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Attorney's Exposure to Personal Liability for Active Participation in the Formation of a Corporation

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upon the findings of a trial judge, they will be reversed only if they are not based on substantial evidence.

Of all the factors which the trial court considers to determine whether there has been a substantial change, the test which has evolved is whether, in spite of all the changes, the property is still suitable for the purpose for which the original restrictions were imposed.

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CORPORATIONS: ATTORNEY'S EXPOSURE TO PERSONAL LIABILITY FOR ACTIVE PARTICIPATION IN THE FORMATION OF A CORPORATION.

In *Minton v. Caveney*, a recent decision rendered by the Supreme Court of California,[1] a wide extension of the alter ego doctrine exposed an attorney to personal liability in a tort action which had originally been filed against a corporation

The Seminole Hot Springs Corporation was incorporated in March, 1954 for the purpose of conducting a public swimming pool business. The corporation leased a swimming pool and opened for business. In June, 1954 the plaintiff's daughter drowned in the pool. In a wrongful death action against the corporation, the plaintiff was awarded a $10,000 judgment. The judgment went unsatisfied however, so plaintiff originated the present action to have the court declare the defendant, Caveney, an attorney who was a director and the secretary-treasurer of the corporation, personally responsible for the judgment obtained against the corporation. Caveney died during the proceedings and his estate was substituted as the party defendant.

After the drowning, the corporation applied to the Commissioner of Corporations for permission to issue three shares of stock, but permission was refused until additional requested information was furnished. This information was never supplied. Consequently a permit was never issued. It was brought out at the trial that Caveney was to have received one of these initial shares of stock, the remainder going to the other two incorporators and directors.

Before his death Caveney related that the corporation did not have any assets; that the corporation was organized but never functioned as a corporation; that he had served in his official capacities as officer and director more as an accomodation to his client (the corporation's president) than for any other reason; and that he was serving in these capacities with the understanding that he would not be an active director.

The trial court found the defendant liable for the sum of $10,000.

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[1] 56 Adv. Cal. 597, 15 Cal.Rptr. 641 (1961).

In upholding the trial court's decision in principle, which had been reversed by the District Court of Appeals,[2] the Supreme Court's opinion reiterated three factors which traditionally have indicated an abuse of the corporate privilege: (a) When the equitable owners treat the corporation's assets as their own; (b) When they hold themselves out as being personally liable for the debts of the corporation; (c) When they provide inadequate capitalization and actively participate in the conduct of the corporate affairs.[3] These considerations are among those frequently cited by the California courts to establish a unity of ownership and interest and to show that an inequitable result will follow if the corporate entity is not disregarded, the two basic requirements for the application of the alter ego doctrine in California.[4]

The Court made no effort to apply (a) or (b) above. But since there was clear and undisputed evidence of inadequate capitalization and evidence which was considered strong enough to support an "inference of active participation," [5] the Court indicated that disregard of the corporate entity would be justified. However, the court reversed the trial court on the different ground that the issue of Caveney's negligence, as opposed to the negligence of the corporation, had not yet been tried on the merits. The previous finding of liability against the corporation could not be considered res judicata with respect to the individuals behind the corporation.

Since the corporation did not own its swimming pool, since it apparently was not protected with adequate liability coverage, and since the corporation had no "assets" by Caveney's own admission, there can be little doubt that the corporation was undercapitalized. However, as pointed out in the case of *Automotriz Del Golfo De California S. A. De C. V. v. Resnick,* inadequate capitalization is not a conclusive test in determining whether to disregard the corporate entity.[6] Other facts are also considered to support the ultimate determination. Here the Court relied on active participation in the affairs of the corporation as a further gauge. The whole opinion appears to hinge on this element, based on the following evidence only:

> The evidence is also undisputed that Caveney was not only the secretary and treasurer of the corporation but was also a director. The evidence that Caveney was to receive one-third of the shares to be issued supports an inference that he was an equitable owner, and the evidence that for a time the records of the

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[2] Minton v. Kraft, 190 A.C.A. 311 (vac.), 12 Cal.Rptr. 86 (1961).

[3] Minton v. Caveney, *supra* note 1, 15 Cal.Rptr. at 643.

[4] Minfie v. Rowley, 187 Cal. 481, 202 Pac. 673 (1921); Watson v. Commonwealth Ins. Co., 8 Cal.2d 61, 63 P.2d 295 (1936); Automotriz Del Golfo De California S. A. De C. V. v. Resnick, 47 Cal.2d 792, 306 P.2d 1 (1957).

[5] Minton v. Caveney, *supra* note 3.

[6] See note 4 *supra.*

[7] Minton v. Caveney, *supra* note 3.

> corporation were kept in Caveney's office supports an inference that he actively participated in the conduct of the business.[7]

A brief, strong dissent questioned the wisdom of the majority opinion in regarding the ordinary professional services of an attorney as active participation in the affairs of a corporation:

> I dissent from any implication that *mere professional activity by an attorney at law, as such,* in the organization of a corporation, can constitute any basis for a finding that the corporation is the attorney's alter ego or that he is otherwise personally liable for its debts, whether based on contract or tort. That in such circumstances an attorney does not incur any personal liability for debts of the corporation remains true whether or not the attorney's professional services include the issuance to him of a qualifying share of stock, the attendance at and participation in an organization meeting or meetings, the holding and exercise for such preliminary purposes in the course of his professional services, of an office or offices, whether secretary or treasurer or presiding officer or any combination of offices in the corporation.[8]

The dissenting opinion further pointed out that a corporation should not be deemed to be carrying on business as a corporation until at least qualifying shares have been issued. Any acts and services performed in organizing the corporation prior to this time could not be considered the acts and services of a corporate being.[9]

The objection of the dissent is to the "implication" that an attorney's normal professional activities in the preliminary stages of a corporation's existence are equated with actual participation in the conduct of the corporation's business. This would effectively expose the attorney to personal liability in the event that the corporate entity is disregarded. The fear expressed seems genuine since the language in the majority opinion is quite explicit:

> It is immaterial whether or not he (Caveney) accepted the office of director as an "accommodation" with the understanding that he would not exercise any of the duties of a director. A person may not in this manner divorce the responsibilities of a director from the statutory duties and powers of that office.[10]

This is extremely strong language. With no further explanatory or qualifying remarks, this case would seem to indicate that the attorney's normal procedures in the organization of proposed corporations will make him an active participant in the business affairs of such corporations during the preliminary stages of their existence. It is now common practice for the attorney to draft the by-laws, record the minutes of the first meeting of the directors, open the corporations's bank account, and so forth. It is not at all unusual for the corporation's attorney to maintain

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[8] *Id.*, 15 Cal.Rptr. at 645.

[9] *Ibid.*

[10] *Id.*, 15 Cal. Rptr. at 644.

all important documents relating to the incorporation in his own office during this preliminary stage.

In view of the possible consequences which logically can be anticipated, the majority opinion ought to be carefully examined to determine whether the broad language used by the Court was justified by the facts of the case and the authorities on which the Court relied.

The opinion cites several cases and treatises to support the acknowledged rule that the corporate entity will be disregarded where there is inadequate capitalization and active participation by the shareholder in the corporation's affairs.[11] These authorities all support one phase of the general proposition or the other, but it is significant to note that none of them extends the application of this rule to a situation involving an attorney participating in the initial procedures of organizing a corporation.

Furthermore, in most of the cited cases in which the corporate form was ignored, the facts clearly indicated that the individual or individuals behind the corporation were positively abusing the privilege of corporate protection.[12] This was not evident in the *Minton* case.

It is not seriously questioned that obvious abuse of a privilege afforded by the state should be regarded as a forfeiture of that right by the individual or individuals who utilize the corporate form as a shield against personal liability. But it is questionable whether such an abuse was present in the instant situation, and *a fortiori*, whether a general rule applicable to any attorney who engages in the initial steps of a corporation's organization can be rightfully derived from such a case.

The Court does not concern itself with a full factual review of Caveney's position vis-a-vis the corporation. Yet their conclusion seems to rely on inferences of fact, *e.g.*, the inference that Caveney actively participated in the corporation's business because he kept the records of the corporation "for a time" in his office. Furthermore, the majority did not find that Caveney exercised any control over the business of the corporation, that he controlled the board of directors, that he commingled his funds with the corporation's funds, that he ever hired or fired em-

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[11] Automotriz v. Resnick, *supra* note 4; Riddle v. Leuschner, 51 Cal.2d 574, 335 P.2d 107 (1959); Stark v. Coker, 20 Cal.2d 839, 129 P.2d 390 (1942); Shafford v. Otto Sales Co., Inc., 149 Cal.App.2d 428, 308 P.2d 428 (1957); Carlesimo v. Schwebel, 87 Cal. App.2d 482, 197 P.2d 167 (1948); BALLANTINE, CORPORATIONS 302-303 (rev. ed. 1946); LATTIN, CORPORATIONS, 68-72; Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373.

[12] These cases involve factual situations which indicate compounded abuse of the corporate privilege. Typical of these situations is the dominant personality who manages and controls the company and treats its assets as his own (Riddle, *supra* note 11); undercapitalization and control of most of the stock (Stark, *supra* note 11); and public reliance on the individual doing business rather than on the corporation, combined with other factors (Shafford v. Otto Sales Co., *supra* note 11 and Automotriz v. Resnick, *supra* note 4).

ployees of the corporation, or that he represented himself as the individual engaged in the particular business.

If Caveney was merely pursuing his activities as an attorney when he organized the corporation, when he agreed to serve as an "inactive director," and when he agreed to maintain the documents relating to the incorporation in his office "for a time," then the decision seems to be a broad extension of the alter ego doctrine. If the Court is truly insistent, as its language would indicate, that an attorney cannot "in this manner divorce the responsibilities from the statutory duties of a director," [13] the practitioner may have to adjust his ordinary professional practices accordingly.

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[13] Minton v. Caveney, *supra* note 3, 15 Cal. Rptr. at 644.