Corporations: Defects, Privilege & Limitations

- Defective Incorporation
  - Forming a corporation is relatively straightforward
  - However, the legal requirements must be carefully followed
  - Consequences of defective formation vary:
    - The managers/shareholders may be treated as partners
    - A third party to a contract may be able to claim nonexistence in order to avoid the contract
    - The corporation may seek to avoid its obligation on the contract due to its nonexistence
- De Jure Corporation
  - A *de jure* corporation exists when there has been substantial compliance with the mandatory (i.e., "shall", "must") incorporation requirements.
  - A *de jure* cannot be successfully challenged as to its existence as a corporation.

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- De Facto Corporation
  - A de facto corporation exists when the promoters/incorporators fail to comply with all of the mandatory provisions, but comply with most.
  - In order to prove a de facto corporation, you must show:
    - A valid statute under which the business could have been incorporated,
    - Promoters make a good faith attempt to comply with the statutory requirements, and
    - Use of corporate powers.
  - Some states no longer support the de facto doctrine.
    - Under the MBCA filing the articles is conclusive proof of the corporation's existence.

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- What's the Point of the De Facto Doctrine?
  - It promotes business transactions
  - It prevents one of the parties from disclaiming the corporation based on nonexistence of the corporation
- Corporation by Estoppel
  - An equitable doctrine designed to prevent injustice
  - When one or more persons hold themselves out as being a corporation a court will estop (prevent) them from denying the existence of the corporation.
  - "Corporation by estoppel applies when a party contracts with an entity that appears to be a corporation, breaches the contract, and then, when sued for breach, tries to avoid liability by challenging the corporation's status and capacity to contract. " McLesky v. Davis Boat Works, Inc., 225 F.3d 654

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- Liability for Defective Incorporation
  - Where the defect is such that not even a corporation by estoppel is formed,
  - Courts will hold the managers/shareholders liable as general partners
  - The MBCA (Section 2.04) imposes joint and several liability on managers and shareholders who:
    - Purport to act on behalf of the corporation, and
    - Know the corporation does not exist
- Limited Liability Reconsidered
  - Advantages of Limited Liability
    - Promotes investment by capping risk
    - Promotes efficiency - investors commit resources to mangers

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- Advantages of Limited Liability
  - Reduces overall cost of investment – bonding and heightened monitoring is not necessary.
  - Promotes diversification in investment.
- Disadvantages of Limited Liability
  - Limited recovery in tort
  - Tort law's "efficiency" (i.e., the party best able to pay) standard is frustrated.

- Piercing the Corporate Veil
  - The law provides a wall between a corporation and its shareholders to limit shareholder liability for corporate actions.
  - Sometimes courts will pierce this veil to hold shareholders individually liable.

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- Piercing the Corporate Veil
  - To pierce the corporate veil, two things must be shown:
    - Shareholder domination: policy, business practices, finances
      - The corporation is an alter ego of the shareholders, or
      - The corporation is an instrumentality of the shareholders
    - Use of domination for an improper purpose
      - Defrauding creditors,
      - Circumventing a statute, or
      - Evading an existing obligation.
  - Evidence of Alter Ego/Instrumentality
    - Disregard corporate formalities
    - Comingling assets of dominate shareholder/corporation

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- Evidence of Alter Ego/Instrumentality
  - Inadequate capitalization
    - Measured at the time of inception
    - Concern – fraud on creditors
  - Transfers of corporate assets for less than fair market value
    - May leave corporation with insufficient assets to function
    - May be done to defraud third party
  - Creating a subsidiary to circumvent/evade statute or contract obligation.
- Parent/Holding Company
  - Subsidiaries/Affiliates subject to control by parent or holding company

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- Parent/Holding Company
  - Disregarding parent/subsidiary distinction
    - The analysis is largely the same as traditional piercing.
      - The largest percentage of piercing in the context is due to one or more statutory violation.
      - Key Question: Whether the statutory scheme would be frustrated if the key shareholder escaped liability.
- Shareholder Loans
  - Is it a loan or capital investment?
  - If outside borrowing is available then a presumption of capital investment arises.

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- Parent/Holding Company
  - Similarly, if the shareholder subordinates the loan to smaller
  - Even if there is a bona fide shareholder loan, courts may order equitable subordination where:
    - The claimant has engaged in inequitable behavior,
    - Misconduct injures creditor or gives unfair advantage to claimant, and
    - Equitable subordination must be consistent with rules of Bankruptcy Act