

ESSAY QUESTION NO. 2

Answer this question in booklet No. 2

Three friends, Dave, Fred, and Mary, form Corp A under Alaska law for the purpose of renting heavy equipment. Dave owns half of the shares and Fred and Mary each own a quarter of the shares. Corp A's articles of incorporation provide that 3 directors will oversee the operations of the corporation. Dave, Fred and Mary serve as the initial directors with Mary also serving as the registered agent. Dave serves as president of Corp A, and hires a general manager to help run the business. Fred and Mary do not have day to day involvement in the business. Corp A has a single business location in Fairbanks, Alaska, and business is slow.

After a year, Mary tenders her resignation as a director, sells all of her interest in Corp A to Fred and moves out of state. When it comes time to refill Mary's director seat, Dave and Fred cannot agree on a replacement director. Neither Dave nor Fred remember to replace Mary as Corp A's registered agent. While they hold annual shareholder meetings, they hold only half of the director meetings required by Corp A's bylaws.

Dave eventually decides that Anchorage would be a better market for equipment rentals. Even though the Articles of Incorporation require director approval for business expansions, Dave rents a lot in Anchorage and sets up a new Corp A business site without speaking to Fred. Dave signs the lease and contracts for utilities in Corp A's name. Deposits are paid out of Corp A's bank account. Dave uses his Corp A-owned pickup truck to drive back and forth between Fairbanks and Anchorage to manage both businesses. Business in Anchorage is starting out strong and looks like it will continue to grow. Dave hides all information about the Anchorage store from Fred and hopes that when the year end financials come out, the Anchorage business will be a big success and Fred will forgive all. Dave admonishes his Fairbanks General Manager to say nothing about the Anchorage office to Fred, and tells him he has the right to take these actions because he is the majority owner of the business.

After several more months of slow business for Corp A in Fairbanks, and still deadlocked over selection of a replacement director, Fred decides he wants to close down Corp A and recover as much of his investment as he can. Fred talks with Dave about voluntarily dissolving Corp A, but cannot convince him. Fred files suit seeking involuntary dissolution of Corp A.

Two weeks after Fred begins the involuntary dissolution process, Dave transfers to Anchorage several large pieces of Corp A's equipment that had been mothballed in a back lot. Dave is unaware that one of the transferred machines, a tractor with a large front bucket, has a broken safety latch, but

Corp A's general manager knows about it and says nothing. New Customer Paul rents the tractor with the faulty safety latch and is hurt when the bucket disengages and falls on his foot.

Paul files suit against Corp A for negligence, and also sues Dave for vicarious liability as an owner of Corp A.

In answering the following questions, assume Customer Paul can and will establish Corp A's negligence.

1. Explain the main legal theory Customer Paul will use to establish Dave's vicarious liability for the negligence of Corp A and the specific findings that the court will need to make in order for Customer Paul to prevail.

2. Discuss what other basis of vicarious liability Customer Paul might be able to use against Dave specifically because the broken tractor was brought to Anchorage after the initiation of Fred's suit to involuntarily dissolve the corporation.

3. Discuss what Fred will have to prove in order to obtain involuntary dissolution of Corp A and what Dave could do to avoid the involuntary dissolution.

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***** QUESTION NO. 2 *****
BUSINESS LAW

1. Explain the main legal theory Customer Paul will use to establish Dave's vicarious liability for the negligence of Corp A and the specific findings that the court will need to make in order for Customer Paul to prevail. (60 points)

Piercing the Corporate Veil

The formation of a corporation generally shields its owners from personal liability for the acts of the Corporation. AS 10.46.438.

The corporate form will be disregarded in two circumstances: (1) if the corporation is a mere instrumentality of the owner Uchitel Co. v. Telephone Co., 646 P.2d 229, 234 (Alaska 1982); or (2) if the owner uses the separate corporate form "to defeat public convenience, justify wrong, commit fraud, or defend crime." McKibben v. Mohawk Oil Co. Ltd., 667 P.2d 1223, 1229 (Alaska 1983).

There are no facts to suggest that Dave, Fred, or Mary formed Corp A for the purposes of shielding themselves from liability for wrongdoing or intended to perpetrate a fraud on the public through use of the corporate form. Therefore, the examinees should focus their analysis on the "mere instrumentality" test.

In Uchitel, 646 P.2d at 235, the court set forth a six part test for determining whether a corporation was a "mere instrumentality" of the owner:

- (1) Does the owner sought to be held liable own all or most of the stock of the corporation?
- (2) Has the owner subscribed to all of the capital stock of the corporation or otherwise caused its incorporation?
- (3) Does the corporation have grossly inadequate capital?
- (4) Does the owner use the property of the corporation as his or her own?
- (5) Do the executives or directors of the corporation act independently in the interest of the corporation or simply take their orders from the owner in the latter's interest?
- (6) Are the formal legal requirements of the corporation observed?

“A party seeking to pierce the corporate veil does not need to present evidence of all six factors; the factors assist the trial court to determine ‘whether the evidence favors piercing the veil.’” Jones v. Bowie Industries, Inc. 282 P.3d 316, (Alaska 2012)(citing Nerox Power Sys. Inc. v. M-B Contracting Co., 54 P.3d 791, 802 (Alaska 2002)).

Applying these six factors to Dave and his conduct in relation to Corp A, there is evidence that would justify disregarding the corporate form on grounds of “mere instrumentality.”

- (1) Dave is a 50% owner, and not a majority owner of Corp A. However, given Mary’s departure and Fred’s non-involvement in the daily business affairs, Dave is exerting most of the ownership power and influence of Corp A.
- (2) Dave was indeed one of the individuals who caused the incorporation of Corp A.
- (3) There is no indication that Corp A is not adequately capitalized since its inventory of equipment appears sufficient for the level of business it is conducting. The facts do not suggest that Corp A has any cash flow issues or inability to meet its liabilities.
- (4) Dave does appear to treat Corp A’s business as his own since he proceeded to set up an entirely new business operation in another city, committed Corp A to legal liabilities, expended Corp A funds, and moved equipment out of the Fairbanks operation without asking for concurrence from the other 50% owner and fellow director, as required by the Articles of Incorporation. Dave’s actions were not those of a President, but rather those of an owner controlling and using the property of the corporation as his own. His use of the corporate assets does not need to be for personal benefit for this factor to be met.
- (5) The “independence” factor was clarified by the supreme court in McCormick c. City of Dillingham, 16 P.3d 735 (Alaska 2001). The court explained that this factor focuses on “corporate independence” and noted that in McCormick, the controller whose liability was at issue controlled the corporation as if he were the sole owner, and affirmed the trial court’s finding that this factor was met. Id. at 745. There is no question that Dave was the one owner in “control” of the business operations since the other two owners did not get involved in the daily operations. The facts are complicated by the fact that Dave holds three positions within Corp A, as owner, director, and president. Therefore, Dave could attempt to rebut this factor by saying that his actions were those of a President. However, Dave’s statement to his general manager that he was authorized to take the actions because he was the “majority owner”

believes the assertion by Dave that his conduct was merely that of a corporate officer or manager. Dave's actions and statement support the conclusion that Dave controlled Corp A like he was the sole owner.

- (6) The facts suggest that Corporation A has had limited success in observing its corporate formalities. While Dave holds an annual shareholder meeting, it has held only half of the required director meetings. In addition, Corp A is currently without a registered agent, and should that fact come to the attention of the Dept. of Commerce, Community and Economic Development, it would be grounds for involuntary dissolution by the State (AS 10.06.633.) The existence of Fred's involuntary dissolution action is unusual in a piercing the corporate veil case. The fact that Dave was developing and promoting Corp A's new business in the Anchorage store at a time when he was statutorily bound to pursue the winding up of its business affairs (AS 10.06.648(c)) and liquidation of its assets suggests that Dave was disregarding the corporate statutory processes. (*Discussed further in answer to next question.*) Such conduct would influence a court in its analysis of whether corporate formalities were being followed.

A court would likely find Dave's conduct towards Corp A sufficiently disrespectful of the separate corporate form to justify piercing the corporate veil in order to establish Dave's vicariously liability as owner of Corp A.

2. Discuss what other basis of vicarious liability Customer Paul might be able to use against Dave specifically because the broken tractor was brought to Anchorage after the initiation of Fred's suit to involuntarily dissolve the corporation. (15 points)

Once Fred initiated his action to involuntarily dissolve Corp A, Dave and Fred were required to "cease to carry on business except to the extent necessary for the beneficial winding up of its business." AS 10.06.615. Dave, however, did not do that. Dave instead loaned Corp A's equipment to the Anchorage business. He continued to use Corp A's pickup truck to support his Anchorage business operations. Nothing in the facts suggests that Dave had yet changed his mode of operating Corp A before Customer Paul was injured.

In Jones v. Bowie Industries, Inc., 282 P.3d 316 (Alaska 2012), the court stated that if a business owner continues to operate a business after its dissolution, that owner can be held personally liable for his actions. The court based this rule on Steenblik v. Lichfield, 906 P.2d 872, 977-79 (Utah 1995), where the Utah Supreme Court followed the majority rule and held that officers and directors are liable for corporate debts incurred after suspension of the corporation. The involuntary dissolution proceedings are considered to commence when the action is initiated.

Therefore, Customer Paul could assert a claim against Dave personally for the negligent actions of Corp A, because Corp A can no longer serve as a shield from liability since it is in the process of being dissolved.

3. Discuss what Fred will have to prove in order to obtain involuntary dissolution of Corp A and what Dave could do to avoid the involuntary dissolution. (25 Points)

Under AS 10.06.628, one half or more of the directors in office or one or more shareholders holding an interest of at least 33 1/3% can file suit for involuntary dissolution in superior court on the following grounds:

- (1) the corporation has abandoned its business for more than one year;
- (2) the directors are deadlocked and cannot agree on management of the corporation;
- (3) the shareholders are deadlocked and unable to fill director vacancies;
- (4) there is fraud, mismanagement or abuse of authority by corporate directors or officers regarding the corporation's property or its shareholders;
- (5) liquidation is necessary to protect the rights or interests of the complaining shareholders;
- (6) the period of the corporation's authorized existence has expired.

In order for Fred to succeed in his suit for involuntary dissolution, he will need to establish one or more of these grounds listed in AS 10.06.628.

The facts are very clear regarding the unfilled director seat. Fred should be able to establish that the shareholders of Corp A were deadlocked and unable to fill the director vacancy left by Mary.

In addition, once Fred becomes aware that Dave has unilaterally and without director approval established a new store location in Anchorage and committed corporate assets and incurred corporate liability in this new store endeavor, Fred should be able to establish that Dave was abusing his authority and acting as though the property interests of Corp A were his alone.

Finally, once the knowledge of Paul's lawsuit comes to light, Fred will also be able to add as grounds for his dissolution suit the fact that Dave unilaterally and without director approval took mothballed equipment without checking to see if it was in a safe, rentable condition and put it into commercial

use, thereby giving rise to the liability to Customer Paul. Such action would constitute mismanagement of Corp A's property.

If Dave wants to avoid dissolution, he has potentially two options:

(1) Purchase of Fred's shares. Dave could purchase the 50% interest held by Fred. AS 10.06.630 authorizes the non-moving holders of at least 50% voting power in the corporation to avoid dissolution by purchasing for cash, the shares of the moving parties. Dave would qualify under this statute as a holder of 50% ownership. The price that Dave would have to pay Fred to acquire Fred's 50% interest would be one-half of the liquidation value of Corp A, taking into account the possible sale of the corporation as a going concern. The court would appoint appraisers to establish the purchase price and the cost of the appraisal would be shared by the parties.

(2) Court Appoint of Provision Director. Dave could also move the court to appoint a provisional director under AS 10.06.640. Under this statute, when the grounds for the involuntary dissolution suit are deadlocked directors, the court may appoint a provisional director who "has all the rights and powers of a director until the deadlock in the board is broken or until the provisional director is removed by order of the court or by approval of the outstanding shares." AS 10.06.640(b). However, since Fred has other grounds for seeking involuntary dissolution, namely Dave's alleged mismanagement of Corp A property and abuse of corporate authority, Dave will also have to adequately remedy the past wrongs to Fred that were caused by his conduct and convince a court that he will honor corporate processes in the future. The fact that Corp A's Anchorage store appears to be successful (except for Customer Paul's injury) may facilitate Dave's effort to convince a court to allow Corp A to continue its existence.