

ESSAY QUESTION NO. 2

Answer this question in booklet No. 2

Since 1995, Joe has owned a trucking business, Ice Roads Inc. specializing in hauling heavy loads over ice roads on Alaska's North Slope. The legal titles to the two trucks used in the business are in Joe's name. Joe is Ice Roads' sole shareholder and employee, and Joe serves as President and Treasurer, while his wife, Lois, is the secretary. Joe and Lois do all of their personal and business banking through their one personal bank account. Lois makes a point of keeping a very organized notebook that contains corporate minutes of annual shareholder meetings and articles of incorporation and bylaws. She also dutifully files Ice Roads' corporate tax return each year.

In early 2008, Joe decides to start a business to transport tourists by bus. Joe incorporates Clear Roads Inc. in Alaska, and lists his wife Lois as the sole shareholder and President. He selects a corporate form of business to avoid personal liability. Lois maintains a proper notebook with Clear Roads' articles, bylaws and corporate minutes of its first shareholder meeting. In March 2008, Joe causes Clear Roads to lease one bus for a term of two years. The bus is to be delivered in Fairbanks May 10, 2008.

Joe calls cruise ship companies hoping to get a contract to move passengers between airports and seaports in the state. In April of 2008, Joe, acting as the general manager of Clear Roads enters into a contract with the Queenland Cruise Ship Company to provide twice weekly bus transportation for passengers between Fairbanks and Anchorage starting June 1. During the negotiations, Queenland asks Joe if Clear Roads Inc. currently meets the minimum requirement of owning two buses and Joe says it does. In accordance with the contract, Queenland pays Clear Roads \$20,000 to equip its two buses with specialized wheel chair lifting equipment to serve Queensland's customers. Even though Joe tells Queensland that he will purchase the specialized equipment, he has no intention of doing so.

Instead of buying the specialized equipment required by the contract, Joe designs his own passenger lift using a sling and pulley he removed from part of the rigging attached to one of his trucks. Joe deposits the \$20,000 into his personal bank account and draws on these funds to cover his personal bills and the bus' fuel bills. Within two weeks of starting performance under the contract, Clear Roads fails to keep up with Queensland's time schedule. Queensland quickly learns that Clear Roads only has one bus and thus can't perform when mechanical issues arise. Queensland also receives passenger complaints about bruises and

bumps caused by Joe's homemade sling and pulley system. Before the end of the 3rd week, Queensland cancels the contract and demands the return of its \$20,000 together with other monetary damages caused by Clear Roads' fraud. Joe does not respond to the demand.

Joe comes to you with Queensland's complaint which alleges fraud by Joe individually and also by Clear Roads Inc. The complaint seeks damages that far exceed Clear Roads Inc.'s assets.

1. Describe whether Joe could be found individually liable for Queensland's cause of action against Clear Roads Inc. and the facts that would support a finding that Joe was personally liable. Do not discuss agency law.
2. Discuss whether Joe is insulated from Queensland's fraud claim against him in his individual capacity because he was acting as an employee of the corporation.
3. At the time of Clear Roads Inc.'s corporate formation, describe how Clear Roads Inc. could be made a wholly owned subsidiary of Ice Roads Inc. and who its incorporator should be.

GRADER'S GUIDE

*** QUESTION NO. 2 ***

SUBJECT: BUSINESS LAW

1. Describe whether Joe could be found individually liable for Queensland's cause of action against Clear Roads Inc. and the facts that would support a finding that Joe was personally liable. Do not discuss agency law. (65 points)

Piercing the Corporate Veil of Clear Roads Inc.

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 P2d 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 P2d 1223, 1229 (Alaska 1983).

A. Analysis of the "Mere Instrumentality" test (45 Points)

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:

- a. Does the owner sought to be held liable own all or most of the stock of the corporation?
- b. Has the owner subscribed to all of the capital stock of the corporation or otherwise caused its incorporation?
- c. Does the corporation have grossly inadequate capital?
- d. Does the owner use the property of the corporation as his or her own?
- e. 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?
- f. Are the formal legal requirements of the corporation observed?

Applying these six factors to Joe and his conduct in relation to Clear Roads Inc., it is pretty clear that there is sufficient evidence to disregard the corporate form on grounds of “mere instrumentality”.

- a. Joe was not a share holder in Clear Roads Inc. in that he had placed ownership of all of the stock in his wife’s name. However, in McCormick c. City of Dillingham, 16 P3d 735 (Alaska 2001), the court was faced with an owner who had transferred all of the stock ownership to his wife, yet continued to operate the corporation as before. There the court held, “when a court considers whether to pierce the corporate veil, it does not simply ask who owns the corporation’s stock, but also inquires who controls the company. If other factors militate in favor of piercing the corporate veil, a court may impose personal liability on the control person even if he owns no stock.” Id. at 744. In this case, there is no question that Joe was the “control person”. The fact that he was not a shareholder will not end the inquiry. But other factors must demonstrate that the corporation is a mere instrumentality of Joe in order for the corporate veil to be pierced under this theory.
- b. Joe was the original incorporator of Clear Roads Inc. although the stock was in his wife hands. He was the catalyst behind the creation of Clear Roads Inc. Its purpose was to supply him with a summer occupation. Thus, this factor would likely be met.
- c. The facts suggest that Clear Roads Inc. was grossly undercapitalized. It had no separate bank account or capital. What start up money it received from Queenland for buying the special transport equipment was put into Joe’s personal bank account and used to pay personal bills as well as bus fuel bills. There was no other capital invested in Clear Roads Inc. The corporation owned no real property and equipment and thus lacked capital assets. Even the sling and pulley were borrowed from Ice Roads Inc. The bus was leased and not owned. The business had only one customer and operated only three weeks and then shut down, so it had little cash flow. Thus, it is likely that this factor would be met.
- d. Clear Roads did not appear to own any assets except the funds it was paid by Queenland and the bus lease. The facts do not suggest that Joe used the bus for personal purposes. But, Joe deposited Clear Roads’ \$20,000 payment from Queenland into his personal bank account and Joe used these funds in part to cover his personal bills. It is likely that this factor would be met.

- e. The question would appear to ask whether Lois acted independently as owner and President of Clear Roads Inc. or simply took orders from Joe, who was not even a director or owner of Clear Roads. McCormick is instructive on how this factor should be applied in such circumstances. The court described this factor as “corporate independence” and noted that the controller whose liability was at issue, controlled the corporation as if he were the sole owner, and affirmed the trial courts’ finding that this factor was met. Id. at 745. Here there is no question that Joe is controlling the corporation, and that Lois, the sole shareholder is merely a passive participant in the operation of the business, even though she does keep the records. There is no evidence that anyone but Joe controlled the conduct of the operations, or the corporation’s future direction. It is likely a court would find this factor to be met.
- f. There is no evidence that Joe and Lois did not adhere to the provisions of the corporation’s articles of incorporation or by-laws. The facts indicate that Lois kept very accurate and neat annual shareholder and meeting records. It is likely a court would find that the formal legal requirements of the corporation were being observed by Lois and Joe and that this factor standing alone does not support piercing the corporate veil. However, given the short duration of the active life of this corporation, there is not much of a track record, nor could there have been many meeting notes.

It is not necessary for all six factors to be satisfied before a finding of “mere instrumentality” can be made. Nerox Power Systems, Inc. v. M-B Contracting Co. Inc., 54 P. 3d 791, 802 (Alaska 2002). In this case, however, the weight of the factors overwhelmingly supports the conclusion that the “mere instrumentality” theory could be used to pierce the corporate veil of Clear Roads Inc.

B. Analysis of the use of corporate form “to defeat public convenience, justify wrong, commit fraud, or defend crime” test. (20 Points)

An owner or controlling party can be held personally liable for corporate actions where the corporate form is used to defeat public convenience, justify wrong, commit fraud or defend crime. Uchitel at 234. This basis for piercing the corporate veil exists regardless of whether the factors demonstrating “mere instrumentality” exist. Id.

The mere fact that Joe might have consciously selected the corporate form for his tourism business, so that he and Lois could avoid liability, would not alone be sufficient proof that they were trying to defeat public

convenience since limitation of liability is a legitimate and recognized characteristic of a corporation.

However, it is pretty clear that Joe caused the corporation to commit an act of fraudulent misrepresentation. His belief that he could do so with impunity because it was the action of the corporation and not an act as an individual was mistaken. Joe lied during the contract formation stage by misrepresenting how many buses the business had. He also had no intention of honoring Queensland's requirements for manner of loading handicapped customers. His pocketing of the \$20,000 under these false pretenses likely qualifies as a criminal act and his commission of this crime would also support the piercing of the corporation veil under this theory. Joe does not appear to have any facts he can point to as a defense against this theory for piercing the corporate veil.

The corporate veil could likely also be pierced under the "use of corporate form to commit fraud" theory.

2. Discuss whether Joe is insulated from Queensland's fraud claim against him in his individual capacity because he was acting as an employee of the corporation. (20 points)

Corporate Employee's personal liability for Fraud

In Casciola v. F.S. Air Service, Inc. 120 P.3d 1059, 1063 n11 (Alaska 2005), the Alaska Supreme Court stated, "All persons may be found liable for their own intentional tortious conduct, including acts of fraudulent misrepresentation. The corporate form does not shield corporate officers or employees who commit torts on behalf of their employer from personal liability." Joe made intentionally false statements concerning Clear Roads having two buses in possession, when in fact Clear Roads had no buses at the time of contracting and only intended to have one bus on hand for performance of the contract. In addition, Joe agreed to the terms for the special loading equipment knowing that he had no intention of honoring them. Even though Joe was acting as an employee of Clear Roads when he caused the corporation to enter into the contract with Queensland and did not sign the contract in his individual capacity, he is still personally liable for his fraudulent conduct. As such, a judgment against him for fraud could be rendered and his personal assets seized to satisfy the judgment, notwithstanding the fact that his actions were in his capacity as a corporate officer or employee.

3. At the time of Clear Roads Inc.'s corporate formation, describe how Clear Roads Inc. could be made a wholly owned subsidiary of Ice Roads Inc. and who its incorporator should be. (15 Points)

Ice Roads Inc. cannot act as the incorporator of Clear Roads Inc. Incorporators must be natural persons. AS 10.06.205. Ice Roads Inc. therefore cannot sign the Articles of Incorporation as an incorporator of the new Alaska corporation.

Therefore, either Joe or Lois, as natural persons, would have to serve as the incorporator of Clear Roads Inc. Joe or Lois would file Articles of Incorporation with the Alaska Department of Commerce, Community & Economic Development, Division of Corporations, Business and Professional Licensing, and indicate in the Articles of Incorporation that Ice Roads Inc. owned all of the stock. This would result in Clear Roads Inc. becoming the wholly owned subsidiary of Ice Roads Inc.

A less efficient process would have the Articles of Incorporation reporting the initial stock as being owned by Joe or Lois; subsequently, Joe or Lois would then have to transfer the stock to Ice Roads Inc.