ESSAY QUESTION NO. 9

Answer this question in booklet No. 9

Three years ago, Olivia Owner, an individual ("Owner"), and Parent Corporation, an Alaska corporation ("ParentCorp"), together properly formed Sprocket Supply, Inc. ("SSI") to supply sprockets to various widget manufacturers. ParentCorp and Owner each own 50% of SSI, and each provided 50% of the starting capital to form SSI. ParentCorp is a manufacturer of specialty widgets.

The Board of Directors of ParentCorp serves as the Board of Directors of SSI. Owner serves as SSI's Chief Executive Officer ("CEO"), for which she collects a salary from SSI equal to that of other sprocket companies' CEOs. In order to reduce administrative expenses, SSI entered into an agreement with ParentCorp in which ParentCorp provides space for SSI's corporate offices in an otherwise unused portion of ParentCorp's office building, ParentCorp's Controller acts as SSI's Treasurer, and ParentCorp provides SSI with accounting and payroll services, computers, and other routine office equipment and services. In return, SSI pays ParentCorp $100 per month. SSI's Treasurer keeps books for SSI separate from ParentCorp's and properly observes the formal corporate legal requirements for SSI. He utilizes SSI letterhead for invoices and correspondence related to SSI's business. SSI now operates at a profit, and neither ParentCorp nor Owner provides SSI with any additional money for its operations. SSI's principal asset is its inventory, because it rents almost everything else except for raw materials from ParentCorp.

In addition, the SSI Board of Directors passed a unanimous resolution at the time of SSI's formation that SSI would provide ParentCorp with ParentCorp's total requirements of sprockets without charge, and that these sprockets would be provided to ParentCorp before fulfilling other sprocket orders. SSI sells all of the remaining sprockets in its inventory to companies that are unrelated to ParentCorp or Owner.

Two years ago, SSI breached a contract to deliver sprockets to Alaska Widget Makers, Inc. ("AWMI"). AWMI sustained $1 million of losses as a result. SSI had sufficient sprockets on hand to fulfill the order at the time it was received. Before it was delivered, however, SSI received ParentCorp's monthly order for sprockets. Pursuant to its policy, SSI first provided the sprockets to service ParentCorp's requirements. After fulfilling ParentCorp's order, insufficient sprockets remained to fulfill AWMI's contract.

AWMI sued SSI, Owner, and ParentCorp. The Court determined that SSI breached the contract, and that the amount of damages to be compensated is $1 million. Depleted of inventory, SSI has only $100,000 in assets. AWMI contends that Owner and ParentCorp should pay the remaining $900,000.

1. How would the court likely rule as to whether Olivia Owner and/or ParentCorp are liable for AWMI's damages as a result of their ownership of SSI? Fully explain your answer.

GRADER'S GUIDE

***** QUESTION NO. 9 *****

SUBJECT: BUSINESS LAW

General law regarding shareholder liability (20 points).
Under Alaska law, corporations typically shield their shareholders from liability for the acts of the corporation. AS 10.06.438(a). Thus, Owner and ParentCorp would generally not be personally liable for any part of the $1 million in damages. SSI would owe the $1 million in its entirety, and Owner and ParentCorp would be liable only to the extent of their share of equity in the corporation. However, under some circumstances the corporate owner may be liable: for instance, when the corporation was formed to defeat the public convenience, justify wrong, commit fraud, or defend crime. There are no facts in the pattern to suggest that SSI was formed to defeat the public convenience, justify wrong, or defend crime. Some argument could be made that SSI was formed to commit a fraud – in particular, through SSI, ParentCorp has potentially created a tool that would allow it to obtain proprietary or trade-secret information from some of its competitors, and could effectively upset those competitors' supply chains. Nonetheless, the fact pattern does not provide evidence that would be sufficient to prove or disprove this possibility, and it is therefore unlikely to be the basis of a court's decision on the matter.

Piercing the corporate veil (30 points).
The corporate veil may also be pierced, however, when the corporation is the "mere instrumentality" of an individual or parent corporation. *Uchitel Co. v. Telephone Co.*, 646 P.2d 229, 235 (Alaska 1982) (individual); *Jackson v. General Elec. Co.*, 514 P.2d 1170, 1173 (Alaska 1973) (corporation); *See Casciola v. F.S. Air Service, Inc.*, 120 P.3d 1059, 1069 n.12 (Alaska 2005) (citing both cases with approval and quoting and applying the *Uchitel Co.* test).

The court follows a quantitative approach when determining whether the corporation is a mere instrumentality. As to corporate parents, courts will look to 11 factors:

1) Whether the parent owns all or most of the capital stock of the corporation;
2) Whether the parent and the corporation have common officers or directors;
3) Whether the parent finances the corporation;
4) Whether the parent subscribes to all of the capital stock or otherwise caused its incorporation;
5) Whether the corporation has grossly inadequate capital;

6) Whether the parent pays the salaries and other expenses or losses of the corporation;

7) Whether the corporation has substantially no business except with the parent, or no assets except those conveyed to it by the parent;

8) Whether the corporation is described as a department or division of the parent in the parent's papers or its officers' statements;

9) Whether the parent uses the property of the corporation as its own;

10) Whether the directors and executives of the corporation do not act independently in the interest of the corporation, but instead take their orders from the parent in its interest; and

11) Whether the formal legal requirements of the corporation are observed.

Jackson, 514 P.2d at 1173. As to individual parents, like Olivia Owner, courts will look only to factors 1, 4, 5, 9, 10, and 11. *Uchitel Co.*, 646 P.2d at 235. The court need not limit itself to these factors, however – the factors "should be considered," but may not be exclusive. *See Nerox Power Systems, Inc. v. M-B Contracting Co., Inc.*, 54 P.3d 791, 804 n.44 (Alaska 2002).

ParentCorp's liability (30 points).

As to ParentCorp, only factor 2 clearly cuts in favor of piercing the veil. ParentCorp and SSI have common directors. Factors 1, 3, and 4 arguably cut in either direction. ParentCorp does not own all or most of the stock, but it owns precisely 50%. It did not completely finance SSI, but it provided half of its initial financing. Assuming that the value of the office space, payroll services, and other administrative services ParentCorp provide to SSI are worth substantially more than the $100 SSI pays for such services, the court would likely hold that ParentCorp also finances SSI's operating activities, which would contribute to a determination that the corporate veil should be pierced.

ParentCorp did not cause SSI's incorporation by itself, but it was 50% responsible for doing so. Nonetheless, a court is not likely to strongly consider these factors as being in favor of veil piercing, as they do not clearly cut one way or the other. The facts do not reveal how much of SSI's business is with ParentCorp, so factor 7 cannot be shown to cut in favor of veil piercing. An argument might be made that any company with only $100,000 in assets and no inventory remaining after servicing its contracts must be grossly undercapitalized, but there is no evidence to suggest that it was undercapitalized at formation, or, indeed, that $100,000 of capitalization is unusual or inadequate in the industry. Thus, factor 5 likely would not be the basis of a veil piercing determination. The fact pattern explicitly states that ParentCorp does not describe SSI as a department or division, and that the formal legal requirements are met. Thus, factors 8 and 11 cut against a finding of piercing the corporate veil. SSI pays Owner's salary, and there is no

evidence to suggest that ParentCorp pays the salaries of any of SSI's other employees. Thus, factor 6 does not cut in favor of piercing the veil.

It is not necessary that all of the factors be found in order to pierce the veil. *Jackson*, 514 P.2d at 1173. Instead, "a parent corporation that does not permit its subsidiary to exercise an individual status may not expect that the subsidiary's independence will be recognized elsewhere." *Id.* Thus, special attention may be given to factors 9 and 10. SSI's only significant asset is its inventory – it rents everything else directly from ParentCorp. ParentCorp is permitted to take, without any additional payment, its entire requirements of sprockets from SSI's inventory. Moreover, it is permitted to take these sprockets even if SSI already has pending orders to which the sprockets have been identified. Thus, ParentCorp is apparently able to utilize SSI's inventory as if it was ParentCorp's own supply cabinet. Moreover, ParentCorp is permitted to do this because SSI's Board of Directors, which is the same as ParentCorp's Board of Directors, instituted a policy that ParentCorp's needs would be put before those of any other SSI customer. These two pieces of evidence strongly suggest that ParentCorp is permitted to use SSI's property as its own, and that SSI's Board does not act in SSI's interest, but, rather, in ParentCorp's interest. On the basis of these facts, the court could conclude that ParentCorp should be liable for some portion of the $1 million judgment because SSI is a mere instrumentality of ParentCorp.

Owner's liability (20 points).

As they did with ParentCorp, factors 1 and 4 do not appear to cut in favor of or against piercing the veil with regard to Owner. There is no evidence of factor 5, and the facts clearly state that factor 11 does not apply. Thus, again, the question comes down to a consideration of factors 9 and 10. Unlike ParentCorp, however, Owner does not have access to SSI's chief asset, its sprocket inventory, and there is no evidence to suggest that SSI behaves to its detriment and to Owner's benefit. Owner's salary is reasonable in the marketplace. Thus, the corporate veil should not be pierced as to Owner.