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Corporate Law: Disregarding the Corporate Entity

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CORPORATE LAW: DISREGARDING THE CORPORATE ENTITY

INTRODUCTION

Chief Justice Marshall defined a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law . . . possess[ing] only those properties which the charter of its creation confers upon it . . . ."[1] Under modern law, corporate formation is governed by the state. Once formed, a corporation is a legal entity, distinct and separate from those who created it.[2] The most prominent feature of the corporation is that it limits the liability of both the shareholders who comprise it and the directors, officers, and corporate personnel who operate within its parameters.[3] A parent corporation's liability can also be limited with respect to the wrongs of its subsidiary.[4] Limited liability in a corporation is often referred to as "the corporate veil."[5] The corporate veil doctrine, however, is not unqualified.

This survey explores two specific exceptions to the corporate limited liability principle. Part I provides a background of the classic common law doctrine of piercing the corporate veil, which allows the shareholders of a corporation to be held personally liable for the acts of the corporation. This part analyzes the Tenth Circuit's latest interpretation of the common law doctrine in a case in which the plaintiff attempted to hold a parent company liable for its subsidiary's actions. Part II examines a "statutory pierce" under the Internal Revenue Code section 6672, looking at two cases exemplifying the recent position of the Tenth Circuit.

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1. Trustees of Dartmouth College v. Woodard, 17 U.S. 518, 636 (1819).

2. BLACK'S LAW DICTIONARY 340 (6th ed. 1990).

3. HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, 130 (3d ed. 1983); *see* Marilyn Blumberg Cane & Robert Burnett, *Piercing the Corporate Veil in Florida: Defining Improper Conduct*, 21 NOVA L. REV. 663, 665 (1997). All fifty states have adopted the principle of limited liability as a fundamental rule of corporate law. Peter French, *Parent Corporation Liability: an Evaluation of the Corporate Veil Piercing Doctrine and its Application to the Toxic Tort Arena*, 5 TUL. ENVTL. L.J. 605, 610 (1992). This rule has been articulated in the Revised Model Business Corporation Act, providing that:

> (a) A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued or specified in the subscription agreement.
>
> (b) Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.

MODEL BUS. CORP. ACT § 6.22 (1991). With respect to shareholder liability, the corporate veil protects both natural persons and artificial entities, such as corporations or similar business associations, that hold stock in the corporation. French, *supra* at 610.

4. *See* Yoder v. Honeywell Inc., 104 F.3d 1215 (10th Cir. 1997) (determining that a consumer of a subsidiary's product could not pierce corporate veil of parent company).

5. Carsten Alting, *Piercing the Corporate Veil in American and German Law—Liabilities of Individuals and Entities: A Comparative View*, 2 TULSA J. COMP. & INT'L L. 187, 190 (1995).

I. THE COMMON LAW DOCTRINE

A. *Background*

The doctrine of "piercing the corporate veil" provides an exception to the principle of limited liability.[6] Courts will pierce the corporate veil when a corporation is used in the furtherance of crime, to facilitate fraud, to justify a wrong, or to defeat public convenience.[7] Additionally, courts may pierce the veil when a corporation has not functioned independently from the wrongdoer.[8] Once the corporate veil is pierced, the corporation is no longer viewed as a legal entity.[9] Instead, the corporation is viewed as an association of persons, exposing the personal assets of the stockholders, corporate directors, and personnel connected with the wrongful activity to claims by creditors seeking compensation for the wrongs committed by the corporation.[10] Thus, when the corporate veil is pierced, only the individuals who are responsible for the acts justifying the pierce are exposed to liability while passive shareholders incur no liability.[11] In the absence of a pierce, the liability of corporate shareholders is generally limited to their respective investment in the capitalization of the company.[12]

DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.[13] represents a classic corporate veil-piercing case.[14] The Fourth Circuit regarded corporate veil piercing as an equitable doctrine, placing the burden of

6. French, *supra* note 3, at 606.

7. Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, From Sure Bet to Long Shot: Gallinger v. North Star Hospital Mutual Assurance, Ltd.*, 22 J. CORP. L. 131, 136 (1996) (quoting United States v. Milwaukee Refrigerator Transit Co., 142 F. 247 (E.D. Wis. 1905)); *see also* Lowell Staats Mining Co., Inc. v. Pioneer Uravan, Inc., 878 F.2d 1259, 1264-65 (10th Cir. 1989) (stating that the plaintiff has the burden of proving that the corporate veil "was used to defeat public convenience, or to justify or protect wrong, fraud or crime").

8. *See* American Fuel Corp. v. Utah Energy Dev. Co., Inc., 122 F.3d 130, 134 (2d Cir. 1997) (setting forth criteria for determining whether a president dominated his company, thus allowing the corporate veil to be pierced); Birbara v. Locke, 99 F.3d 1233, 1238 (1st Cir. 1996) (stating that the veil may be pierced when the wrongdoer either exercises pervasive control over the company to its detriment or when the companies are so intermingled that they are ambiguous).

9. Klein, *supra* note 7, at 136.

10. French, *supra* note 3, at 606.

11. J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 5.2, at 43 (1994) (noting that only those who caused the piercing lose the protection provided by the corporate form).

12. HENN & ALEXANDER, *supra* note 3, at 130. There are, however, unlimited or double liability corporations which exist in a limited number of jurisdictions. *Id.*

13. 540 F.2d 681 (4th Cir. 1976).

14. French, *supra* note 3, at 612. In *DeWitt*, the creditor brought action seeking to hold the corporation's president personally liable. *DeWitt*, 540 F.2d at 683. The Fourth Circuit determined that the shareholders were separate from the corporation in which they held shares and determined the president was personally liable. *Id.* The court noted that ruling otherwise would create an extension of the corporate form, beyond its legitimate purpose, or would produce an unjust or inequitable result. *Id.*

loss on the most responsible party, despite a lack of intent to defraud.[15] Many states have adopted this doctrine, though courts have not all applied it as liberally as the Fourth Circuit in *DeWitt*.[16] Many modern courts utilize a two-part inquiry to consider when determining whether to pierce the corporate veil and subject the corporate insiders to personal liability.[17] First, the courts address whether the unity of interest and ownership are strong enough to make the corporate identity indiscernible from that of the individual.[18] Second, the court considers whether an inequity would result if the bad acts are treated as those of the corporation alone.[19]

The Tenth Circuit has acknowledged that the corporate veil exists for the purpose of insulating businesses from liability and therefore has been reluctant and cautious in its application of the veil piercing doctrine.[20] In

15. *DeWitt*, 540 F.2d at 683. The court enumerated eight factors to consider in determining whether equity would be served by piercing the corporate veil. These factors include

> whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking, failure to observe corporate formalities, non-payment of dividends, debtor corporation insolvency at the time, dominant shareholder siphoning of corporate funds, non-functioning of other officers or directors, absence of corporate records, and the fact that the corporation is merely a facade for the operations of the dominant shareholder or shareholders.

DeWitt, 540 F.2d at 686-87 (citations omitted); *see also* French, *supra* note 3, at 613.

16. French, *supra* note 3, at 614. This variation in application is not surprising, however, because states have developed widely divergent methods and rationales for piercing the corporate veil. Note, *Piercing the Corporate Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 HARV. L. REV. 853, 855 (1982).

17. Sung Bae Kim, *A Comparison of the Doctrines of Piercing the Corporate Veil in the United States*, 3 TULSA J. COMP. & INT'L L. 73, 75 (1995); *see* Oklahoma Oil and Gas Exploration Drilling Program v. W.M.A. Corp., 877 P.2d 605, 609 (Okla. Ct. App 1994); Salt Lake City Corp. v. James Constr., Inc., 761 P.2d 42, 46-47 (Utah Ct. App. 1988). There does exist a federal common law doctrine pertaining to piercing the corporate veil. NLRB v. Greater Kansas City Roofing, 2 F.3d 1047, 1052 (10th Cir. 1993). This test requires two distinct inquiries:

> (i) Was there such unity of interest and lack of respect given to the separate identity of the corporation by its shareholders that the personalities and assets of the corporation and the individual are indistinct, and (ii) would adherence to the corporate fiction sanction a fraud, promote injustice, or lead to an evasion of legal obligations.

City Roofing, 2 F.3d at 1052. The "internal affairs doctrine" allows federal common law to be applied when the state has little interest in the case and there are federal interests involved. Kim, *supra* at 77-78.

18. Kim, *supra* note 17, at 75.

19. *Id.* Some states have not required a showing of inequity resulting from a failure to pierce the veil, but have necessitated a demonstration of injustice which would result from such a failure. *See* Jackson Hole Traders, Inc. v. Joseph, 931 P.2d 244, 251 (Wyo. 1997). Some courts have established a third prong to this test which necessitates a showing that an injustice would result from a failure to pierce the corporate veil. Kim, *supra* note 17, at 75; *see* Doughty v. CSX Transp., Inc., 905 P.2d 106, 111 (Kan. 1995); *see also* French, *supra* note 3, at 611 (citing Saphir v. Nuestadt, 413 A.2d 843, 853 (Conn. Super. 1979)). Many jurisdictions have, however, considered this third factor to be superfluous, finding that it is encompassed within the second prong. Kim, *supra* note 17, at 75.

20. Boughton v. Cotter Corp., 65 F.3d 823, 836 (10th Cir. 1995); *see also* Cascade Energy and Metals Corp. v. Banks, 896 F.2d 1557, 1576 (10th Cir. 1990); Skidmore v. Canada Life, 907 F.2d 1026 (10th Cir. 1990). State courts within the Tenth Circuit have also been "reluctant and cautious" when piercing the corporate veil. *See* Sampson v. Hunt, 665 P.2d 743, 751 (Kan. 1983); Kvassay v. Murray, 808 P.2d 896, 906 (Kan. Ct. App. 1991); Salt Lake City Corp. v. James Constr., Inc. 761 P.2d 42, 46 (Utah Ct. App. 1988); Colman v. Colman, 743 P.2d 782, 786 (Utah Ct. App. 1987).

Yoder v. Honeywell,[21] the court established that the corporate veil could be pierced when recognition of the corporation as a separate legal entity would be unfair.[22] Hence, the court found that equity would permit a court to disregard the corporate form when the shareholders used the corporation as a mere instrumentality to conduct their own personal affairs, without regard to the corporation's independent existence, or for the purpose of evading or defeating legislative policy, or to perpetrate fraud.[23]

The veil of a parent corporation may also be pierced in a parent/subsidiary relationship, holding the officers of the parent corporation personally liable for the actions of its subsidiary.[24] The Tenth Circuit established that when determining whether a subsidiary acted as a mere instrumentality of its parent, warranting a pierce requires a review of many factors.[25] The court must consider the amount of subsidiary stock owned by the parent company, the amount of the subsidiary's expenses and salaries paid by the parent company, and the amount, if any, of shared business and assets.[26] In addition, the court must determine if the companies have common officers and directors in order to assess whether the subsidiary's officers and directors acted independently, or whether the subsidiary's officers took direction from the parent corporation.[27] The court also considers how adequately the subsidiary has been capitalized.[28] The court must also examine the parent company's designation and classification of the subsidiary in its financial statements.[29] Finally, the court must investigate whether each company meets the formal requirements of incorporation.[30] By weighing each of these factors,

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21. 104 F.3d 1215 (10th Cir. 1997).

22. *Yoder*, 104 F.3d at 1220; *see* Micciche v. Billings, 727 P.2d 367, 372-73 (Colo. 1986); AMFAC Mechanical Supply Co. v. Federer, 645 P.2d 73, 81 (Wyo. 1982).

23. *Yoder*, 104 F.3d at 1220; *see Micciche*, 727 P.2d at 373; *see also* Reader v. Dertina and Assoc. Mktg., Inc., 693 P.2d 398, 399 (Colo. Ct. App. 1984) (noting that a court may pierce "where the corporate entity has been used to defeat public convenience, or to justify or to protect, wrong, fraud, or crime or in other similar situations where equity requires"); *Kvassay*, 808 P.2d at 906 (stating a corporate entity may be disregarded if it is used to cover fraud or to work injustice, or if necessary to achieve equity); Rogers v. Rahill, 827 P.2d 896, 897 (Okla. Ct. App. 1991) (stating that Oklahoma law allows the piercing of the corporate veil if the corporate entity is used "(1) to defeat public convenience, (2) justify wrong, (3) to perpetrate fraud whether actual or implied, or (4) to defend crime."); Bergh v. Mills, 763 P.2d 214, 218 (Wyo. 1988) (stating that a showing of fraud may be sufficient in itself to warrant a piercing of the corporate veil).

24. Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940); *see* Scott v. AZL Resources, Inc., 753 P.2d 897, 900 (N.M. 1988) (determining that mere control by a parent corporation is insufficient to pierce the corporate veil, and instead requiring that the plaintiff demonstrate moral culpability attributable to the parent, such as use of the subsidiary to commit fraud).

25. *Fish*, 114 F.2d at 191.

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.* The court must examine whether the subsidiary was referred to as a subsidiary or as a department of the parent corporation. *Id.*

30. *Id.*

the court can assess whether the subsidiary acted as a mere instrumentality of the parent company, enabling the court to assign liability to a parent for the actions of its subsidiary. The Tenth Circuit considered just such a case during the survey period.[31]

B. Yoder v. Honeywell Inc.[32]

1. Facts

In *Yoder*, the plaintiff, an employee, claimed she incurred stress injuries from the consistent use of a defectively designed keyboard while at her place of employment. The plaintiff sought compensation for her injuries and subsequent suffering.[33] Rather than suing the manufacturer of the keyboard, Bull HN Information Systems Inc. (Bull), the plaintiff sought to pierce the corporate veil and hold Honeywell, Inc. (Honeywell), Bull's parent, liable.[34] The plaintiff contended that Bull was not a corporation separate from Honeywell, but rather that it was a mere instrumentality of Honeywell.[35] The district court granted Honeywell summary judgment and dismissed the claim, relying on the fact that the keyboards were not made by Honeywell, but rather, by Bull, a wholly-owned subsidiary of Honeywell.[36]

2. Decision

The Tenth Circuit first made the determination that Colorado law shall govern.[37] The court recognized that the purpose of incorporation includes the isolation of liabilities among separate entities.[38] When it would be unfair to recognize the subsidiary as a separate entity because of a significant improper use of the corporate structure, however, the parent company should be held liable for its subsidiaries' wrongs.[39] In order to demonstrate this "unfairness," the plaintiff must demonstrate that the parent company disregarded the independence of its subsidiary and that the subsidiary acted as a mere instrumentality for the transaction

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31. The survey period extended from September 1, 1996 through August 31, 1997.

32. 104 F.3d 1215, 1218 (10th Cir. 1997).

33. *Yoder* 104 F.3d at 1218.

34. *Id.* at 1220. Bull HN Information Systems Inc. is a subsidiary of Honeywell that was formerly known as Honeywell Information Systems Inc. *Id.* at 1218.

35. *Id.* at 1218.

36. *Id.* at 1219.

37. *Id.* at 1220. The court concluded that Colorado law applied even though the case originated in New York and the company was incorporated in Delaware. *Id.* at 1219-20. In accordance with New York law, once it is determined that there is an actual conflict in substantive law, then the "interest analysis" test is applied to determine jurisdiction of a case. *Id.* (citing Schultz v. Boy Scouts of Am., Inc., 480 N.E.2d 679, 684 (N.Y. 1985)). The interest analysis test requires the court to first decide which state has the greatest interest in the litigation, then apply the substantive law of that state. *Id.* at 1220.

38. *Id.*

39. *Id.*

of the shareholders' own affairs.[40] In addition, the plaintiff must show that the subsidiary acted to perpetrate wrongful behavior or to evade important legislative policy.[41]

In considering all the relevant factors, the court determined that Bull acted as an independent subsidiary, rather than as an instrumentality of Honeywell.[42] The court found that Honeywell owned all of Bull's stock, and the two corporations shared some of the same directors.[43] In addition, Honeywell provided financial support to its subsidiary and facilitated the process to incorporate Bull.[44]

Although these two entities were closely linked, the court found that Bull was not grossly undercapitalized, nor did Honeywell pay salaries or other expenses for Bull.[45] Honeywell constituted only five percent of Bull's business.[46] Additionally, the court also determined that Honeywell did not refer to Bull as a department or division in its financial statements, nor did Honeywell direct Bull's executives or directors.[47] Moreover, Honeywell consistently observed the legal formalities in the maintenance of the separate identities of these two corporations.[48] Therefore, the Tenth Circuit recognized Honeywell and Bull as separate corporate entities and affirmed the trial court's dismissal of the plaintiff's products liability action.[49]

C. *Other Circuits*

Within the survey period, other circuits set forth the rationale for piercing the corporate veil. In *National Soffit & Escutcheons Inc. v. Su-*

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40. *Id.*

41. *Id.*

42. *Id.* at 1221. This test sets forth an elementary basis for determining whether the subsidiary is an instrumentality of the parent. These elements include whether:

> (1) The parent corporation owns all or a majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, "the subsidiary" is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Id. at 1215 (quoting Lowell Staats Mining Co. v. Pioneer Uravan, Inc., 878 F.2d 1259, 1262-63 (10th Cir. 1989)).

43. *Id.*

44. *Id.* at 1221-22.

45. *Id.* at 1222.

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 1225.

perior Systems, Inc., the Seventh Circuit reiterated the general doctrine of piercing the corporate veil.[50] The court asserted that a plaintiff must demonstrate (1) that the corporate form was "ignored, controlled or manipulated, and that it was merely the instrumentality of another, and (2) that the misuse of the corporate form would constitute a fraud or promote injustice."[51] Further, the court established eight factors to consider when determining whether to employ its equitable power to pierce the corporate veil, with respect to parent/subsidiary relationships.[52] These factors include (1) the undercapitalization of the subsidiary; (2) the absence of corporate records; (3) the fraudulent representation by the corporation's shareholders or directors; (4) the use of the corporation to promote fraud, injustice, or illegal activities; (5) the payment by the corporation of individual obligations; (6) the commingling of assets or affairs; (7) the failure to observe required formalities; and (8) the other shareholder acts or conduct.[53]

The Second and Ninth Circuits both embraced a veil-piercing test similar to that established in *Escutcheons*.[54] These courts require evidence of complete domination over the subservient corporation, coupled with a showing that this domination was used to perpetrate a fraud or wrong.[55] In *Chan v. Society Expeditions, Inc.*, the Ninth Circuit asserted that the corporate form could be disregarded if the corporate entity was so dominated that its alter ego, the dominating individual or parent, was actually conducting its own business, and not that of the corporation.[56] The court determined that the common ownership of three corporations by the parent company alone, was not enough to justify ignoring the corporate shield.[57]

In *American Fuel Corp. v. Utah Energy Development Co.*,[58] the Second Circuit considered whether a president exercised such domina-

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50. 98 F.3d 262, 265 (7th Cir. 1996).

51. *Escutcheons*, 98 F.3d at 265.

52. *Id.*

53. *Id.*

54. Chan v. Society Expeditions, Inc., 123 F.3d 1287, 1294 (9th Cir. 1997); American Fuel Corp., v. Utah Energy Dev. Co., Inc., 122 F.3d 130, 134 (2nd Cir. 1997); Bridgestone/Firestone, Inc. v. Recovery Credit Servs., Inc., 98 F.3d 13, 17 (2nd Cir. 1996).

55. *Chan*, 123 F.3d at 1294; *American Fuel*, 122 F.3d. at 130; *Bridgestone*, 98 F.3d at 17.

56. *Chan*, 123 F.3d at 1294.

57. *Id.*

58. 122 F.3d 130 (2nd Cir. 1997). The court identified a list of factors to identify a dominated corporation:

> (1) Whether corporate formalities are observed, (2) whether the capitalization is adequate, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) whether there is overlap in ownership, officers, directors, and personnel, (5) whether the corporate entities share common office space, address and telephone number, (6) the amount of business discretion displayed by the allegedly dominated corporation, (7) whether the alleged dominator deals with the dominated corporation at arms length, (8) whether the corporation is treated as an independent profit center, (9) whether others pay or guarantee debts of the dominated corporation, and (10)

tion over his corporation that a veil pierce is warranted.[59] The company had no contracts, no office space for employees, no capital of its own, nor did it have an individual address or bank account.[60] Additionally, the president contributed his own capital to the company.[61] The court noted, however, that the other corporate officer had the same amount of authority over the company.[62] In addition, there was no indication that the president commingled the corporate funds with his personal funds, or that there was any need for an independent source of funds.[63] Upon consideration of these factors, the court determined that the company was an entity separate from its president.[64]

In *Birbara v. Locke*,[65] the First Circuit embraced the two-part test from the 1968 Massachusetts Supreme Court case *My Bread Baking Co. v. Cumberland Farms, Inc.*[66] *My Bread* established two circumstances which warrant a departure from the general principle of corporate separateness.[67] The court determined that when a representative of one corporation actively and directly participates in the activities of another corporation, exercising pervasive control to the detriment of one of the companies involved, the corporation will not be regarded as a separate entity.[68] Or, in the alternative, when the separateness of two companies is substantially disregarded in the intermingling of activities between the two entities, or when serious ambiguity arises regarding the manner and capacity in which the corporations and their representatives are acting, the court will set aside the principle of separateness.[69] The *My Bread* test is more restrictive in its means of disregarding the corporate veil than those means offered in other jurisdictions.

D. *Analysis*

The *Yoder* court adhered to the common law veil-piercing inquiry, emphasizing that the veil could be pierced if it would be unfair to recognize the subsidiary as separate from its parent corporation.[70] Both the Tenth and the Second Circuits have recognized a ten part test used to

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whether the corporation in question had property that was used by the alleged dominator as if it were the dominator's own.

American Fuel, 122 F.3d at 134.

59. *Id.* at 134.
60. *Id.* at 134-35.
61. *Id.* at 135.
62. *Id.*
63. *Id.*
64. *Id.*
65. 99 F.3d 1233 (1st Cir. 1996).
66. *Birbara*, 99 F.3d at 1238 (citing My Bread Baking Co. v. Cumberland Farms, Inc., 233 N.E.2d 748, 751-52 (Mass. 1968)).
67. *Id.* (citing *My Bread*, 233 N.E.2d 748, 752).
68. *Id.* (citing *My Bread*, 233 N.E.2d 748, 751-52).
69. *Id.* (citing *My Bread*, 233 N.E.2d 748, 751-52).
70. Yoder v. Honeywell, Inc., 104 F.3d 1215, 1220 (10th Cir. 1997).

determine whether a subsidiary is an instrumentality of its parent, which would establish a unity of interest between the two and legitimize a court's decision to pierce the veil.[71] These tests differ in several ways. Unlike the Second Circuit test,[72] the *Yoder* test emphasized the parent company's ownership of stock in its subsidiary, the designation of the subsidiary as a department within the parent company's corporate papers, and whether the parent company represents the majority of its subsidiary's business.[73] Unlike *Yoder*,[74] the Second Circuit's test evaluated the amount of assets and office space shared by the parent and subsidiary companies and the extent to which the subsidiary acted as an independent profit center.[75]

The First Circuit's adoption of the *My Bread* veil-piercing test departed from the two-pronged veil-piercing test derived from common law and exemplified in *Yoder*.[76] Rather than looking at whether there was a unity of interest among a corporation and an individual or subsidiary, as the common law doctrine dictates, the *My Bread* test requires one of two showings.[77] There must be a showing that the corporation had either been pervasively controlled to its detriment, or, in the alternative, that a lack of separateness or a demonstrated intermingling of activities created an ambiguous relationship between the company and the individual or subsidiary.[78] The Second Circuit's *My Bread* test does not consider whether there would be an injustice resulting from a failure to pierce the veil.[79] The Sixth Circuit was much more stringent in its requirements, necessitating not only proof that the company was only an instrumentality of the individual or subsidiary, but also that it was used wrongfully, resulting in injustice.[80]

II. OFFICER LIABILITY UNDER SECTION 6672

A. *Background*

During the survey period, the Tenth Circuit also examined the veil-piercing doctrine with respect to corporate officers in their capacity as

71. American Fuel Corp. v. Utah Energy Dev. Co., 122 F.3d 130, 134 (2d Cir. 1997); *Yoder*, 104 F.3d at 1221.

72. *American*, 122 F.3d at 134.

73. *Yoder*, 104 F.3d at 1221.

74. *Id.*

75. *American Fuel*, 122 F.3d at 134.

76. *Compare* Birbara v. Locke, 99 F.3d 1233, 1238 (1st Cir. 1996), *with Yoder*, 104 F.3d at 1220.

77. *Birbara*, 99 F.3d at 1238 (citing My Bread Baking Co. v. Cumberland Farms, Inc., 233 N.E.2d 748, 751-52 (Mass. 1968)).

78. *Id.* (citing *My Bread*, 233 N.E.2d at 752).

79. *Id.* (citing *My Bread*, 233 N.E.2d at 752).

80. RCS Engineered Prods. Co., Inc., v. Himmelspach, 102 F.3d 223, 226 (6th Cir. 1996).

employers.[81] An officer can be charged with the duties of collecting, truthfully accounting for and paying over to the government taxes withheld from the company's employees. This officer is considered a "responsible person" for the carrying out of these duties.[82] When a responsible person willfully fails to pay these tax withholdings to the government, Internal Revenue Code § 6672 imposes, among other penalties, full liability upon the individual for the unpaid tax.[83] The Tenth Circuit analyzed this requirement, determining that "willfulness" is demonstrated when a corporate officer recklessly disregards the risk that withheld taxes would not be paid to the government.[84]

B. *Tenth Circuit Decisions*

1. *Finley v. United States*

a. *Facts*

Finley, secretary-treasurer and board member of the Halsey-Tevis, Inc. (Halsey), informed Halsey's president that the company had withheld social security and income taxes from its employees, but failed to pay them for the last half of 1988.[85] The president instructed Finley to make these payments; however, the president took no other action and did not make further inquiries into the matter, despite the fact that he had the ability to issue checks on the company's behalf.[86]

In a subsequent tangle of financial problems, Halsey's bank account was frozen.[87] As a result, Halsey was unable to make these payments to the government.[88] Halsey did, however, provide the bank with $105,000

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81. *See* Finley v. United States, 123 F.3d 1342 (10th Cir. 1997); Goldston v. United States, 104 F.3d 1198 (10th Cir. 1997); Denbo v. United States, 988 F.2d 1029 (10th Cir. 1993).

82. I.R.C. § 6672(a) (1994 & Supp. 1997); *see Finley*, 123 F.3d at 1348 (stating that a "responsible person" is personally liable for failure to pay witholding taxes); *Goldston* 104 F.3d at 1200; *Denbo*, 988 F.2d at 1032.

83. I.R.C. § 6672(a) (1994 & Supp. 1997). This statute provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Id.; *see* Slodov v. United States, 436 U.S. 238, 248 (1978) (stating that persons responsible for collecting income tax and failing to remit it will be subjected to personal liability).

84. *Finley*, 123 F.3d at 1343.

85. *Id.*

86. *Id.* at 1344.

87 *Id.*

88. *Id.*

in collections and requested that it be applied toward the debt.[89] The bank refused and, instead, applied it to Halsey's loan indebtedness.[90]

The IRS assessed a $144,876 penalty against Halsey's president personally for not taking further action and failing to pay the taxes under section 6672.[91] The IRS argued that Halsey's president, as a corporate officer, should be held personally liable for his company's failure to pay withheld taxes and social security when he knew of the failure and had sufficient authority to correct it.[92] The district court found in favor of the government in a post-trial motion for judgment, finding that "a reasonable jury could not have found that [the company president] met his burden of proof."[93]

b. *Decision*

The Tenth Circuit stated that federal statutory law holds a corporate officer or employee personally liable for the entire amount of the withheld taxes if he or she willfully failed to remit them to the government.[94] The statute holds an officer liable even if the officer did not have a motive or specific intent to defraud the government.[95] The court asserted that it may find that a corporate officer acted willfully when he or she proceeded with a "reckless disregard of a known or obvious risk that trust funds may not be remitted to the government."[96] Accordingly, the court considered the president's failure to investigate or correct the mismanagement of funds as a demonstration of willful conduct.[97] The court noted that a jury could determine whether a responsible person willfully failed to pay the government, considering the totality of the circumstances.[98]

The court proceeded to apply an exception to the general rule that a presumption of liability results from a finding of willful conduct.[99] The court stated that the exception would be applied if the court found that the officer had reasonable cause to withhold payment to the government.[100] The court concluded that to successfully invoke this ex-

89 *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at 1345.
93. *Id.* at 1344.
94. *Id.* (citing I.R.C. § 6672(a) (1994 & Supp. 1997)).
95. *Id.*
96. *Id.* at 1345 (quoting Denbo v. United States, 988 F.2d 1029, 1033 (10th Cir. 1993)).
97. *Id.*
98. *Id.* at 1348.
99. *Id.*
100. *Id.* The "reasonable cause" exception has been narrowly construed in order to "(1) further the basic purpose of § 6672 to protect government revenue, (2) discourage corporations from self-executing government loans using the tax monies they hold in trust, and (3) avoid making the government 'an unwilling partner in a floundering business.'" *Id.* (citing Collins v. United States, 848 F.2d 740, 741-42 (6th Cir. 1988)); *see* Thibodeau v. United States, 828 F.2d 1499, 1506 (11th Cir. 1987); Newsome v. United States, 431 F.2d 742, 747 (5th Cir. 1970)).

ception, one would have to demonstrate that "(1) the taxpayer has made reasonable efforts to protect the trust funds, but (2) those efforts have been frustrated by circumstances outside the taxpayers control."[101] The Tenth Circuit remanded *Finley* to the trial court to determine whether Johnson met these criteria, a finding that would allow the company president to escape liability.[102]

2. *Goldston v. United States*[103]

a. *Facts*

Goldston, the sole shareholder of Sunnylane Electronic, Inc. (Sunnylane), collected more than $27,000 in FICA federal income taxes from his employees, but failed to remit this money to the IRS.[104] Sunnylane reported the withholdings to the IRS.[105] The IRS assessed a penalty against Goldston under section 6672, although the assessment was later determined to be void.[106] Goldston filed for Chapter 11 bankruptcy relief and the case was dismissed.[107] As a result, the IRS filed a notice of a federal tax lien with the state register of deeds.[108] Then Goldston filed for Chapter 13 protection from liability in which the IRS filed a secured claim.[109] This claim of tax liability, however, was based on the prior assessment.[110] The district court affirmed the bankruptcy court's granting of the government's motion for summary judgment, holding that the statute obligates the taxpayer to pay the withheld taxes to the government.[111]

b. *Decision*

Because Goldston collected taxes and failed to remit them to the government, the circuit court identified him as a "responsible person" and imposed personal liability under section 6672 for the withheld funds.[112] The court determined that Goldston's failure to pay taxes was actionable as a breach of his statutory duty imposed by section 7501,[113] which requires the employer to collect taxes from employees and remit them to the government.[114] As a result, the IRS was entitled to collect the

101. *Finley*, 123 F.3d at 1348.
102. *Id.* at 1350.
103. Goldston v. United States, 104 F.3d 1198, 1200 (10th Cir. 1997).
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. 26 U.S.C. § 7501 (1994). The general rule stated in this statute says that:

tax despite the IRS's assessment of the liability.[115] Hence, liability attached to the corporate "responsible person" when he or she withheld the collected taxes regardless of prior assessments.[116]

C. *Other Circuits*

During the survey period, the Seventh Circuit recognized the need to demonstrate that an officer "willfully" failed to remit taxes and determined that the requirement was satisfied by the showing of a reckless disregard of a known risk that the taxes might not be paid.[117] In *Mazzeo v. United States*,[118] the Second Circuit interpreted "willfully" to include those nonpayments of withheld funds to the government that were "voluntary, conscious, and intentional, as opposed to accidental."[119] Thus, the Second Circuit failed to include "recklessness" in its interpretation of "willfulness."[120]

Similarly to the Seventh Circuit, the Ninth Circuit, in *Phillips v. United States Internal Revenue Service*,[121] specifically asserted that a showing of a reckless disregard may be sufficient to meet the "willful" requirement necessary to hold an officer liable for failing to remit taxes.[122] Accordingly, the court defined willfulness as a "voluntary, conscious and intentional act to prefer other creditors over the United States."[123] In addition, the court did not require a showing that the corporate officer acted with a "bad motive" in order to meet the definition of willfulness.[124]

In *Bugge v. United States*,[125] the Fifth Circuit determined that the IRS could hold each person deemed a "responsible person" accountable for all of the corporation's delinquency.[126] The Second Circuit held that the definition of a "responsible person" was to include any person "connected closely enough with the business to prevent the [tax] default from

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> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such funds arose.

26 U.S.C. § 7501.

115. *Goldston*, 104 F.3d at 1201.

116. *Id.*

117. United States v. Kim, 111 F.3d 1351, 1357 (7th Cir. 1997).

118. 131 F.3d 295 (2d Cir. 1997).

119. *Mazzeo*, 131 F.3d at 299 (quoting Kalb v. United States, 505 F.2d 506, 511 (2d Cir. 1974)).

120. *Id.*

121. 73 F.3d 939 (9th Cir. 1996).

122. *Phillips*, 73 F.3d at 942.

123. *Id.*

124. *Id.*

125. 99 F.3d 740 (5th Cir. 1996).

126. *Bugge*, 99 F.3d at 744.

occurring."[127] In *Phillips*, the Ninth Circuit determined that although the corporate executive was hospitalized, he was held personally liable because he either clearly ought to have known that the withheld taxes were not being paid, or that there was a risk that the money was not paid to the government, when he had an opportunity to investigate whether they had been paid.[128]

D. *Analysis*

Finley[129] and *Goldston*[130] represent cases in which the Tenth Circuit pierced the corporate veil pursuant to a statutory rule, as opposed to the application of the common law doctrine. Following the rule set forth by section 6672, the *Finley* court held that a corporate officer could be held personally liable when he or she willfully fails to investigate or correct mismanagement after learning of tax withholding delinquencies.[131] The Seventh Circuit determined that a reckless disregard of a risk that the withheld taxed might not be paid was sufficient to meet the statutory requirement of "willfulness."[132] The Second Circuit was more conservative in its interpretation of "willful," holding that proof of a reckless disregard of a known risk that the withheld taxes may not be remitted was insufficient to expose the officers to liability.[133]

The *Goldston* court applied the strict statutory rule thrusting personal liability upon those who are responsible for collecting taxes and fail to remit them, regardless of prior assessment liability.[134] Both the Second and Ninth Circuits further defined what constitutes a "responsible person."[135] These circuits defined responsibility by examining the extent of the individual's relationship to his or her business.[136] Responsible persons could, according to the Fifth Circuit, each be responsible for the entire amount of the corporation's tax delinquency.[137]

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127. Mazzeo v. United States, 131 F.3d 295, 298 (2d Cir. 1997) (quoting Fiataruolo v. United States, 8 F.3d 930, 939 (2d Cir. 1993) (internal quotation marks omitted)).

128. *Phillips*, 73 F.3d at 940-44.

129. Finley v. United States, 123 F.3d 1342 (10th Cir. 1997).

130. Goldston v. United States, 104 F.3d 1198 (10th Cir. 1997).

131. *Finley*, 123 F.3d at 1343.

132. United States v. Kim, 111 F.3d 1351, 1358 (7th Cir. 1997).

133. Mazzeo v. United States, 131 F.3d 295, 299 (2d Cir. 1997).

134. *Goldston*, 104 F.3d at 1201.

135. *Mazzeo*, 131 F.3d at 298; *Phillips*, 73 F.3d at 941.

136. *Mazzeo*, 131 F.3d at 298 (stating that responsible individuals include all those who are connected closely enough with the company to prevent the tax default from occurring); *Phillips*, 73 F.3d at 941 (concluding that the defendants admission of his "responsible person" status was warranted due to the fact that he owned the company, was in charge of the bank accounts, and decided which bills would be paid).

137. Bugge v. United States, 99 F.3d 740, 744 (5th Cir. 1996).

CONCLUSION

In the past year, the Tenth Circuit has further explored the parameters of the principle of corporate limited liability by examining circumstances that warrant its disregard. The court failed to pierce the corporate veil when a parent company was sued for a tort allegedly committed by its subsidiary. While some circuits differed from the Tenth Circuit's corporate veil-piercing analysis, the Tenth Circuit was consistent with the prevailing common law interpretation of the doctrine. The Tenth Circuit has broadly interpreted the "willful" requirement of section 6672, extending it to situations in which the officer recklessly disregarded a risk that the tax withholdings would not be remitted to the government.

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