> 221 Ala. 331, 128 S. 799 (1930).

<sup>21</sup> Note, Non-Tax Aspects of Thin Incorporation, 31 Vand. L. Rev. 751, 768 (1960).

<sup>22</sup> *Shafford v. Otto Sales Co., Inc.*, 149 Cal. App. 2d 428, 260 P. 2d 269 (1953); *Ballantine, Corporations* § 129, pp. 302-303 (rev. ed. 1946).

<sup>23</sup> *Supra* n. 21.

<sup>24</sup> 117 F. 2d 497 (5th Cir. 1941), cert. den., 313 U. S. 583 (1941).

owner should be permitted to lend his corporation an amount equivalent to the capital stock value. However, it is impossible to make an arbitrary ruling. Each case should be decided on its own merits.

The "inadequate capital" argument for piercing the corporate veil is stronger in a tort action than in a contract action. There are practical ways and means of determining the credit risk in dealing with a particular corporation; and since the limited liability of corporate stockholders is common knowledge in the business world, the creditors know beforehand the limitations they accept when they choose to do business with a one-man corporation.

Despite the apparent fairness of the adequate capital test, not all courts have adopted it. Some states have shown more interest in the manner in which the business was operated. If the operations conform to the test set out above, then the sole owner is granted limited liability, the rationale being that limited liability is granted by the corporation laws of the state, and if there has been substantial compliance, then limited liability is automatic.<sup>25</sup>

Needless to say, persons with claims against the corporation are interested more in the capital risked by the owner than in the corporate formalities.

The states of New York and Idaho have specifically refused to apply this test in tort actions against the sole shareholder for unintentional torts of employees.

The leading New York case is *Mull v. Ackerman, Colt Co. Inc.*<sup>26</sup> Here the plaintiff sought to recover \$500,000.00 damages for the crushing of both his legs by a taxicab owned by a one-man corporation. In New York it was common knowledge that the owners of large fleets of taxicabs, for the purpose of limiting the amount of possible recovery with respect to any accident, had developed methods of continuing to operate large fleets of many hundreds of taxicabs, while maintaining ownership of the taxicabs in the names of many corporations. The plaintiff alleged that it was fraud for the defendant to form a series of corporations, each owning only two cabs, in order to limit his liability. The court refused to find such to be fraud, relying on the famous

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<sup>25</sup> Elenkrieg v. Siebrecht, *supra*, n. 8; Buckner v. Dillard, 184 Okla. 586, 89 P. 2d 326 (1939).

<sup>26</sup> 178 F. Supp. 720 (D. C. N. Y.), appeal dismissed, 279 F. 2d 25 (2nd Cir. 1959).

*Elenkrieg* case<sup>27</sup> for the proposition that a man may incorporate his business for the very purpose of escaping liability.

The court went on to say that the rule would cause obvious injustice in this case but that any relief would have to come from the legislature, since it was perfectly clear that, under New York law, where a corporation is legally created and does in fact exist the sole owner is not personally liable. This argument has two weaknesses. First, the legislature did not create the one-man corporation in New York, rather it was the judiciary that recognized the device. Thus the court had a higher degree of responsibility for the proper regulation of the one-man corporation than did the legislature.<sup>28</sup> Second, while the court indicated that it was bound by precedent, it could very easily have gotten around the *Elenkreig* case by limiting its holding to its facts. For while the *Elenkreig* case has some very broad statements that seem to repudiate the "adequate capital" theory, the facts of the case indicate that there was adequate capital in the case before the court.

The Idaho Supreme Court rejected the adequate capital test in *Hayhurst v. Boyd*.<sup>29</sup> Here plaintiff sought to recover for damages sustained while a patient in defendant's hospital. The hospital corporation owned no property and had a capitalization of only \$360.00. The building, equipment and furnishings used to operate the hospital were owned by another of defendant's corporations. The court refused to disregard the corporate veil, saying that there was no law which required the hospital to own the property it used in its operations.

To be contrasted with the New York and Idaho cases are the California cases which seem to have reached the opposite extreme. In *Mintan v. Cavaney*,<sup>30</sup> plaintiff's daughter drowned in a pool which was the sole asset of X corporation. After being unable to obtain satisfaction on a \$10,000.00 judgment against the

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<sup>27</sup> *Supra* n. 8.

<sup>28</sup> For other New York cases see: *Petrovich v. Felco Chemical Corp.*, 194 Misc. 111, 86 N. Y. S. 2d 328 (1949); *Werner v. Hearst*, 177 N. Y. 63, 69 N. E. 221 (1903); *Robinson v. Chase Maintenance Corp.*, 190 N. Y. S. 2d 733 (1958).

<sup>29</sup> 50 Idaho 752, 300 P. 895 (1931).

<sup>30</sup> 15 Cal. Rep. 641, 364 P. 2d 473 (1961); For other California cases see: *Temple v. Badya Bay Fisheries, Inc.*, 180 Cal. App. 2d 279, 4 Cal. Rep. 300 (1960); *Automotriz Del Golfo De California v. Resnick*, 47 Cal. 2d 792, 306 P. 2d 1 (1957).

corporation, plaintiff brought this action to hold the attorney who incorporated the two-man corporation personally liable on the judgment. The attorney had been serving temporarily as secretary-treasurer and director of the corporation. Apparently, it is common practice for an attorney who is incorporating a one or two-man corporation to temporarily serve as a dummy incorporator, director or officer.

Nevertheless, the court held that the attorney would be personally liable as a director and officer if it was shown that there was no attempt to provide adequate capitalization for the corporation. However, since the defendant was not a party to the original action against the corporation, plaintiff would have to retry the case and make the defendant a party to the action.

A more reasonable application of the adequate capital test appears in *Sayers v. Navillus Oil Co.*<sup>31</sup> Here plaintiff's husband was killed in an oil well explosion. The sole asset of the one-man corporation for whom he worked was the oil well which was also destroyed in the explosion. The well had been operated successfully for about a year. The court, in refusing to hold the sole stockholder personally liable, pointed out that the corporation had been founded with adequate capital.

### Intentional Torts

There are few reported cases dealing with tortious intentional misconduct committed in the execution of the corporate business by the sole stockholder. Logically, it would seem that the courts should deny the privilege of limited liability when the sole owner has himself committed the tort.<sup>32</sup> The *Academy Award Products v. Bulova Watch Co.*<sup>33</sup> case sustained this position by holding that the corporate shield affords no protection to the sole owner of a corporation who used the corporation to injure the plaintiff by falsely procuring registration of a trade mark for the purpose of harassing the plaintiff.<sup>34</sup>

However, it is possible that some courts will, without distinction, apply the broad standard of limited liability to both intentional torts by the owner and torts by employees of the

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<sup>31</sup> 41 S. W. 2d 506 (Tex. Civ. App. 1931).

<sup>32</sup> Cataldo, *supra*, n. 1, at 477.

<sup>33</sup> 129 F. Supp. 780 (S. D. N. Y. 1955), *aff'd* 233 F. 2d 499 (1955).

<sup>34</sup> Also see *Jackson v. Kirschman*, 175 S. 105 (La. App. 1937).



corporation. The case of *Wihl v. Wells*<sup>35</sup> is troublesome in this respect. While the holding of the case denied limited liability, the court had difficulty in meeting the defendant's argument that he did nothing outside of his official duty as an officer of the corporation. The court apparently rested its decision on the fact that the corporation was formed for the very purpose of infringing the copyright in question.

If the intentional tort is one such as assault or false imprisonment, where there is clearly a right to sue the sole owner personally, then disregarding the corporate veil is of less importance. Here the injured party can reach the sole owner's shares of stock in satisfaction of any judgment he may receive. This procedure protects corporate creditors who have priority in the corporate assets.<sup>36</sup>

### Conclusion

Some courts have had difficulty reaching equitable results in one-man corporation tort cases. This is regrettable not only from the standpoint of the injustice inflicted, but also because such decisions might bring about a legislative rejection of a very useful concept.

The reasons for recognizing one-man corporations far outweigh the disadvantages. First, the present plight of the small businessman makes it desirable to reinforce his position in the economy. And it can scarcely be doubted that the owners of many small businesses have relied heavily on the possibility of limiting losses by incorporating. Second, why should two or three men be able to limit their liability and one man be denied that privilege? Is there magic in numbers? As the court said in *Solomon v. Solomon & Co., Ltd.*,<sup>37</sup> "How does it concern the creditors whether the capital of the company is owned by seven persons . . . or almost entirely by one." Third, the denial of limited liability to one-man corporations would discourage one source of venture capital. Fourth, is it possible to prevent the "brave and daring souls" from using dummies in order to incorporate? Such an attempt would probably result in allowing the very people who are likely to cause trouble to use the

<sup>35</sup> 231 F. 2d 550 (7th Cir., 1956).

<sup>36</sup> *Geory v. Cain*, 79 Utah 268, 9 P. 2d 396 (1932); *Ernest v. Moore*, 254 S. W. 2d 347 (Ky. App. 1953).

<sup>37</sup> L. R. (1897) App. Cas. 22.

corporate entity while the more reliable, high minded individuals who would not resort to dummies would be denied the corporate form. Fifth, the courts of most states have recognized the one-man corporation for over half a century. Literally thousands of them exist across the country today. To attempt to abolish these entities at this late date would bring on an avalanche of problems.

Perhaps the only real argument against allowing one-man corporations is their peculiar susceptibility to fraudulent use. The opportunity for manipulation of assets, and the superior knowledge of the sole shareholder, allow fraud and deviations that are almost impossible to detect. But this disadvantage simply does not outweigh the advantages. What is needed is proper regulation. Courts should be ever aware of the peculiarities of the one-man corporation and should not dogmatically apply principles developed for large corporations to the one-man corporation. Universal recognition of the "adequate capital" theory would be a big step in this direction.