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Corporate Law

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Corporate Law

I. COURT EXAMINES FUNDAMENTAL UNFAIRNESS REQUIREMENT FOR PIERCING CORPORATE VEIL

In *Multimedia Publishing of South Carolina, Inc. v. Mullins*¹ the South Carolina Supreme Court interpreted part of the fundamental unfairness analysis for piercing the corporate veil.² The South Carolina Court of Appeals developed this two-pronged test for piercing the corporate veil in *Sturkie v. Sifty*.³ The second prong is a two-part analysis that considers whether injustice will result if the court does not hold the shareholder personally liable for claims against the corporation.⁴

The first part of the fundamental unfairness prong asks whether the shareholder was aware of the claim against the corporation.⁵ The second part asks if the shareholder acted self-servingly and in disregard of that claim.⁶ In *Multimedia* the court held that a shareholder becomes aware of a claim when the shareholder “has notice of facts which, if pursued with due diligence, would lead to knowledge of the claim.”⁷

Multimedia sought to enforce a judgment against Food Stores by piercing the corporate veil and holding J.R. Mullins, the owner and majority shareholder, personally liable.⁸ Mullins held all of the company’s offices except vice-president⁹ and was the majority shareholder of seventeen other corpora-

1. ___ S.C. ___, 431 S.E.2d 569 (1993).

2. *See id.* at ___, 431 S.E.2d at 571. The test for piercing the corporate veil involves two prongs: “The first prong is an eight factor analysis of the shareholder’s relationship to the corporation. The second prong requires that a plaintiff prove the ‘fundamental unfairness’ of recognizing the corporate veil” *Id.* at ___, 431 S.E.2d at 571.

3. 280 S.C. 453, 313 S.E.2d 316 (Ct. App. 1984). The court developed the South Carolina test for piercing the corporate veil from *DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976) and *Federal Deposit Insurance Corp. v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983). *See Sturkie*, 280 S.C. at 457-59, 313 S.E.2d at 318-19.

4. *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319.

5. *Id.*

6. *Id.*

7. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 572.

8. *Id.* at ___, 431 S.E.2d at 571.

9. *Id.* at ___, 431 S.E.2d at 571; *Multimedia Publishing of S.C., Inc. v. Mullins*, No. 92-UP-079, slip op. at 82 (S.C. Ct. App. Apr. 15, 1992) (per curiam), *aff’d*, ___ S.C. ___, 431 S.E.2d 569 (1993).

tions.¹⁰ He incorporated Food Stores with one thousand dollars.¹¹ Mullins transferred assets from his other corporations to Food Stores.¹² Furthermore, Mullins directed the vice-president of Food Stores to advertise through Multimedia.¹³

The court rejected the argument that awareness of a claim requires proof of actual knowledge: “[W]hen a person has notice of facts as are sufficient to put him on inquiry, and those facts, if pursued with due diligence, would lead to knowledge of other facts, he must be presumed to have knowledge of the undisclosed facts.”¹⁴

The court reasoned that because fundamental unfairness does not require fraud, the knowledge required to find fundamental unfairness must be less than that required to find fraud.¹⁵ Fraud requires knowledge of falsity or a reckless disregard for the truth.¹⁶ A requirement of actual knowledge to find fundamental unfairness would require a higher standard of knowledge than that required to find fraud.¹⁷

The court also rejected the defenses that Mullins asserted. Mullins argued that he did not have knowledge because he left the corporation’s daily control to others.¹⁸ However, a person’s “own negligence and dereliction of duty” is not a defense.¹⁹ Additionally, Mullins argued that his knowledge as a director could not be imputed to him as an individual.²⁰ But, the law presumes that knowledge acquired by a director is the knowledge of that person as an individual.²¹

10. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 571.

11. *Id.* at ___, 431 S.E.2d at 571.

12. *Id.* at ___, 431 S.E.2d at 571.

13. *Id.* at ___, 431 S.E.2d at 571.

14. *Id.* at ___, 431 S.E.2d at 572 (citing *Norris v. Greenville S. & A. Ry.*, 111 S.C. 322, 330, 97 S.E. 848, 850 (1919)). Mullins cited *Daniels v. Berry*, 148 S.C. 446, 146 S.E. 420 (1929), for the proposition that “aware” requires actual knowledge. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 571. However, *Daniels* interpreted a penal statute, whereas being aware for piercing the corporate veil is not limited by statutory construction. See *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 571-72. Statutory interpretation requires strict construction of a word using its plain, everyday meaning. *Daniels*, 148 S.C. at 461-62, 146 S.E. at 425.

15. See *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 572.

16. *Id.* at ___, 431 S.E.2d at 572 (citing *First State Sav. & Loan v. Phelps*, 299 S.C. 441, 446, 385 S.E.2d 821, 824 (1989)).

17. *Id.* at ___, 431 S.E.2d at 572.

18. *Id.* at ___, 431 S.E.2d at 572.

19. *Id.* at ___, 431 S.E.2d at 572.

20. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 572.

21. *Id.* at ___, 431 S.E.2d at 572 (citing *McCarty v. Kepreta*, 139 N.W. 992, 1000 (N.D. 1913)).

In addition to showing unfairness, a litigant must also show an improper relationship between the defendant and the corporation. *Sturkie* provides a list of factors to consider in making this determination:

(1) whether the corporation was grossly undercapitalized; (2) failure to observe corporate formalities; (3) nonpayment of dividends; (4) insolvency of the debtor corporation at the time; (5) siphoning of funds of the corporation by the dominant stockholder; (6) nonfunctioning of other officers or directors; (7) absence of corporate records; and, (8) the fact the corporation was merely a façade for the operations of the dominant stockholder.²²

The existence of several factors does not compel piercing. However, the presence of a sufficient number of factors suggests that the corporation did not observe formalities.²³ Once a court finds failure to observe formalities, it will inquire whether fundamental unfairness will result unless the corporate veil is pierced.

In determining observation of formalities, a court also looks at the corporation's capitalization. A court may find undercapitalization when an unsuccessful corporation exhausts its initial capital.²⁴ "[T]he obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter."²⁵ When a corporation is "in financial trouble almost from its inception,"²⁶ the shareholders undercapitalized the corporation. Furthermore, a court may find undercapitalization when a corporation initially has substantial assets but becomes insolvent later.²⁷ Additionally, the *DeWitt* court concluded that the inability to pay dividends is "persuasive proof" of undercapitalization.²⁸

Also, a corporation fails to observe formalities when it does not hold meetings, execute minutes, or adopt resolutions before taking corporate

22. *C.T. Lowndes & Co. v. Suburban Gas & Appliance Co.*, 307 S.C. 394, 396-97, 415 S.E.2d 404, 405 (Ct. App. 1991), *cert. denied*, ___ S.C. ___, ___ S.E.2d ___ (1992).

23. *See DeWitt Truck Brokers*, 540 F.2d at 687; *Cumberland Wood Prods., Inc. v. Bennett*, 308 S.C. 268, 271-72, 417 S.E.2d 617, 619 (Ct. App. 1992); *Sturkie*, 280 S.C. at 458, 313 S.E.2d at 318.

24. *See DeWitt*, 540 F.2d at 688.

25. *Id.* at 686 (citing James R. Gillespie, *The Thin Corporate Line: Loss of Limited Liability Protection*, 45 N.D. L. REV. 363 (1969)).

26. *Sturkie*, 280 S.C. at 455-57, 313 S.E.2d at 317-18.

27. *See Sea Pines Co.*, 692 F.2d at 974-76. In *Sea Pines*, the Fourth Circuit Court of Appeals agreed with the district court's finding that the corporation was undercapitalized when the corporation had \$2.5 million in property and assets, \$1,000 in capital stock, and \$64,000 in retained earnings but became insolvent within one year. *Id.*

28. *DeWitt*, 540 F.2d at 688.

action.²⁹ Without minutes of the shareholders' or directors' meetings, no evidence exists that the corporation held meetings.³⁰ The corporation should adopt resolutions authorizing payments and salaries for shareholders.³¹ Moreover, corporate formalities do not permit the sale of a corporation and the distribution of substantially all of its assets without a resolution proposed by the directors and approved by the shareholders.³²

The South Carolina Business Corporation Act outlines the corporate formalities required by South Carolina.³³ Following these requirements should satisfy the first part of the piercing test.

Corporations organized under the Statutory Close Corporation Supplement³⁴ have fewer formalities to observe. Moreover, "[t]he failure of a statutory close corporation to observe the usual corporate formalities or requirements relating to the exercise of its corporate powers or management of its business and affairs is not a ground for imposing personal liability on the shareholders for liabilities of the corporation."³⁵ Thus, a statutory close corporation follows formalities when it abides by the requirements of the Statutory Close Corporation Supplement.

Courts look also for failure to declare dividends in relationship to the personal benefits shareholders receive from the corporation.³⁶ Shareholders should not withdraw money arbitrarily from the corporation when the corporation cannot pay dividends.³⁷ Nor should shareholders randomly repay themselves loans when money is available.³⁸ The South Carolina Court of Appeals questioned even a shareholder's receiving a salary based on his personal expenses while the corporation paid no dividends.³⁹ The corpora-

29. *See id.* at 687-88.

30. *See id.* The requirements for shareholders' meetings are found in the South Carolina Business Corporation Act. *See* S.C. CODE ANN. §§ 33-7-101 to -107 (Law. Co-op. 1990). Requirements for directors' meetings are found in §§ 33-8-200 to -250. *See id.* §§ 33-8-200 to -250.

31. *See* S.C. CODE ANN. § 33-6-400 (Law. Co-op. 1990); *DeWitt*, 540 F.2d at 688 (finding failure to observe formalities when, among other things, the majority shareholder annually withdrew substantial funds from the corporation without the authority of corporate resolutions); *cf. Cumberland*, 308 S.C. at 270, 417 S.E.2d at 618-19 (finding failure to observe corporate formalities when the majority shareholder's salary was paid without authorization by resolution and based upon his household expenses).

32. S.C. CODE ANN. § 33-12-102 (Law. Co-op. 1990); *see also C.T. Lowndes*, 307 S.C. at 396, 415 S.E.2d at 405.

33. S.C. CODE ANN. §§ 33-1-101 to -20-105 (Law. Co-op. 1990 & Supp. 1993).

34. *Id.* §§ 33-18-101 to -500 (Law. Co-op. 1990).

35. *Id.* § 33-18-250.

36. *DeWitt*, 540 F.2d at 687.

37. *See id.* at 688.

38. *See Sturkie*, 280 S.C. at 455-56, 313 S.E.2d at 317.

39. *See Cumberland*, 308 S.C. at 270-71, 417 S.E.2d at 618.

tion's insolvency when a party brings a piercing action relates to whether the court should hold the shareholder liable for the corporation's debts. Often courts look at insolvency in relationship to the corporation's capitalization⁴⁰ and the majority shareholder's personal use of corporate funds.⁴¹ Additionally, under the South Carolina Business Corporation Act, a corporation cannot distribute corporate assets to shareholders if the distributions would render the corporation insolvent.⁴²

Whether dominant shareholders siphon corporate funds relates to the corporation's solvency. If the corporation is insolvent, a court may consider as siphoning the repayment of shareholders' loans made when the corporation was having financial difficulty.⁴³ The court may also find siphoning when a shareholder receives a salary while the corporation operates at a loss.⁴⁴ A court finds siphoning of corporate funds when the corporation sells its assets and distributes the proceeds for the majority shareholder's personal benefit without paying the corporation's debts.⁴⁵

The nonfunctioning of the other officers or directors relates to the use of the corporation for protection of a majority shareholder's personal business interests. A court finds nonfunctioning of other officers and directors when the sole shareholder is the only functioning director and officer. Also, a court may find nonfunctioning when the majority shareholder's spouse owns the rest of the stock and holds the remaining offices⁴⁶ or when the sole shareholder operates the corporation only with the help of obedient children.⁴⁷ Also, a court may find nonfunctioning of officers and directors of a subsidiary corporation when the parent and subsidiary have common officers and the subsidiary's officers do not act independently.⁴⁸

The absence of corporate records is evidence of a failure to observe corporate formalities. Section 33-16-101 of the South Carolina Business Corporation Act sets out the requirements for corporate records including: the articles of incorporation and by-laws, minutes of meetings, records of actions taken without meeting, accounting records, and lists of shareholders and directors.⁴⁹ Without stock records, the corporation cannot verify the existence of other shareholders, and without records of directors' meetings,

40. See *supra* notes 24-28 and accompanying text.

41. See *infra* notes 43-45 and accompanying text.

42. S.C. CODE ANN. § 33-6-400 (Law. Co-op. 1990).

43. See *Sturkie*, 280 S.C. at 455, 313 S.E.2d at 317.

44. See *Cumberland*, 308 S.C. at 270, 417 S.E.2d at 618.

45. *C.T. Lowndes*, 307 S.C. at 395-96, 415 S.E.2d at 405.

46. See *Cumberland*, 308 S.C. at 270-71, 417 S.E.2d at 618-19.

47. See *C.T. Lowndes*, 307 S.C. at 395, 415 S.E.2d at 405.

48. See *Sea Pines*, 692 F.2d at 976.

49. S.C. CODE ANN. § 33-16-101 (Law. Co-op. 1990 & Supp. 1993).

nothing evidences the presence of any other active directors.⁵⁰ Shareholders should keep transactional records when making loans to the corporation and when repaying themselves.⁵¹ Furthermore, shareholders should keep records justifying the payment of corporate assets not in the ordinary course of business.⁵²

Finally, courts ask if the corporation served merely as the dominant shareholder's "alter ego."⁵³ A court found failure to observe corporate formalities when the corporations "were under the exclusive control and domination of [the sole shareholder] and . . . merely façades for [the sole shareholder's] personal activities and functioned solely for his financial advantage."⁵⁴ A court may consider a subsidiary merely a façade for the operations of a majority shareholder, the parent corporation, if the corporations share common directors and officers and have interlocking financing.⁵⁵ Additionally, courts question commingled directors and shared offices of a subsidiary and parent corporation.⁵⁶

The second prong of the piercing test considers whether fundamental unfairness will result unless the court holds the shareholder personally liable. It requires: "(1) that the defendant was aware of the plaintiff's claim against the corporation, and (2) thereafter, the defendant acted in a self-serving manner with regard to the property of the corporation and in disregard of the plaintiff's claim in the property."⁵⁷ "The essence of the fairness test is simply that an individual businessman cannot be allowed to hide from the normal consequences of carefree entrepreneuring by doing so through a corporate shell."⁵⁸

Multimedia interpreted the first part of the fundamental unfairness prong.⁵⁹ A defendant is aware of a claim against the corporation if the defendant has notice of facts that would lead to knowledge of the claim.⁶⁰ In *Multimedia*, the defendant Mullins served as the sole shareholder and director of the corporation.⁶¹ He advised the only other officer to obtain

50. See *DeWitt*, 540 F.2d at 687.

51. See *Sturkie*, 280 S.C. at 455, 313 S.E.2d at 317.

52. See *C.T. Lowndes*, 307 S.C. at 395-96, 415 S.E.2d at 405.

53. *DeWitt*, 540 F.2d at 685; See *Sea Pines*, 692 F.2d at 976.

54. *C.T. Lowndes*, 307 S.C. at 396, 415 S.E.2d at 405.

55. See *Sea Pines*, 692 F.2d at 975-76.

56. See *Peoples Fed. Sav. & Loan v. Myrtle Beach Golf & Yacht Club*, ___ S.C. ___, ___, 425 S.E.2d 764, 770 (Ct. App. 1992), cert. dismissed, 443 S.E.2d 807 (1994).

57. *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319.

58. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 573 (citing *Laya v. Erin Homes, Inc.*, 352 S.E.2d 93 (W. Va. 1986)).

59. *Id.* at ___, 431 S.E.2d at 572.

60. *Id.* at ___, 431 S.E.2d at 572.

61. *Id.* at ___, 431 S.E.2d at 571.

advertising for the corporation.⁶² Mullins, himself, selected the newspaper published by the plaintiff.⁶³ Thus, the court found that Mullins knew of Multimedia's claim against the corporation.⁶⁴

The second part of the fundamental unfairness prong asks whether the shareholder acted for personal benefit and with unfairness to the creditor. In *Multimedia* the corporation's store closed and transferred all of its inventory to another of Mullins' corporations without payment or other consideration.⁶⁵ Mullins ignored the Bulk Sales Act,⁶⁶ denying the corporation's creditors a chance to receive payment.⁶⁷ In *Multimedia*, the court of appeals agreed with the trial court's conclusion that "at no time has any fair play been observed by this Court as regards any *bona fide* creditor Mullins acted in a self-serving manner with regard to the property of the corporation and in disregard of Multimedia's claim."⁶⁸

A shareholder and director of an insolvent corporation may have a duty to be aware of claims against the corporation. "[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."⁶⁹ In dicta in *Multimedia*, the South Carolina Supreme Court suggests that directors are charged with knowledge that they should have obtained in the exercise of their duties as directors.⁷⁰ A court may consider the failure to acquire such knowledge as negligence and a dereliction of duty.⁷¹

South Carolina courts have not applied the *Sturkie* test for piercing the corporate veil to a tort claim. Shareholders may remove assets from the corporation to avoid tort liability. However, when a corporation observes strict corporate formalities, courts cannot pierce the veil under *Sturkie*, despite the resulting unfairness.⁷² Courts probably will not allow shareholders to strip a corporation of its assets to avoid a tort claim while holding shareholders personally liable for a contractual claim. Thus, South Carolina courts may use other legal theories to provide recovery for tort liability when shareholders intentionally strip the corporation of its assets.⁷³

62. *Id.* at ___, 431 S.E.2d at 571; *Multimedia*, No. 92-UP-079 at 82.

63. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 571.

64. *Id.* at ___, 431 S.E.2d at 572.

65. *Multimedia*, No. 92-UP-079 at 80.

66. S.C. CODE ANN. §§ 36-6-101 to -111 (Law. Co-op. 1977).

67. *Multimedia*, No. 92-UP-079 at 80, 82.

68. *Id.* at 82 (quoting trial judge).

69. *Sea Pines*, 692 F.2d at 976-77.

70. *Multimedia*, ___ S.C. at ___, 431 S.E.2d at 572 (citing *Gay v. Akin*, 766 P.2d 985 (Okla. 1988)).

71. *See id.* at ___, 431 S.E.2d at 572.

72. *See Sturkie*, 280 S.C. 457-58, 313 S.E.2d at 318.

73. *Cf.* 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS §

In *Multimedia*, the South Carolina Supreme Court held that to find that a shareholder is aware of a claim against the shareholder's corporation does not require proof of actual knowledge. Courts may find a shareholder aware of a claim if the shareholder has knowledge of facts sufficient to put that shareholder on notice and if the shareholder would have discovered the claim through inquiry. Furthermore, when a corporation is insolvent, a shareholder who also is a director likely has a duty to be aware of claims against the corporation. If a shareholder acts in disregard of claims that the shareholder failed to discover, courts may find fundamental unfairness. Therefore, to protect themselves against piercing, shareholders should strictly observe corporate formalities.

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1.10 (3d ed. 1992) (reasoning that courts often rely on other legal rules to hold shareholders liable for tort actions because piercing is related to the bargain setting and the reasons for piercing are not always present in tort claims).