ESSAY QUESTION NO. 4

Answer this question in booklet No. 4

Many years ago, Mr. and Mrs. Balto formed "Sled Dogs, Inc." an Alaska corporation, for the purpose of raising Alaska bred and trained sled dogs for sale. They chose to incorporate so that their personal assets would be shielded from any liability arising out of the operation of the business. They purchased an empty lot next to the family home and built a concrete kennel with fenced dog runs for 30 dogs. Title to the lot and the kennel was in the name of the corporation. The Baltos' daughter, Jill, helped raise and train the dogs as she grew up.

After Jill went off to college, the Baltos decided that it was too much work to keep the business running and they decided to shut it down. But Jill came home and asked her parents to let her take over the family business, using the dog lot and kennel. The Baltos agreed and appointed Jill as the corporation's President, replacing Mr. Balto. They offered Jill 70% ownership of the shares in the corporation but she declined saying she didn't need the legal headaches. Mr. and Mrs. Balto, as the sole shareholders and directors of the corporation, entered into a written agreement with Jill, whereby it was agreed that the net annual profits, if any, would be divided as follows: 70 % paid to Jill; 10% paid to Mr. and Mrs. Balto, and 20% retained by the corporation in earnings.

Jill consistently deposited the proceeds from dog sales into the corporate account, and paid only expenses related to Sled Dogs, Inc. out of the corporation's bank account. The corporation held its annual shareholder and director meetings every Fourth of July, following a family picnic. These meetings served to inform the Baltos about how the business had performed over the prior 12 months, and Jill's future plans for the corporation. Jill typed up the minutes from these meetings and retained them in a file.

Jill quickly established a demand for her dogs across the Northwest by setting up a website in the corporate name, and advertising in towns known for sled dog racing. Because of the success of her advertising, Sled Dogs, Inc. was able to sell dogs in advance of their births, based on their stated pedigrees. Jill prospered financially under her arrangement with her parents, and was growing accustomed to the healthy cash flow she was receiving from the business.

The Baltos were quite pleased with how Jill was doing with the business until they learned that they, the corporation, and Jill had been sued for fraudulent misrepresentation by Paul Peterson, a disgruntled purchaser of 8 puppies. Unbeknownst to the elder Baltos, the last 4 litters of pre-sold pups had died shortly after birth as a result of a lethal virus. Jill, unwilling to cause the corporation to refund the pre-paid monies, went to the local animal shelter and

acquired 25 puppies that appeared to have sled dog blood lines and using Sled Dogs, Inc.'s name, shipped them to the unsuspecting purchasers with the representation on Sled Dogs, Inc. stationary that they were the same puppies described in the purchase contracts previously entered into between the corporation and the purchasers. Paul Peterson received 8 of these pound puppies.

By the time the case was scheduled for trial, six more purchasers had joined the lawsuit as plaintiffs, making aggregate claims well in excess of Sled Dogs, Inc.'s corporate assets. The defendants named in the case are Sled Dogs, Inc., Jill, and Mr. and Mrs. Balto.

1. Discuss the legal theories under which Jill and/or the elder Baltos could be held liable to Paul and the other plaintiffs for the acts of the corporation.

2. Can Paul and the other plaintiffs obtain a judgment against Jill personally for her own individual liability, notwithstanding the existence of the corporation? Explain.

GRADER'S GUIDE

***** QUESTION NO. 4 *****

SUBJECT: BUSINESS LAW

Question 1: Discuss the legal theories under which Jill and/or the Baltos could be held liable to Paul and the other plaintiffs for the acts of the corporation. (75 Points)

The formation of a corporation generally shields its owners from personal liability for the acts of the Corporation. AS 10.06.438.

The corporate veil may be pierced 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, 1229-30 (Alaska 1983).

A. Analysis of the "Mere Instrumentality" test (60 Points)

In Uchitel, the court set forth a six-part test for determining whether a corporation was a "mere instrumentality" of the owner:

(a) Does the shareholder 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 Jill and her conduct in relation to Sled Dogs, Inc., there appears to be insufficient evidence to disregard the corporate form on the grounds of "mere instrumentality".

(a) This factor applies more to the Baltos than to Jill. Jill is not a shareholder in Sled Dogs, Inc. She declined stock ownership when it was offered to her by her parents. In McCormick c. City of Dillingham, 16 P3d 735, (Alaska 1990), 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 Jill was the "control person". The fact that she is not a shareholder will not end the inquiry. But other factors must demonstrate that the corporation is a mere instrumentality of Jill in order for the corporate veil to be pierced under this theory. The elder Baltos do own all of the stock of the corporation, so this factor would be clearly met as to them.

(b) This factor applies to the elder Baltos, who originally incorporated Sled Dogs, Inc., and subscribed to all of its capital stock. Jill had not subscribed to all of the capital stock of the corporation, and, while she is clearly responsible for corporation's current existence, she had not caused its incorporation.

(c) The facts do not suggest that Sled Dogs, Inc., is grossly undercapitalized. The corporation owns the real property and kennel as capital assets. It appears the business was generating a healthy cash flow and it has retained 20% of its earnings. There is no indication that the corporation was unable to pay its bills or purchase the supplies it needed to maintain its operations. Thus, it is unlikely that this factor would be considered met. The fact that the plaintiffs' aggregate claims exceed the corporation's assets is not itself an indication that that the corporation is grossly undercapitalized.

(d) There is no evidence that Jill or the elder Baltos used the property of the corporation as their own. In fact the evidence suggests the opposite. Jill paid only expenses related to Sled Dogs, Inc. out of the corporation's bank account.

(e) The factor of whether the executives or directors of the corporation acted independently in the interest of the corporation or simply took their orders from Jill in Jill's interest is more difficult to apply, given the fact that Jill was not an owner, but was an officer of the corporation. In McCormick, the court described this factor as "corporate independence" and noted that the control person 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 Jill is controlling the corporation, and that her parents, the sole shareholders and directors are merely passive participants in a portion of the net revenues each year. There is no evidence that anyone but Jill is controlling the conduct of the operations, or the corporation's future direction. It is likely a court would find this factor to be

met as to Jill. Conversely, there is no evidence that the elder Baltos have any control over the corporation, and this factor would not be met as to them.

(f) There is no evidence that the formal requirements of the corporation were not observed. The facts indicate that annual shareholder and director meetings were held and minutes recorded and kept. The agreement regarding the dividing up of annual net profits was in writing, and approved by the elder Baltos as owners and directors. It is likely a court would find that the formal legal requirements of the corporation were being observed by Jill and that this factor was not met.

While it is not necessary for all six factors to be satisfied before a finding of "mere instrumentality" can be made, there is an insufficient basis here to pierce the corporate veil to hold either Jill or the elder Baltos personally liable under this approach. The court in Murat v. F/V Shelikof Strait, 793 P.2d 69, 76-77 (Alaska 1990) considered the possibility that "mere instrumentality" could be found on the basis of only two factors, but ultimately determined there was inadequate factual basis for applying the theory in that case. Here, the only factor supporting the theory that the corporation is a "mere instrumentality" of Jill is that she has full control of the corporation's activities, where she is the sole employee. As to the elder Baltos, the only two applicable factors are that they are the incorporators and own all of the stock. But since they exercise no control over the corporation, these factors alone do not establish that the corporation is their "mere instrumentality." The plaintiffs would not succeed on this theory of liability against either Jill or her parents.

B. Analysis of the use of corporate form "to defeat public convenience, justify wrong, commit fraud, or defend crime" test. (15 Points)

The second approach used by Alaska courts to hold an owner or controlling party personally liable for corporate actions is where the corporate form is used to defeat public convenience, justify wrong, commit fraud or defend crime. Uchitel, 646 P.2d at 234 (citing Elliott v. Brown, 569 P.2d 1323, 1326 (Alaska 1977)). This basis for piercing the corporate veil exists regardless of whether there are sufficient factors demonstrating that the corporation is "mere instrumentality." Id.

While the Baltos originally selected the corporate form for doing business so that they could avoid liability, this alone would not be sufficient proof that they were trying to defeat public convenience since limitation of liability is a legitimate and recognized characteristic of a corporation. Paul and the other plaintiffs would argue that, by causing the corporation to commit an act of fraudulent misrepresentation, Jill used the corporate form to commit fraud. A court is unlikely to be persuaded to pierce the corporate veil under these circumstances. Jill's fraudulent act was committed for the benefit of the

corporation. There is no evidence that the corporate form itself was used to commit the fraud, justify wrong or defend crime.

Question 2: Can Paul and the other plaintiffs obtain a judgment against Jill personally for her own individual liability, notwithstanding the existence of the corporation? Explain. (25 Points)

The fact that Jill was acting in her capacity as president of the corporation does not shield her from personal liability for intentional torts she commits on behalf of the corporation. "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." Casciola v. F.S. Air Service, Inc., 120 P.3d 1059, 1063, n. 11 (Alaska 2005).

Jill's acts would appear to fall squarely within the intentional tort of fraudulent misrepresentation. Since she was acting for the corporation, Sled Dogs, Inc., may also be liable, but the corporate form does not shield Jill from her individual liability for the fraudulent misrepresentation.