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CORPORATIONS: LIABILITY OF ACCOMMODATION DIRECTORS: *MUELLER v. J.I.M. CONSTRUCTION CO.* (CAL. 1964)

The decision in the case of *Meuller v. The J.I.M. Construction Co.*,[1] now pending before the District Court of Appeal, Division One, should be of great interest to members of the California Bar. The question involved concerns the liability of an attorney and his two office secretaries as accommodation directors of a corporation formed for a client. During the process of incorporation, in order to expedite the filing of the Articles of Incorporation, the attorney and the two secretaries became directors of record. Shortly after the articles were filed, the three directors resigned. Several months thereafter the corporation became indebted to a lumber company for goods sold and delivered at the request of the Construction Company. Because there were no funds to satisfy a judgment against the Construction Company, suit was instituted against the defendants as partners doing business under a corporate name.

The plaintiffs, assignees of the Lumber Company, alleged that the corporate entity should be disregarded and that defendants should be held liable on the authority of *Minton v. Caveney*.[2] Upon submission of the pleadings the defendants moved for summary judgment. The motion was granted, and the plaintiffs have appealed.

The case has possibilities of significantly affecting the fashion in which many California lawyers attend to the business of forming corporations for their clients. A widespread custom provides that lawyers and their employees, for the purpose of expediting matters, may become the first directors or incorporators of a new corporation, as in this case. Later, as here, when the formalities are attended to, they resign their directorships and turn the business over to those who requested the incorporation originally. Should liability eventually attach on the facts of this case, a great many members of the California bar may have cause for concern as to their status as incorporators of small companies that eventually flounder.

The case of *Minton v. Caveney*,[3] upon which the appellant

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[1] Mueller v. J.I.M. Construction Co., Civil Number 152349, Superior Court, Santa Clara County (Mar. 15, 1964).

[2] 56 Cal. 2d 576, 15 Cal. Rptr. 641, 364 P.2d 473 (1961). See Note, 2 SANTA CLARA LAW. 90 (1962).

[3] *Id.*

principally relies, involved a situation that differs in many respects from the *Mueller* case. In *Minton*, the defendant, a lawyer, helped to incorporate the Seminole Hot Springs Corporation. The only property owned by the Company at the time of incorporation was a leasehold interest in a swimming pool which it intended to operate for profit. The plaintiff's daughter drowned in the pool, and eventually the plaintiff recovered a judgment against the corporation for $10,000. The judgment was returned unsatisfied. The plaintiffs then sued Caveney, the lawyer, on the theory that he was an incorporator and director, and that this was a case in which the corporate entity should be disregarded. The facts showed however, that Caveney was an equitable owner of one third of the outstanding shares and that, in addition, he had "actively participated in the conduct of the business."[4] The Supreme Court refused to hold Caveney liable at this time as he had not been a party to the litigation that adjudged the Seminole Hot Springs Corporation liable to the plaintiff. The majority opinion in *Minton* holds,

> It is immaterial whether or not he 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.[5]

The dissent states,

> 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. . . .[6]

These two unfortunate statements have given rise to the suggestion that the attorney and his secretaries in the *Mueller* case should be held liable, If so, then the result will be an extension of the theory of disregard of the corporate entity to hold liable one who is neither a stockholder nor a manager.

The separate corporate entity received strong recognition in the latter part of the last century in the English case of *Broderip v.Salomon*.[7] In that case the owner of an established business incorporated and assumed the position of a large secured creditor. When the company became insolvent the owner-manager held a preferred position as to the other creditors. When he was sought to be held

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[4] *Id.* at 580, 15 Cal. Rptr. at 643, 364 P.2d at 474.

[5] *Id.*

[6] *Id.* at 582. See LATTIN, CORPORATIONS, 243 (1959), for discussion of the courts' frequent lenient treatment of so-called inactive directors.

[7] L.R. (1895) 2 Ch. 323, 1897 A.C. 22.

personally liable on the corporation's debts, the House of Lords took the position that the corporation was distinct from its shareholders. In other words, the debts of the corporation were not the debts of the one who owned it.

The courts have not followed the strict position taken in this case. California courts have not hesitated to disregard the corporate entity when the facts seemed to demand it. In the numerous cases that have pierced the corporate veil in California, two requirements have evolved: 1) There must be a unity of ownership and management; 2) an inequitable result will occur if the entity is not disregarded.[8] This rule has been most recently applied in the case of *Auer v. Frank*,[9] wherein it was stated, ". . . both these elements must be found to exist before the corporate existence will be disregarded."[10]

In determining whether or not to ignore the corporate entity, a number of factors are ordinarily considered. Among these may be inadequate capitalization, the treatment by an individual of the assets of the corporation as his own, the holding out by an individual that he is himself liable for the debts of the corporation, the confusion of individual and corporate records, and many other indications of a lack of separateness between the individual and the corporation.[11] A noted writer maintains that the expression "disregard of the corporate entity" is loose phraseology. He claims that the problems in this area are problems in determining the limitations "upon the exercise of the legal privilege of separate capacity in view of its proper ends and functions."[12]

When proper incorporation procedures have been followed, the entity is created. The problem for the courts is to indicate exactly how far they will allow this privilege to be exercised. When the use of the entity becomes abuse, it will be disregarded, and the owners will be held liable. This is because the owners are the ones given the privilege of limiting their liability to the extent of corporate assets.

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[8] Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 833, 26 Cal. Rptr. 806, 812 (1962). This case very thoroughly explores the doctrine of disregard of the corporate entity and its use in California, and contains references therein to almost every case of significance on the subject in this state.

[9] 227 A.C.A. 422, 38 Cal. Rptr. 684 (1964). This case was decided in the same court that is hearing the appeal in the *Mueller* case.

[10] *Id.* at 433.

[11] Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 835, 837, 23 Cal. Rptr. 806, 807, (1962). This case contains references to authority for each proposition cited in this paragraph. See footnote 8, *supra.*

[12] BALLENTINE, PRIVATE CORPORATIONS 26 (1927).

In the *Mueller* case there is essentially a policy decision facing the courts. If the entity is disregarded and the former directors held, new law will be made regarding the liability of directors of corporations. The policy to justify such a role would place a strong emphasis upon the form of the transaction. The reasoning would suggest that those who deal with a corporation do so in reliance upon the names of the directors of record. Authority for such a decision would presumably be predicated on the authority of the *Minton* case.

If on the other hand the attorney and his two secretaries are not held liable, the result will be in accord with the established weight of authority in California and elsewhere.[13] No case has been found where a non-owner has been held liable to the creditors of a corporation on any legal theory that disregards the corporate entity. The requirement of ownership of shares is undoubtedly not necessary in every case;[14] it would seem, however, that there must be more of an attempt to avoid the specific requirement of ownership, in the nature of a sham, before unity of ownership and management is eliminated as a prerequisite to disregarding the entity. It is also probably desirable to disregard the entity and hold liable only those who are evading responsibilities the law would otherwise have imposed upon them. On the facts of the *Mueller* case there seems to be little reason for holding the defendants liable, particularly when they were only performing the ministerial functions incident to forming the corporation. The summary judgment should be affirmed.

C. Duane Carlsmith

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[13] In an examination of some 85 California cases involving the issue of disregard of the corporate entity, in none of these was there even a suggestion that the entity be disregarded so as to hold a director who is not an owner liable. Additionally, the text writers do not seem to have discussed the possibility. See for instance, BALLENTINE, PRIVATE CORPORATIONS 26 (1927), LATTIN, CORPORATIONS 64 (1959), FLETCHER, CYC. CORP. § 25 (Rev. vol. 1963). It should be noted that one defendant in a California case was relieved from liability on the basis that he owned none of the stock. *Riddle v. Leuschner*, 51 Cal. 2d 574, 334 P.2d 107 (1959).

[14] For instance, in *Start v. Coker*, 20 Cal. 2d 839, 129 P.2d 390 (1942) one defendant was held liable when the corporate entity was disregarded on the basis of ownership of one share out of 150 outstanding shares. In this case however, the defendant was the wife of the owner of substantially all the rest of the stock, and the facts indicated that both the husband and the wife devoted substantially all their efforts in the management of the operation.