



## Delaware Corporation Law and Practice

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### CHAPTER 8 Commencement of Corporate Activity and the Nature of Corporate Existence

#### *1-8 Delaware Corporation Law and Practice* § 8.02

#### **§ 8.02 The Meaning of Separate Corporate Existence**

The creation of a corporation by the filing of a certificate of incorporation and the holding of an organizational meeting brings into existence a separate independent jurial entity. Historically, Delaware courts have been meticulous in their recognition of the concept of separate corporate existence; there are only a handful of reported cases in which the "corporate veil" has been "pierced." A series of decisions, primarily in the United States District Court for Delaware, but also to some extent in the Court of Chancery, has, largely by *dicta*, suggested both an apparent relaxation of the rigorous standards applied in the earlier cases and a greater willingness to question claims of separate corporate identity. While to date, in cases actually decided on the merits, the historical reluctance to disregard separate corporate existence remains for the most part intact, these opinions have introduced a degree of uncertainty into what had been considered a fairly well-settled field.

It was and is the general rule that a corporation is treated as an independent legal entity, with an identity separate and apart from its stockholders and from its officers or directors, even where it is a wholly-owned subsidiary of another corporation, and even where its officers or directors are the same persons who hold those offices in the parent company. The only exceptions historically had arisen where there was fraud, or where a sole stockholder had either disregarded his or its subsidiary's separate corporate form or treated the corporation as a mere "instrumentality" or extension of himself or itself.

The few reported cases in which the separate corporate identity has been disregarded serve to illustrate the limited extent to which Delaware courts have in the past deemed it appropriate to "pierce the corporate veil." The leading older case, *Martin v. D.B. Martin*,<sup>n1</sup> permitted a stockholder of a parent company to have a broad inspection of the books and records of an underlying pyramid of subsidiaries on the basis of his claim that mismanagement and self-dealing permeated the entire corporate structure and could not be remedied unless the inspection encompassed books of the subsidiary entities. However, the precedential value of *Martin* was considerably eroded by *Skouras v. Admiralty Enterprises, Inc.*,<sup>n2</sup> where the Court of Chancery limited a stockholder's inspection to the records of the parent company, even though it served merely as a holding company for an operating company whose officers and directors paralleled the parents. The Court did, however, give the stockholder the right to reapply for further relief if the initial limited inspection proved inadequate.<sup>n3</sup> In 2003, the statutory basis for stockholder inspections<sup>n4</sup> was amended to adopt, subject to certain enumerated limitations, the approach taken in *Martin*. However, the legislative synopsis accompanying the amendment makes expressly clear that the "piercing" inherent in the statute is limited to inspection of documents only and has no application in other areas.

The "instrumentality" theory was illustrated by *Equitable Trust Co. v. Gallagher*.<sup>n5</sup> The sole stockholder of an automobile agency, wishing to reward a longtime employee, created a trust of some of his shares, designating the corporation as trustee. The employee was granted irrevocably a life estate in the trust's shares. The owner subsequently proposed to enhance the employee's gift by giving her outright an equal number of shares while canceling the trust, but the

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employee died before the change was effected. Rejecting a contention that the inchoate proposal was an unenforceable promise to make a gift, the Court found that the proposed cancellation of the employee's life estate was sufficient consideration to render the employer's second promise enforceable, even though, arguably, the trustee corporation was an entity separate and apart from the employer-stockholder. The Court found that the employer treated the corporation as a mere extension of himself, at least as far as his treatment of the employee was concerned.

The "instrumentality" theory was also recognized in *Walsh v. Hotel Corp. of America*,<sup>n6</sup> although the procedural context did not require the court to flesh out the concept. Plaintiff, injured in a fall at a Massachusetts motel, sued the New York corporation which ostensibly owned and managed the motel and which was jurisdictionally present in Delaware. The defendant by way of defense asserted that the responsible party was in fact its wholly-owned Massachusetts subsidiary, which owned the motel and over which Delaware courts could not obtain jurisdiction. Upon appeal from a dismissal of the case, the Supreme Court reversed and permitted plaintiff to amend her complaint to assert an "instrumentality" theory against the parent corporation because the parent allegedly had held itself out to the public as the owner-operator of the motel. It authorized discovery to develop the facts. The Court emphasized it was not holding on the record then before it that the Massachusetts subsidiary was a mere "instrumentality" of its parent, but merely that the "instrumentality" theory was recognizable in Delaware if the facts so warranted.<sup>n7</sup>

The foregoing represent all reported Delaware cases in which the decision actually turned upon a piercing of the corporate veil.<sup>n8</sup> More typical are cases such as *Pauley Petroleum Inc., et al. v. Continental Oil*,<sup>n9</sup> where the Court refused to order the Delaware parent of a wholly-owned Mexican subsidiary to cause the subsidiary to stop prosecuting an action in Mexico, even though the Court recognized that the parent in fact controlled the subsidiary. The Court found no fraud or misuse of the corporate form, and hence, the subsidiary was treated as a wholly independent entity. Similar approaches were taken in *Buechner v. Farbenfabriken Bayer Aktiengesellschaft*,<sup>n10</sup> where the Court refused for purposes of attachment to treat shares of a Delaware corporation owned by a wholly-owned Canadian subsidiary of a German parent as the property of the parent, and in *In re Sunshine Corporation Shareholder Litigation*,<sup>n11</sup> where a charter restriction banning share repurchases while preferred dividends were in arrears was held not to cover such purchases by pre-existing subsidiaries.<sup>n12</sup>

The separate corporate identity concept can be a two edged sword. For example, in a case where an employee sued his employer for wrongful discharge, the defendant corporation was not permitted to offset money allegedly embezzled from a subsidiary on the grounds that the claim belonged to the subsidiary only.<sup>n13</sup> The Court subsequently ruled, however, that the employee's wrongful conduct vis-a-vis the subsidiary did constitute justification for his discharge by the parent corporation.<sup>n14</sup>

The recent arguable erosion of this consistent approach to the "piercing" issue was presaged by two decisions of the United States District Court for Delaware. In *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil Inc.*,<sup>n15</sup> Senior Judge Caleb Wright appeared to redefine the "instrumentality" theory of the earlier Delaware cases to suggest that there was a lawful basis for holding a parent liable for its subsidiary's obligations even in the absence of fraud or "holding out." He hypothesized that under certain circumstances a parent company could non-fraudulently so control its subsidiary's activities as to create a liability akin to that of a principal for the acts of its agent. Having enunciated the theory, however, Judge Wright effectively emasculated it by rejecting its application to the facts of his case, where the parent had organized and funded the subsidiary as the operating vehicle to exploit oil concessions granted initially to the parent. Instead, he applied the traditional indicia of separate corporate existence of the subsidiary to reject the piercing contention. In *Phoenix Canada Oil Co. Ltd. v. Texaco, Inc.*,<sup>n16</sup> Judge Jane R. Roth gave lip service recognition to *Japan Petroleum* but reached the same result on largely the same reasoning--viz. the indicia of separate existence.

However, in *United States v. Golden Acres, Inc.*,<sup>n17</sup> Judge Roth, expressly applying a federal, not Delaware, standard in her analysis, held that the ostensible separate corporate form of a mortgagor would not block the imposition of personal liability upon the corporation's stockholders for a deficiency judgment obtained upon a foreclosure by the Department of Housing and Urban Development. The evidence revealed that the stockholders had treated the corporation's coffers as a private bank account over an extended period while ignoring its obligations to the mortgagee, but the judge found it unnecessary to decide whether "piercing" was warranted under the Delaware authorities. Instead, she held that federal policy required application of uniform national standards to prevent frustration of specific federal objectives. She defined her approach as an "alter ego" analysis, requiring examination of several factors, which, she stated,

... include[d] whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder.

She added:

[N]o single factor could justify a decision to disregard the corporate entity, but that some combination of them was required, and that an overall element of injustice or unfairness must always be present, as well.

Judge Roth's formulation of the alter ego standard was quoted verbatim and utilized as a tool of analysis by the Delaware Chancery Court in *Harco National Insurance Co. v. Green Farms, Inc.*, n18 although Vice Chancellor Maurice A. Hartnett, III acknowledged that the alter ego theory had never been adopted by the Delaware courts. He found the facts sufficiently controverted, however, to preclude a determination of the piercing issue on summary judgment.

The topic came full circle when U.S. Senior District Court Judge Murray M. Schwartz, relying expressly upon *Harco*, applied the alter ego analysis of *Golden Acres* as a matter of Delaware law in *Harper v. Delaware Valley Broadcasters, Inc.* n19 In a somewhat contradictory discussion, Judge Schwartz found that, although a "showing of fraud or something like fraud [was] necessary to persuade the Delaware courts to pierce a corporate veil" under the alter ego theory, no fraud need be shown. Rather, the courts need only consider whether inequity, unfairness or injustice would result from recognition of a claimed separate corporate identity. However, he found no such inequity in the record before him and refused to charge a sole stockholder with the obligation of his corporation.

The confusion concerning the Delaware law exhibited by Judge Schwartz in *Harper* was understandable in the light of the earlier holding of the Court of Chancery in *Mabon, Nugent & Co. v. Texas American Energy Corp.*, n20 where it was claimed that a parent corporation was liable for its wholly-owned subsidiary's defaulted debentures. At the time of the issuance of the debentures, the subsidiary had been an independent public company, but there had been a subsequent reorganization in which a holding company had been created with the public shareholders becoming holders of the parent. The separate existence of the subsidiary had been maintained in the reorganization, and there was no express assumption of its bonded indebtedness. On a motion to dismiss, the Court rejected any claim of fraud because there were no allegations that either parent or subsidiary had ever affirmatively misrepresented what had occurred. The "agency" theory of *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil, Inc.* n21 was also rejected as unsupported under the facts. Nonetheless, the Court found that a basis for piercing the corporate veil on an estoppel theory had been sufficiently pleaded, since plaintiff alleged that the format of the published consolidated financial statements of the parent had misled him and the marketplace generally into believing that the subsidiary's indebtedness had been assumed by the parent. Although the decision might be narrowly construable as little more than another "holding out" case similar to *Walsh v. Hotel Corp. of America, Inc.*, n22 the Court muddied the waters when it summarized its holding by concluding that "there are equitable considerations ... [in the facts as alleged] that would support piercing the corporate veil."

This uncomfortably broad justification for "piercing" was reinforced by a subsequent decision in the *Mabon Nugent* case, which denied defendant's motion for summary judgment on the basis of a disputed factual record. n23 While giving lip service recognition to the earlier authorities suggesting fraud was required to support the disregarding of a corporation's independent existence, Vice Chancellor Carolyn Berger relied upon *Harco National Insurance Co. v. Green Farms, Inc.* n24 arguably to broaden the concept of piercing the corporate veil on undefined "equitable grounds," well beyond the concept of estoppel which had been the basis of her earlier decision. n25

In *Midland Interiors, Inc. v. Burleigh*, n26 however, the Court of Chancery found justification for piercing the corporate veil on the basis of fraud. Thus, although several authorities make it at least arguable that the Delaware courts will consider piercing the corporate veil whenever they believe "equity" or "justice" will be served, the holding in *Midland* suggests that the earlier requirements of fraud or misuse of the corporate form have not been entirely discarded. Additionally, several cases have reverted to the fraud or sham standard in rejecting claims for piercing. n27

On the other hand, a corporation which has established a subsidiary will not be permitted to claim that the subsidiary is merely an alter ego of its creator in order to defeat a contention that the subsidiary is a necessary party to a suit. n28 Likewise, it has been held that a parent corporation could not pierce its own corporate veil to bring direct claims on behalf of its wholly owned subsidiary against the former CEO of both the parent corporation and the subsidiary. n29

Aside from their specific rulings with respect to piercing the corporate veil, the Delaware courts have not been blind to reality in the relationship of stockholder to corporation, and there are innumerable decisions which recognize that stockholders hold economic interests which parallel those of the corporations in which they own stock. Thus, in considering whether directors have breached their fiduciary duty, the courts will not be deterred by a contention that the vehicle for such breach is an ostensibly separate corporation in which the director is a mere stockholder. Similarly, directors of a parent may be held accountable for breach of fiduciary duty for causing, or failing to prevent, action by a wholly-owned subsidiary which is injurious to the parent's stockholders. n30 However, these cases cannot be considered "piercing" cases in the sense in which the term is conventionally applied--i.e., the holding of a person directly liable for a claim against the corporation in which he holds stock. n31

### Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Corporations Formation Corporate Existence, Powers & Purpose Existence Business & Corporate Law Corporations Formation Corporate Existence, Powers & Purpose Powers Distinct & Separate Principle Business & Corporate Law Corporations Shareholders Disregard of Corporate Entity Alter Ego General Overview Business & Corporate Law Corporations Shareholders Disregard of Corporate Entity Alter Ego Corporate Formalities Business & Corporate Law Corporations Shareholders Disregard of Corporate Entity Single Business Enterprise

### FOOTNOTES:

(n1)Footnote 1. *Martin v. D.B. Martin*, 88 A. 612 (Del. Ch. 1913) .

(n2)Footnote 2. *Skouras v. Admiralty Enters., Inc.*, 386 A.2d 674 (Del. Ch. 1978) .

(n3)Footnote 3. *Accord, Landgarten v. York Research Corp.*, 1988 Del. Ch. LEXIS 20 (Feb. 3, 1988) . See Ch. 27 below for a fuller discussion of the stockholders' right to inspect.

(n4)Footnote 4. 8 Del. C. § 220. See Ch. 27 below for a fuller discussion of the stockholders' right to inspect.

(n5)Footnote 5. *Equitable Trust Co. v. Gallagher*, 99 A.2d 490 (Del. 1953) , modified, 102 A.2d 538 (Del. 1954) .

(n6)Footnote 6. *Walsh v. Hotel Corp. of America*, 231 A.2d 458 (Del. 1967) .

(n7)Footnote 7. The "instrumentality" theory has also been applied to creditors who have arguably taken over operation of a corporate debtor in a "work-out" situation. In the leading case, *Irwin & Leighton v. W.M. Anderson Co.*, 532 A.2d 983 (Del. Ch. 1987) , however, the Court held that the creditor's actions did not warrant the conclusion that it was operating the debtor and declined to "pierce."

(n8)Footnote 8. There are a handful of unreported decisions, largely involving small private businesses, in which the Court rejected an attempt by a sole proprietor-stockholder who had ignored the formalities of his ostensible incorporation in operating his business to utilize it to avoid his obligations. See, e.g., *Ford v. Harris Moving and Storage Inc.*, 1981 Del. Ch. LEXIS 529 (June 16, 1981) ; *Alger Oil Co., Inc. v. McDonald Assoc. Inc.*, 1980 Del. Ch. LEXIS 544 (Oct. 8, 1980) .

(n9)Footnote 9. *Pauley Petroleum Inc. v. Continental Oil*, 231 A.2d 450 (Del. Ch. 1967) , aff'd, 239 A.2d 629 (Del. 1968) .

(n10)Footnote 10. *Buechner v. Farbenfabriken Bayer Aktiengesellschaft*, 151 A.2d 125 (Del. Ch. 1959) , aff'd, 154 A.2d 684 (Del. 1959) .

(n11)Footnote 11. *In re Sunstates Corp. S'holder Litig.*, 788 A.2d 530 (Del. Ch. 2001) .

(n12)Footnote 12. The Court did suggest that its result might have been different if the subsidiaries had been organized for purposes of circumventing the restriction. *In re Sunstates Corp. S'holder Litig.*, 788 A.2d 530 (Del. Ch. 2001) . See also *Shenandoah Life Ins. Co. v. Valero Energy Corp.*, 1988 Del. Ch. LEXIS 84 (June 21, 1988) .

(n13)Footnote 13. *Tilden v. E.A. Stevenson Co.*, 130 A. 236 (Del. Super. Ct. 1925) ; see also *Frantz v. Templeman Oil Corp.*, 134 A. 47 (Del. Super. Ct. 1926) .

(n14)Footnote 14. *Tilden v. E.A. Stevenson Co.*, 132 A. 739 (Del. Super. Ct. 1926) .

(n15)Footnote 15. *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil Inc.*, 456 F. Supp. 831, 840 (D. Del. 1978) .

(n16)Footnote 16. *Phoenix Canada Oil Co. Ltd. v. Texaco, Inc.*, 658 F. Supp. 1061 (D. Del. 1987) , *aff'd*, 842 F.2d 1466 (3d Cir. 1988) .

(n17)Footnote 17. *United States v. Golden Acres, Inc.*, 702 F. Supp. 1097 (D. Del. 1988) .

(n18)Footnote 18. *Harco Nat'l Ins. Co. v. Green Farms, Inc.*, 1989 Del. Ch. LEXIS 114 (Sept. 19, 1989) .

(n19)Footnote 19. *Harper v. Delaware Valley Broadcasters, Inc.*, 743 F. Supp. 1076 (D. Del. 1990) .

(n20)Footnote 20. *Mabon, Nugent Co. v. Texas American Energy Corp.*, 1988 Del. Ch. LEXIS 11 (Jan. 27, 1988) .

(n21)Footnote 21. *Japan Petroleum Co. (Nigeria) Ltd. v. Ashland Oil, Inc.*, 456 F. Supp. 831, 840 (D. Del. 1978) .

(n22)Footnote 22. *Walsh v. Hotel Corp. of America*, 231 A.2d 458 (Del. 1967) .

(n23)Footnote 23. *Mabon, Nugent & Co. v. Texas American Energy Corp.*, 1990 Del. Ch. LEXIS 46 (Apr. 12, 1990) .

(n24)Footnote 24. *Harco National Ins. Co. v. Green Farms, Inc.*, 1989 Del. Ch. LEXIS 114 (Sept. 19, 1989) .

(n25)Footnote 25. See also *Leslie v. Telephonics Office Technologies*, 1993 Del. Ch. LEXIS 272 (Dec. 30, 1993) .

(n26)Footnote 26. *Midland Interiors, Inc. v. Burleigh*, 2006 Del. Ch. LEXIS 220 (Dec. 19, 2006) .

(n27)Footnote 27. See, e.g., *Wallace v. Wood*, 752 A.2d 1175 (Del. Ch. 1999) ; *Gadsden v. Home Preservation Co.*, 2004 Del. Ch. LEXIS 14 (Feb. 20, 2004) ; *In re Sunstates Corp. S'holder Litig.*, 788 A.2d 530 (Del. Ch. 2001) ; *Microstrategy Inc. v. Acacia Research Corp.*, 2010 Del. Ch. LEXIS 254 (Dec. 30, 2010) . See also *Outokumpu Eng'g Enters. v. Kepi*, 685 A.2d 724 (Del. Super. Ct. 1996) .

(n28)Footnote 28. See, e.g., *Johnson & Johnson v. Coopervision, Inc.*, 720 F. Supp. 1116, 1126 (D. Del. 1989) .

(n29)Footnote 29. *Case Fin., Inc. v. Alden*, 2009 Del. Ch. LEXIS 153 (Aug. 21, 2009) .

(n30)Footnote 30. *Grace Brothers Ltd. v. UniHolding Corp.*, 2000 Del. Ch. LEXIS 101 (July 12, 2000) .

(n31)Footnote 31. Other Delaware cases recognizing the principle of independent corporate existence include *Braasch v. Goldschmidt*, 199 A.2d 760 (Del. Ch. 1964) ; *Stauffer v. Standard Brands, Inc.*, 178 A.2d 311 (Del. Ch. 1962) , *aff'd*, 187 A.2d 78 (Del. 1962) ; *Bird v. Wilmington Society of Fine Arts*, 43 A.2d 476 (Del. 1945) ; *Coxe v. Handy*, 24 F. Supp. 178 (D. Del. 1938) , *aff'd*, 103 F.2d 873 (3d Cir. 1939) ; *Owl Fumigating Corp. v. California Cyanide Co.*, 24 F.2d 718 (D. Del. 1928) , *aff'd*, 30 F.2d 812 (3d Cir. 1929) ; *Radio Corp. of America v. Philadelphia Storage Battery Co.*, 6 A.2d 329 (Del. 1939) ; *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260 (D. Del. 1989) .

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