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Non-Tax Aspects of Thin Incorporation

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payments for the services of the doctor. This type of arrangement would have the same result as if the doctor simply paid the hospital for its essential facilities and services, but it would give the hospital the advantage of maintaining a staff of doctors with diversified qualifications on a reasonably certain basis.

The problem is one which should be solved with the utmost haste for it affects every member of society, and the services of both the opposing camps are essential in the fight to improve public health standards. The problem could be solved through the legislatures of the states but these bodies are at times quite slow to act. It would seem therefore that the courts should recognize the problem and judicially modify or even change the rule to conform to the current needs of society.[49]

JERRY B. MARTIN

NON-TAX ASPECTS OF THIN INCORPORATION

It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities.

Ballantine, Corporations

I. SCOPE AND BACKGROUND

The coveted privilege of conducting business in the corporate form is not an unconditional grant.[1] As consideration for granting the corporate privilege of doing business with limited liability, the law requires that the shareholders "put at the risk of the business some stake which shall appear reasonably adequate for its prospective needs."[2] This "stake," characterized as *equity capital*,[3] represents

49. Recent developments in the fields of taxation and corporation law will make it necessary for attorneys concerned with the problem to keep up to date on current statutes, judicial decisions, and decisions of attorneys general in their particular states.

1. "Incorporation affords a method of conducting or participating in a business enterprise with risk limited to the capital which has been put into that enterprise. It is in the nature of a compromise between entrepreneurs who, naturally, would like to minimize their risk and creditors who would seek to enlarge it." LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 111 (1936).

2. BALLANTINE, CORPORATIONS 570 (rev. ed. 1946). This same idea has been expressed by Professor Elvin R. Latty: "In other words, the law requires, as a consideration for granting the privilege of doing business with limited liability, the payment, into the corporate pool of assets, of a fund of property reasonably adequate for the organization and conduct of a business of the size, nature, and other characteristics of the business in question." LATTY, *op. cit. supra* note 1, at 121.

3. The term "equity capital" is generally used in relation to the capitaliza-

that portion of the shareholders' capital investment which is required by law as the basis of financial responsibility for the protection of corporate creditors.[4] This special fund[5] is substituted for the personal liability which the participants would otherwise have for the debts of an unincorporated business.[6] Equity capital is placed unconditionally at the risk of the business.[7] The shareholders, as the owners of the corporation, are required to be the risk takers as well as the profit sharers. They cannot shift this burden of business risk to the corporate creditors by placing restrictions upon the investment of equity capital which would allow the withdrawal of this special fund and the defeat of the creditors' claims.[8] This does not mean, however, that the participants in a corporate enterprise are limited to the investment of equity capital as the sole means of capitalization. The participants may advance assets to the corporation in the form of

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tion of corporate enterprises to designate that portion of a corporation's total capital which is represented by its capital stock. See 1 O'NEAL, CLOSE CORPORATIONS § 2.09 (1958); ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES §§ 10.01, 10.03 (3d ed. 1958). At the time of initial capitalization, the amount of a corporation's equity capital will normally be equal to the amount of its capital stock. Strictly construed, however, equity capital is the equity of the shareholders in the assets of the corporation after all claims of corporate creditors, including those of the shareholders, have been deducted. See LATTY, *op. cit. supra* note 1, at 134, 135. For a statutory definition of equity capital see INT. REV. CODE of 1954, § 1244(c) (2) (B).

4. Equity capital is to be distinguished from the concept of "legal capital" which is a legislative safeguard for the protection of corporate creditors. For general discussions of corporate capital see BALLANTINE, *op. cit. supra* note 2, at 478, 479, 570, 571 (rev. ed. 1946); FLETCHER, PRIVATE CORPORATIONS § 5080 (perm. ed. rev. repl. 1958); ROHRLICH, *op. cit. supra* note 3, § 10.01. For nonlegal discussions see DEWING, FINANCIAL POLICY OF CORPORATIONS 50-58 (4th ed. 1941); GERSTENBERG, FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS 76-77 (3d rev. ed. 1951); GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 72-77, 337 (3d ed. 1955); KATZ, INTRODUCTION TO ACCOUNTING 151 (1954); LINCOLN, APPLIED BUSINESS FINANCE 96 (5th ed. 1941).

5. Properly speaking, equity capital is not a "fund." See LATTY, *op. cit. supra* note 1, at 134, 135. In 1824 Mr. Justice Story stated that "the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank." Wood v. Drummer, 30 Fed. Cas. 435, 436 (No. 17,944) (C.C. Me. 1824). Although this "trust fund" theory has often been repeated by the courts, it has generally been discredited by writers in the field of corporation law. See BALLANTINE, *op. cit. supra* note 2, at 479; Warren, *Safeguarding the Creditors of Corporations*, 36 HARV. L. REV. 509, 544-47 (1923).

6. See BALLANTINE, *op cit. supra* note 2, at 4; 1 O'NEAL, *op cit. supra* note 5, § 1.10; ROHRLICH, *op. cit. supra* note 3, § 4.07.

7. Equity investments, unlike assets advanced by the shareholders as loans or under lease arrangements, cannot be withdrawn from the business if it begins to fail. Moreover, equity investments provide no basis for participation by the shareholders in insolvency proceedings on a parity with corporate creditors if the corporation becomes insolvent.

8. "There is danger that shareholders will try to evade even . . . limited liability, either by making fictitious contributions to the ostensible capital or by giving themselves prior claims to the corporate assets or by withdrawing their investment from the business." BALLANTINE, *op. cit. supra* note 2, at 571.

loans[9] or through lease devices.[10] Moreover, the corporation may borrow assets from outsiders.[11] Such capital contributions are characterized as *debt capital.*[12] Debt capital, as distinguished from equity capital, is not placed unconditionally at the risk of the business. On the contrary, debt capital, whether advanced by the shareholders or outsiders, is normally transferred to the corporation only upon definite terms and conditions.[13]

Traditionally, the concept of creditor protection has been the basic legal theory underlying the capitalization of corporate enterprises,[14] and the legal impetus has been toward more equity and less debt capital.[15] Today, however, the tax laws exert a strong influence

9. The leading English case of Salomon v. A. Salomon & Co., [1897] A.C. 22 (1896), seems to be the first significant decision to hold that a shareholder may also be a creditor of his own corporation. For American cases which have sustained a debtor-creditor relationship between corporation and shareholder, see *In re* Madelaine, Inc., 164 F.2d 419 (2d Cir. 1947); Goldstein v. Wolfson, 132 F.2d 624 (2d Cir. 1943); Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941). *Cf.* Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937). For discussions of tax cases involving the standing of a shareholder as a creditor of his own corporation, see Bittker, *Thin Capitalization: Some Current Questions,* 10 U. FLA. L. REV. 25 (1957); Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?,* 5 U. FLA. L. REV. 355 (1952); Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls,* 61 HARV. L. REV. 50 (1947).

10. See Luckenbach S. S. Co. v. W. R. Grace & Co., 267 Fed. 676 (4th Cir. 1920); LATTY, *op. cit. supra* note 1, at 111-14.

11. See 1 O'NEAL, *op. cit. supra* note 3, § 2.09; ROHRLICH, *op. cit. supra* note 3, § 10.02.

12. The term "debt capital" is generally used in relation to the capitalization of corporate enterprises to designate that portion of a corporation's total capital which is represented by its outstanding bonds, debentures, notes or other similar forms of corporate indebtedness. The concept of legal capital does not include debt. ROHRLICH, *op. cit. supra* note 3, § 10.01. "But in common financial parlance the long term funded debt of a corporation is usually regarded as forming a part of its capital structure." Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942). "The 'capitalization,' financial structure or permanent financing of a corporation is based on the issue of capital securities. These include not only stocks but also bonds and debentures,—the long term or funded debts." BALLANTINE, *op. cit. supra* note 2, at 494.

13. This is especially true in the capitalization of a "thin" corporation where the anticipated tax advantages will depend upon the shareholders' loans being treated as valid claims against the corporation. See 1 O'NEAL, *op. cit. supra* note 3, § 2.11.

14. Although the capitalization of a business serves the primary legal purpose of protecting corporate creditors, it has two other very practical functions; (1) the raising of the necessary funds required in the operation of the business, and (2) the allocation among the shareholders of their respective participations in the control of the corporation, in the ownership of its assets, and in the distribution of corporate earnings. See ROHRLICH, *op. cit. supra* note 3, § 10.01. Query, whether the organizers of a corporation actually give primary consideration to creditor protection in the capitalization of their business in light of the practical importance of these two latter functions?

15. See Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958); International Tel. & Tel. Corp. v. Holton, 247 F.2d 178 (4th Cir. 1957); L & M Realty Corp. v. Leo, 249 F.2d 668 (4th Cir. 1957); Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941); S. H. Riddle v. Yosemite Creek Co., 322 P.2d 538 (Cal. 1958); Automotriz Del Golfo De Cal. v. Resnick, 47 Cal.2d 792, 306 P.2d 1 (1957); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 428 (1957); Carlesimo v. Schwebel, 87 Cal. App. 2d 482,

which runs directly contrary to the notion of creditor protection. Under the present tax laws[16] the shareholders in a close corporation or a one-man company can normally achieve the most advantageous tax results by incorporating with a minimum of equity capital and a maximum amount of the total capitalization in the form of debt.[17]

The tax-saving device of *thin incorporation* is currently the most fashionable method of achieving a low equity capitalization[18] and produces the most substantial tax advantages.[19] In a thinly incorporated enterprise the participants "furnish all the assets needed by the corporation and receive from the corporation in return for their contributions not just stock, but both stock and bonds or other indebtedness of the corporation."[20] Thus a participant occupies the dual positions of owner and creditor of the corporation. At least four principal tax advantages flow from thin incorporation.[21] First, the interest which the corporation must pay on its debt to the shareholders is deductible as an expense from the gross income of the corporation.[22] Second, the corporation's obligation to repay its shareholder debt reduces the corporation's risk of incurring the accumulated

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197 P.2d 167 (1948). *Cf.* Pepper v. Litton, 308 U.S. 295 (1939); Luckenbach S. S. Co. v. W. R. Grace & Co., 267 Fed. 676 (4th Cir. 1920); Dixie Coal Mining & Mfg. Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930); Mosher v. Salt River Valley Water Users' Ass'n, 39 Ariz. 567, 8 P.2d 1077 (1932); Atwater & Co. v. Fall River Pocahontas Collieries Co., 119 W. Va. 549, 195 S.E. 99 (1938).

16. Int. Rev. Code of 1954.

17. "If the equity is small, a substantial part of future earnings frequently can be retained in the business to retire debts or to finance growth and expansion. The shareholders will not be taxed on the increase in the net worth of the corporation until they sell their shares, and then only at capital gains rates. If a shareholder keeps his shares until he dies, he has realized no taxable gain as there has been no disposition of the shares; therefore the shares are subject only to estate and inheritance taxes on their fair market value." 1 O'Neal, *op. cit. supra* note 3, § 2.09, at 53.

18. See generally, 1 O'Neal, *op. cit. supra* note 3, §§ 2.09-2.13; 2 Rabkin & Johnson, Federal Income, Gift and Estate Taxation § 35.08(2) (1954); Rohrlich, *op. cit. supra* note 3, § 10.03; Sarner, Organizational Problems of Small Businesses 66-70 (1956); Bittker, *Thin Capitalization: Some Current Questions*, 10 U. Fla. L. Rev. 25 (1957); Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?*, 5 U. Fla. L. Rev. 355 (1952); Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls*, 61 Harv. L. Rev. 50 (1947); Semmel, *Tax Consequences of Inadequate Capitalization*, 48 Colum. L. Rev. 202 (1948).

19. There are two other generally recognized methods for effecting a low equity capitalization. First, where an existing business such as an individual proprietor or partnership is to be incorporated, "the participants can withdraw part of the assets before incorporation and leave the corporation to operate on reduced assets. . . . Second, in organizing a business, the participants can contribute only a part of the assets to be used in corporate operations and let the corporation borrow the remainder from outsiders." 1 O'Neal, *op. cit. supra* note 3, § 2.09, at 54. See Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?*, 5 U. Fla. L. Rev. 355-59 (1952). For an example of the first method see Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958).

20. 1 O'Neal, *op. cit. supra* note 3, § 2.09, at 54.

21. *Ibid.*; Rohrlich, *op. cit. supra* note 3, § 10.03.

22. Int. Rev. Code of 1954, § 163. If these same distributions of corporate earnings had been made in the form of dividends, they would not be deductible by the corporation. Int. Rev. Code of 1954, § 301(c)(1).

earnings surtax by providing an additional justification for the retention of accumulated earnings in the business.[23] Third, the repayment of the principal debt to the shareholders is treated as a return of capital, enabling the corporation to distribute corporate earnings to the shareholders without a dividend tax.[24] Fourth, if the corporation should fail the shareholders may be able to claim a bad debt deduction rather than a capital loss.[25] As noted above, thin incorporation is a method of capitalization available where the participants are to provide all of the corporate assets and in practice the foregoing tax considerations are of controlling importance only in those cases where the participants are supplying the total capitalization.[26]

The tax aspects of thin incorporation have been extensively discussed by both the writers[27] and the courts.[28] However, there has been very little consideration given to the non-tax consequences which might flow from this low equity capitalization pattern.[29] In their haste to acclaim the tax advantages inherent in thin incorpora-

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23. INT. REV. CODE OF 1954, § 531 imposes a surtax on the earnings of a corporation which "are permitted to accumulate beyond the reasonable needs of the business." The retention of earnings for the purpose of retiring corporate debts normally will not be treated as an "unreasonable accumulation." See Lion Clothing Co., 8 T.C. 1181 (1947). But, "whether the practice of deliberately organizing initially with a low equity and a large debt to accomplish this very end of retaining earnings undistributed will not invoke a judicial reaction remains to be seen, especially in view of the statutory reference to corporations 'formed' for the purpose of preventing the imposition of the surtax on the shareholders." ROHRLICH, *op. cit. supra* note 3, § 10.03, at 328, 329.

24. If the shareholders' advances to the corporation were all in the form of equity investments and represented by shares of stock, these distributions would run the risk of being taxed to the shareholders as dividends paid on the redemption of stock. See INT. REV. CODE OF 1954, § 302.

25. See INT. REV. CODE OF 1954, §§ 165, 166. "A loss sustained on a stock investment is usually subject to the capital loss limitations of the Internal Revenue Code. On the other hand, a bad debt may be fully deductible (if incurred in the taxpayer's trade or business) or treated as a short-term capital loss which is still an advantage to the creditor over the shareholder who holds his stock more than six months." ROHRLICH, *op. cit. supra* note 3, § 10.03, at 329.

26. See ROHRLICH, *op cit. supra* note 3, § 10.03, at 322, 323.

27. See note 18 *supra*.

28. *E.g.*, John Kelley Co. v. Commissioner, 326 U.S. 521 (1946) (in which the Court combined for decision Commissioner v. John Kelley Co., 146 F.2d 466 (7th Cir. 1944), and Talbot Mills v. Commissioner, 146 F.2d 809 (1st Cir. 1944)); Maloney v. Spencer, 172 F.2d 638 (9th Cir. 1949); Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); Ruspyn Corp., 18 T.C. 769 (1952); Pierce Estates, Inc., 16 T.C. 1020 (1951); Sabine Royalty Corp., 17 T.C. 1071 (1951); Isidor Dobkin, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951); Arthur V. McDermott, 13 T.C. 468 (1949); Swoby Corp., 9 T.C. 887 (1947); 1432 Broadway Corp., 4 T.C. 1158 (1945), *aff'd per curiam*, 160 F.2d 885 (2d Cir. 1947).

29. At least two writers in the field of corporation law, however, have indicated the problems which may arise between the conflicting concepts of creditor protection and low equity capitalization. See 1 O'NEAL, CLOSE CORPORATIONS § 2.10 (1958); ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 10.03 (3d ed. 1958).

tion, the tax writers seem to have overlooked the fundamental concept of corporation law which requires that the shareholders bear the risk of their business by unconditionally investing assets in the corporation which are sufficient to protect the corporate creditors. The purpose of this note is to consider the legal consequences, other than tax, which may result from the practice of thin incorporation. The note is limited to a consideration of the two principal results which may be produced by inadequate equity capital:[30] (1) Where the corporation has been inadequately capitalized, the shareholders may be denied the right to assert a claim as a creditor against the corporation except in subordination to the claims of outside creditors; and (2) where the capital structure is "too thin" to perform its legal function of protecting corporate creditors, the shareholders may be held personally liable for claims against the corporation.

II. Inadequate Equity Capital

At the outset it is necessary to clearly define what is meant by the term "inadequate equity capital" in relation to the denial of limited liability and the subordination of shareholders' claims against the corporation. Inadequate capital is not here used in the strict sense of the "legal"[31] or "stated"[32] capital required by general corporation statutes as the "margin of net assets or value which is to be retained in the business as against withdrawals in favor of the shareholders."[33] Although the concept of legal or stated capital is designed to protect corporate creditors by limiting the payment of dividends to the shareholders and the purchase by the corporation of its own stock,[34] it does not purport to be an adequate measure of the financial needs of the

30. One of the non-legal consequences which may result from thin capitalization is the impairment of the corporation's future credit standing. The initial debt burden may be so large as to preclude the possibility of future borrowing from outside creditors.

31. "The legal capital is an amount, a limitation, not the actual corporate assets or property." Ballantine, Corporations 478 (rev. ed. 1946). Legal capital is normally an amount equal to the aggregate par value of all shares issued with a par value. If the corporation has outstanding shares with no par value, then the legal capital will include an amount equal to the aggregate consideration received for these shares which has been allocated to the capital account.

32. "With the introduction of no-par value shares, more precise definitions of the legal capital of both par and no-par shares became necessary. Modern corporation acts have . . . substituted the term 'stated capital.' This term is . . . derived from the practice of specifying that part of the subscription price for no-par shares which should be attributed to capital and that part which is attributed to paid-in surplus." Ballantine, *op cit. supra* note 31, at 478. For a thorough discussion of the term "stated capital" as used in modern corporation statutes, see Garrett, *Capital and Surplus Under the New Corporation Statutes,* 23 Law & Contemp. Prob. 239, 245-57 (1958).

33. Ballantine, *op. cit. supra* note 31, at 479.

34. *Ibid.*

particular business.[35] Nor is inadequate capital here used in the economic sense of the total assets required in the operation of the corporation's business.[36] The total amount of all the assets used in the corporate enterprise may be fully adequate to meet the operational demands of the business in question,[37] but this is no assurance that the required proportion of risk capital has been invested by the shareholders.

"Equity capital," in its causal relation to the denial of limited liability and the subordination of shareholders' claims, is more nearly synonymous with the accounting concept of corporate capital which is variously expressed as "net worth," "proprietorship," or "proprietary equity."[38] "It is the value of the contribution to the corporate estate by the shareholders arrived at by ascertaining the excess in value, if any, of the assets over all liabilities, including liabilities (aside from capital stock) to the proprietary interests."[39] In other words, it is the equity of the shareholders in the assets of the corporation after all claims of corporate creditors, including those of the shareholder-creditors, have been deducted.[40]

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35. "[Legal] capital is often purely an arbitrary proportion of the consideration received for shares of stock which some one has decided to segregate on paper and label 'capital' . . . . Such capital may be but nominal and still have no bearing on creditors' rights." LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 134 (1936).

36. In the economic sense, the capital of a corporation includes all its assets from whatever source derived, encompassing both equity and debt capital. See FLETCHER, PRIVATE CORPORATIONS § 5080 (Perm. ed. rev. repl. 1958). As one writer has stated, "the distinction between owned and borrowed, although very important from the point of view of financial policy, is in the end legal and not economic. The corporation uses its capital as a single fund, whatever the sources or the obligations involved in getting it and holding it." DEWING, FINANCIAL POLICY OF CORPORATIONS 50 (4th ed. 1941). From the economic standpoint, the capitalization of a corporation is not controlled by the factor of creditor protection. Rather, the capital structure will be determined by such factors as the amount of funds initially required, the prospects for future growth, the expected "turnover" of operating assets, the estimated return on investments, the allocation of corporate control, and the predicted stability of earnings. See GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 184 (3d ed. 1955). For a discussion of the methods of financing small business enterprises see ROHRLICH, *op cit. supra* note 29, § 10.02. See generally Masslich, *Financing a New Enterprise*, 5 ILL. L. REV. 70 (1910); Rohrlich, *Some Current Thoughts on Corporate Capitalization*, 1 VAND. L. REV. 553 (1948); Weaver, *Equity Financing for the Small Firm*, Harv. Bus. Rev., Mar.-Apr. 1956, p. 91; Wilhelm, *How Small Business Competes for Funds*, 11 LAW & CONTEMP. PROB. 220 (1945).

37. "Ordinarily, in one of these corporations organized with what is here called inadequate capital, the totality of all the assets used in the corporation's business, that is, the aggregate of the property (including money and credit) made available to its use by the [shareholders] . . . through loans, leases, mortgages, etc., is perfectly adequate to operate the business in question." LATTY, *op. cit. supra* note 35, at 134.

38. For discussions of these accounting terms, see KATZ, INTRODUCTION TO ACCOUNTING §§ 97-105 (1954); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTRODUCTORY, ch. 1 (5th ed. 1957).

39. LATTY, *op. cit. supra* note 35, at 135.

40. This is merely an expression of the fundamental accounting equation—that proprietorship equals assets minus liabilities.

Yet the legal consequences of inadequate equity capital do not flow from the mere fact that this equity capital is low; else the privilege of limited liability would be lost at the very time when it is most needed, *i.e.*, when the shareholders' original equity investment has been depleted and the corporation begins to fail.[41] Under such circumstances the law does not require the shareholders to cease business and liquidate the corporation on the penalty of losing their immunity from personal liability. Low equity capital, of itself, is not the objectionable feature which results in the denial of limited liability or the subordination of shareholders' claims to outside creditors. Rather, it is a low ratio of equity capital to debt capital which constitutes the critical factor in these cases.[42] The law objects to a low ratio of equity capital to debt capital because it allows the shareholders to shift the risks of the enterprise to the corporate creditors by advancing assets to the corporation which are not placed unconditionally at the risk of the business.[43] The evil lies in the fact that creditors are led to deal with the corporation on the basis of the total capital investment, whereas only a part of that total capital is actually ventured unconditionally for the protection of corporate creditors. For example, if a creditor deals with a corporation whose total capital requirement is $20,000 his risk is considerably greater where $15,000 of that amount is in the form of loans made by the shareholders to the corporation than where $15,000 is in the form of equity capital and only $5,000 in the form of debt capital.

Defining the nature of "inadequate equity capital" is a relatively simple matter. The remaining problem of ascertaining what constitutes inadequate equity capital for the particular business in question, how the adequacy of this capital is to be determined and at what point in the life of the corporation this determination is to be made is clearly more difficult. What is adequate or inadequate equity capital is not subject to a test which can be applied with mathematical certainty in every case. A moment's reflection will convince one of the difficulty in determining what the risks involved in the operation of a particular business are and whether the shareholders have met those risks by the investment of an adequate amount of equity capital.[44] It can only be said in general terms that "a separate finan-

41. One of the chief attributes of incorporation is the shareholders' privilege of doing business with the risk of personal liability limited to their corporate investments. The shareholders are not charged with duty of capitalizing their corporation to meet all possible liabilities which may arise in the future. As one writer has stated, "it seems obvious that capitalization reasonably adequate to carry on the particular business must always be tested as of the time of the inception of corporate existence rather than near its economic death." LATTIN, CORPORATIONS 72 (1959).

42. See cases cited note 15 *supra*.

43. See LATTY, *op. cit. supra* note 35, at 135, 136.

44. Perhaps this difficulty accounts for the courts' general tendency to rest

cial unit should be set up and maintained. This unit should be sufficiently financed so as to carry the normal strains upon it. The risks attendant on the conduct of a business of that type can roughly be averaged and that average met."[45] Although the law objects to a low ratio of equity capital to debt capital, some debt is allowed.[46] But even though some ratio of equity to debt is allowed, the courts have not attempted to indicate what is a permissible ratio. Moreover, it would seem that the fixing of such an allowable ratio is a practical impossibility because a ratio which is permissible in one industry might be excessive in another, and even within a single industry no two enterprises are exactly the same.[47] It is generally agreed that the adequacy of the capitalization is to be tested at the time of the organization of the business.[48] But as one writer has recently indicated: "Post-organization manipulation by the [shareholders] . . . which weakens the [corporation's] financial position will tend to have the same, and probably even more serious, consequences than initial under-capitalization."[49]

Thus, while the nature of inadequate equity capital may be defined with reasonable certainty, the ultimate problem of what is adequate or inadequate equity capital for a particular business and how this adequacy is to be tested remains largely unanswered. As the following cases illustrate, however, the courts are giving increased vitality to inadequate capital in limiting the extent to which shareholders may be creditors of their own enterprise and still avail themselves of the privilege of doing business as a corporation. In considering these cases it is important to bear in mind the relation of inadequate capital, as herein defined, to the tax-saving device of thin incorporation. Under the practice of thin incorporation the shareholders are seeking to achieve the very type of capital structure to which the law objects, *i.e.,* capitalization with a low equity to debt ratio. Where this device has been resorted to in practice, equity to debt ratios as low as 1:2 and even 1:4 are not uncommon.[50] It is submitted that such low equity capitalization is potentially a determinative factor in subjecting the participants in a thin corporation to the danger of incurring the consequences discussed in the following material.

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their decisions on such theories as the "alter ego" or "instrumentality" rule rather than enter into a discussion and analysis of inadequate capital as a determinative factor in these cases.

45. Douglas & Shanks, *Insulation From Liability Through Subsidiary Corporations,* 39 YALE L.J. 193, 196, 197 (1929).

46. See note 9, *supra.*

47. See 1 O'NEAL, *op. cit. supra* note 29, § 2.10, at 59.

48. See LATTIN, CORPORATIONS 72 (1959); LATTY, *op. cit. supra* note 35, at 120, 121; ROHRLICH, *op. cit. supra* note 29, § 12.03, at 443.

49. *Id.* at 443, 444.

50. See Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?,* 5 U. FLA. L. REV. 355 (1952).

III. NON-TAX CONSEQUENCES OF THIN INCORPORATION

Thin incorporation, although laden with attractive tax advantages for the participants in a closely held corporation, is potentially capable of producing at least two serious, non-tax consequences. First, the courts in insolvency proceedings may deny the shareholders standing to assert claims as creditors against their own corporation and treat their loans and other forms of debt contributions to the corporation as equity capital.[51] In some cases the courts may allow the shareholder-creditors to establish claims against their insolvent corporation, but only in subordination to the claims of outside creditors.[52] Second, the courts may treat the low equity capitalization as an abuse of the separate entity privilege and hold the shareholders personally liable for claims against the corporation.[53] These consequences are directly attributable, either in whole or in part, to inadequate equity capital. However none of the cases in which inadequate equity capital has been recognized as a determining factor in the imposition of these consequences have involved what is presently termed a thinly incorporated enterprise.[54] Some of the cases have involved corporations, organized prior to the enactment of the present tax laws, whose low equity capitalization was not designed to obtain the tax benefits of thin incorporation. Other cases have involved parent-subsidiary relationships where the courts imposed these consequences upon the parent corporation of an inadequately capitalized subsidiary. In all of the cases, however, the decisions have rested, at least in part, upon the theory that the shareholders failed to provide the corporation with an adequate amount of equity capital, thus throwing the risks of the business upon the corporate creditors. These cases illustrate the potential non-tax consequences which may befall the participants in a thinly incorporated enterprise. The parent-subsidiary cases are particularly relevant, not only because they have given rise to one of the leading doctrines in this area of the law, but also because "subsidiary corporations have many of the characteristics of close corporations; and the literature on subsidiary and parent corporations is often helpful in solving close corporation problems."[55]

51. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958); Arnold v. Phillips, 117 F.2d 497 (5th Cir. 1941); 1 O'NEAL, CLOSE CORPORATIONS § 2.10 (1958).

52. See cases cited note 51 *supra.*

53. See BALLANTINE, CORPORATIONS §§ 122, 129; 1 O'NEAL, *op. cit. supra* note 51, § 1.10.

54. See text accompanying note 20 *supra; cf.* Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958).

55. 1 O'NEAL, *op. cit. supra* note 51, § 1.05, at 6. Professor Latty, however, would draw a distinction between the consequences imposed upon the parent corporation of an inadequately capitalized subsidiary and the individual shareholders of an inadequately capitalized corporation. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS ch. 8 (1936). But the courts have not adopted this distinction. See Automotriz Del Golfo De Cal. v. Resnick, 47 Cal.2d 792, 306

A. Denial and Subordination of Shareholder's Claims Against the Corporation

Any discussion of the judicial treatment of shareholders' claims as creditors of their own corporation must begin with the landmark case of *Salomon v. A. Salomon & Co., Ltd.*,[56] decided by the House of Lords in 1897. In that case an enterprising merchant, Aaron Salomon, transferred his profitable business to a private limited company whose incorporators were Salomon and members of his family. Salomon received for his business a total price of 39,000 pounds, paid by 1000 pounds in cash, 10,000 pounds in debentures secured by a first lien on all the assets of the company, and 20,000 fully paid up shares. Only seven shares were issued to Salomon's family. From these facts it appears that the corporation was capitalized with an equity to debt ratio of approximately 2:1.[57] After a brief career the company became bankrupt. In the insolvency proceedings, the rights of Salomon as a secured creditor of his own corporation were attacked by outside creditors on the ground that Salomon would take all the assets under his debentures, leaving the corporate creditors with nothing. The lower courts sustained the contentions of the outside creditors, holding that it was unlawful to create such a judgment-proof arrangement under which the owner was to take all the profits without running the risks of the business.[58] In reversing the lower courts, the House of Lords upheld the validity of the corporate arrangement and permitted Salomon to prove a claim on his debentures in priority to the outside creditors.

The *Salomon* case established the proposition that a shareholder may be a creditor as well as an owner of his corporation.[59] From the standpoint of corporate capitalization the case also stands as an early indication that some ratio of equity capital to debt capital is allowable.[60] Since the *Salomon* case there have been a number of

P.2d 1 (1957); Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 197 P.2d 167 (1948).

56. [1897] A.C. 22 (1896).

57. In addition to the amounts enumerated, Salomon received for his transfer a sum not noted in the report which was paid in discharge of his personal business debts.

58. Broderip v. Salomon, [1895] 2 Ch. 323.

59. However, this proposition has not been accepted without question. Professor Ballantine has stated that: "the most questionable point upheld [in the *Salomon* case] . . . was that of permitting a sole shareholder to prove a claim on his debentures in priority to the unsecured creditors, when he had created at the outset a kind of judgment proof setup . . . ." BALLANTINE, *op. cit. supra* note 53, at 301, 302. Although the policy reasons for allowing a shareholder to occupy the status of a creditor of his own corporation may be questioned, as a practical matter the shareholders may be the only source of credit for some small corporations.

60. The case has been cited as an early indication that a ratio of more than two parts equity capital to one part debt will be an acceptable capitalization. See LATTY, *op. cit. supra* note 55, at 136.

decisions by American courts which have permitted shareholders to assert a claim as a creditor of their own corporation.[61] "But the courts will scrutinize the good faith and fairness of a transaction by which the controlling shareholders seek to recover a purported loan to themselves in what is their own business in competition with other creditors, and will consider the adequacy of the capital furnished and other circumstances."[62]

The leading doctrine in this area of the law is the well-known "Deep Rock doctrine" which was laid down by the Supreme Court in *Taylor v. Standard Gas & Elec. Co.*[63] In that case the Standard Gas & Electric Company sought to establish a claim in the insolvency proceedings of the Deep Rock Oil Corporation, a subsidiary organized and controlled by Standard. Standard owned all of Deep Rock's common stock, which was the sole voting stock, and completely controlled the subsidiary's management. Deep Rock also had publicly-held preferred stock and an issue of notes outstanding in public hands. From the time of its organization Deep Rock was inadequately capitalized,[64] and borrowed extensively throughout its life on an open account from Standard. At the time of Deep Rock's bankruptcy the open account showed a balance of $9,000,000 which was the basis of Standard's claim in the insolvency proceedings. The preferred shareholders of Deep Rock contested Standard's claim on the ground that Deep Rock was a mere instrumentality or agent of Standard. The Supreme Court sustained the contentions of the preferred shareholders and subordinated Standard's claim to the claims of the preferred shareholders and outside creditors of Deep Rock, but not under the "instrumentality rule."[65] Rather, the Court rested its decision upon "the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice."[66] The Court held that the inadequate capitalization and mismanagement of Deep Rock by Standard were appropriate circumstances for the application of the principle in this case.[67]

61. See cases cited note 9 *supra*.
62. BALLANTINE, *op. cit. supra* note 53, at 302.
63. 306 U.S. 307 (1939).
64. "From the outset Deep Rock was insufficiently capitalized, was topheavy with debt and was in parlous financial condition. Standard so managed [Deep Rock's] . . . affairs as always to have a stranglehold upon it." *Id.* at 315.
65. The "instrumentality rule" is a verbal formula often used by the courts in holding a parent corporation liable for the acts and debts of its subsidiary company where the parent has so controlled and managed the subsidiary that the latter has no separate and independent existence, but is deemed a part of the parent corporation. However, the formula has been criticized as failing to deal realistically with the problem of the abuse of the corporate entity privilege. See BALLANTINE, *op. cit. supra* note 53, at 293; LATTY, *op. cit. supra* note 55, at 156-91.
66. 306 U.S. 307, at 322.
67. These two factors have been characterized as the inadequate capitali-

The Deep Rock doctrine has been interpreted to mean at least this:

> Where a showing can be made that a subsidiary corporation having public preferred stockholders [or creditors] was inadequately capitalized from the outset and was managed substantially in the interest of its parent, rather than in its own interests, the parent will not, in a bankruptcy or reorganization proceeding affecting the subsidiary, be permitted to assert a claim as a creditor, except in subordination to the claims of preferred stockholders [or creditors of the subsidiary].[68]

Although the Deep Rock doctrine has been applied primarily in cases involving a parent-subsidiary relationship,[69] the underlying principles seem equally applicable to the individual shareholders in a one-man company or a close corporation.[70] Moreover, the inadequate capitalization aspect of the doctrine, with its impetus toward more equity capital and less debt, is clearly contrary to the tax concept of thin incorporation which is in the direction of less equity and more debt. The doctrine might well be imposed to prevent the participants in a thinly incorporated enterprise from asserting a claim against the corporation on the basis of their loans or other forms of debt investments, except in subordination to the claims of outside creditors.

In *Arnold v. Phillips*,[71] the principles of the Deep Rock doctrine were applied in determining an individual shareholder's standing to assert a claim as a creditor of his insolvent corporation with respect to loans made at the time of the corporation's organization and during its operating life. In that case Arnold and two others incorporated a brewing company with an authorized capital stock of $50,000, all paid in cash by Arnold. Arnold held 498 shares of stock, and the other two incorporators each held one share. During the first year Arnold made additional advances of approximately $75,500 to complete the plant and begin operations. After two years of prosperous business, the corporation began to fail and Arnold made further advances of about $50,000. Subsequently the corporation failed and Arnold sought to participate in the bankruptcy proceedings on the basis of the two series of advances. There was no evidence of intentional fraud or mismanagement by Arnold. The court treated the two series of advances separately, holding the advances made during the organiza-

zation and mismanagement aspects of the Deep Rock doctrine. See ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 10.03 (3d ed. 1958).

68. Israels, *The Implications and Limitations of the "Deep Rock" Doctrine*, 42 COLUM. L. REV. 376, 379 (1942). For other discussions of the Deep Rock doctrine see Hornstein, *A New Forum for Stockholders*, 45 COLUM. L. REV. 35 (1945); Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COLUM. L. REV. 1124 (1942); Sprecher, *The Conflict of Equities under the "Deep Rock" Doctrine*, 43 COLUM. L. REV. 336 (1943).

69. See Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941); Pepper v. Litton, 308 U.S. 295 (1939); Gannet Co. v. Larry, 221 F.2d 269 (2d Cir. 1955).

70. See ROHRLICH, *op. cit. supra* note 67, § 10.03, at 321.

71. 117 F.2d 497 (5th Cir. 1941).

tional period to be equity capital for which Arnold could not assert a claim in bankruptcy but sustaining his claim for the advances made after the corporation had begun operations. As to the first advances the court stated that: "Although the charter provided for no more capital than $50,000, what it took to build the plant and equip it was a permanent investment, in its nature capital."[72] Thus, the court considered the total equity capital to be $125,500[73] which then reflected a ratio of equity to debt of approximately 2.5:1. The court held this to be an adequate amount of equity capital, stating that: "It would be hard to say in this case that $50,000 was not a substantial capital, and impossible so to say after holding that the real capital was $125,000, though some of it was irregularly paid in."[74] In allowing Arnold's claim on the second series of advances the court did not apply a ratio test, but applied what has been termed the "normalcy test,"[75] *i.e.,* whether such debt contributions "would be available to similar corporations in similar circumstances through the ordinary commercial and financial channels, unaided by any bolstering from the proprietary interests."[76] The court's reasoning was that if a bank would lend, why not let the controlling shareholder lend?

Arnold v. Phillips represents the first significant application of the principles of the Deep Rock doctrine to an individual shareholder. From the standpoint of thin incorporation the case clearly indicates that the low equity capitalization of a thinly incorporated enterprise may constitute a controlling factor in determining the participants' standing to prove a claim as a creditor of their own corporation if the business should fail. In this regard it is important to note that the element of mismanagement, a determining factor in *Taylor v. Standard Gas & Elec. Co.* and one aspect of the Deep Rock doctrine, was expressly found by the court to be absent in the *Arnold* case.[77] The case stands, therefore, as an indication that the factor of inadequate capitalization, alone, may constitute sufficient grounds for denying shareholder-creditors' claims against their insolvent corporation. The case is also significant from the standpoint of thin incorporation in that the court treated the two series of advances separately. The loans and other forms of debt contributions made by the

72. *Id.* at 501.
73. This was the total amount of Arnold's equity investment in the business, *i.e.,* the original $50,000 investment plus the first series of advances of $75,500 which the court treated as equity capital.
74. 117 F.2d 497, 502.
75. See LATTY, *op. cit. supra* note 55, at 136.
76. *Ibid.*
77. "There is nothing to show the enterprise was entered upon or prosecuted with a fraudulent purpose. . . . We do not find any such mismanagement as would compel disregard of the corporate entity as a remedy against injustice." 117 F.2d 497, 502.

shareholders under the practice of thin incorporation are almost always made during the organizational phase of the corporate life.[78] According to the decision in *Arnold v. Phillips,* advances made during this period seem to be subjected to a more rigid test and treated as equity investments if they are used in creating the corporation or putting it into operation. The court did not consider the adequacy or inadequacy of the authorized capital in determining that these advances were to be treated as equity capital. Thus the case at least raises the question of whether advances made during the organizational phase of the corporate life are to be subjected to a different test to the extent that they are used in bringing the corporation into existence as an operating unit.

Since *Arnold v. Phillips* there have been two recent cases involving the subordination of shareholders' claims primarily on the basis of inadequate equity capital, in which it was shown that the low equity capitalization was resorted to in order to obtain better income tax results.

In the most recent case, *Costello v. Fazio,*[79] three partners, operating with a total capital investment of $51,620, decided to incorporate their business. In order to achieve the best tax consequences, they converted $45,620 of their investment into debt capital prior to incorporation by having the partnership execute promissory notes to them for this amount. Thus the corporation was left to operate on equity capital of only $6,000 which reflected an equity to debt ratio of less than 1:7 at the time of organization. The corporation subsequently became bankrupt and the shareholders' claims were opposed by the trustee in bankruptcy on the ground that the promissory notes actually represented equity investments. Accounting experts and financial analysts were called for both sides to testify on the question of the adequacy of the corporation's equity capital. One witness for the shareholder-claimants testified that the capital account was transferred to a debt account because "it was contemplated that the notes would be paid out of the profits of the business. . . . [I]f promissory notes had not been issued, the profits would have been distributed only as dividends, and . . . as such they would have been taxable."[80] A majority of the expert witnesses felt that the corporation needed at least as much equity capital as the partnership required before the reduction took place.[81] The court held that the

78. "[T]he use of debt in the capitalization of a corporation calls for planning before incorporation. After a corporation has been organized and commences operations, an attempt to recapitalize by issuing bonds for part of the stock is almost certain to have disastrous tax consequences." 1 O'NEAL, CLOSE CORPORATIONS § 2.09, at 56 (1958).
79. 256 F.2d 903 (9th Cir. 1958).
80. *Id.* at 907.
81. One witness testified that ". . . in incorporating a business already in existence, where the approximate amount of permanent capital needed had

corporation was "grossly undercapitalized" and that the shareholders' claims should be subordinated to the claims of outside creditors.

Costello v. Fazio seems to be the first significant case in which the principles developed in *Taylor v. Standard Gas & Elec. Co.* and *Arnold v. Phillips* have been applied to impose non-tax consequences upon the participants in a thinly incorporated enterprise. Although the method of capitalization used in the *Costello* case does not fall precisely within the narrow definition of "thin incorporation," it does represent one of the recognized methods for achieving a low equity capitalization and produces the same beneficial tax results.[82] In the *Costello* case the court was squarely presented with the issue of what constituted adequate equity capital for the particular business in question. The court properly found that the corporation was inadequately capitalized, but erroneously characterized the term "adequacy of capital" as referring to "legal capital, or stated capital."[83] As explained previously, inadequate capital in its causal relation to the subordination of shareholders' claims does not refer to legal or stated capital.[84] In reaching its decision, the court was also faced with the question of whether the factor of mismanagement was a necessary requisite to the subordination of the shareholders' claims. The shareholder-claimants had argued that "fraud or mismanagement must always be present if claims are to be subordinated in a situation involving undercapitalization."[85] The court held that: "This is not the rule. The test to be applied, as announced in [*Taylor v. Standard Gas & Elec. Co.*] . . . is whether the transaction can be justified 'within the bounds of reason and fairness.' "[86] Thus, in addition to illustrating the application of the principles of the Deep Rock doctrine to a thinly incorporated enterprise, *Costello v. Fazio* offers a definite ruling on the point indicated in *Arnold v. Phillips*, *i.e.*, that the element of mismanagement is not a requisite to the subordination of shareholders' claims where equity capital is found to be inadequate.

In the earlier case of *L. & N. Realty Co. v. Leo*,[87] the question of

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been established by experience, normal procedure called for continuing such capital in the form of common or preferred stock." *Id.* at 906.

82. See note 19 *supra*. Actually the incorporation in this case falls very nearly within the technical definition of "thin incorporation," because the transaction was essentially a withdrawal of equity investments and reinvesting them in the form of debt contributions to the new corporation.

83. The court stated that: "when we speak of inadequacy of capital in regard to whether loans by shareholders shall be subordinated to claims of general creditors, we are not referring to working capital. We are referring to the amount of the investment of the shareholders in the corporation. This capital is usually referred to as legal capital, or stated capital in reference to restrictions on the declaration of dividends to stockholders." 256 F.2d 903, 907.

84. See discussion of inadequate equity capital in text accompanying notes 31-35 *supra*.

85. 256 F.2d 903, 910.

86. *Ibid.*

87. 249 F.2d 668 (4th Cir. 1957).

a shareholder's standing as a creditor of his own corporation arose under unusual circumstances. There, the estate of a deceased shareholder filed an involuntary petition in bankruptcy against the corporation on the ground that the surviving shareholder had made preferential payments to outside creditors which exhausted the corporate assets and left the shareholders' claims unpaid. The standing of the estate to file this petition depended upon whether the claim of the deceased shareholder, which the estate asserted, was of the same class as the claims of outside creditors. If the deceased shareholder's claim was to be subordinated to outside claims then it was not in the same class and no preferential treatment had resulted from the satisfaction of the latter. It was shown that the shareholders had incorporated a real estate business with an equity investment of $19,000, and that shortly after its organization they had advanced approximately $17,000 apiece in the form of loans. In subordinating the shareholders' claims and dismissing the involuntary petition, the court found "that the money was advanced as loans rather than as subscription to stock in the thought that this would be helpful for income tax purposes."[88] The court stated that: "In such situation, while the loans are not to be treated as investments in stock, it is clear that they were capital contributions to a corporation inadequately capitalized and that . . . they should be subordinated to the claims of other creditors."[89] The corporation was not, strictly speaking, a "thin corporation" initially organized with a low equity to debt capitalization for tax-saving purposes, but the evidence indicates that the shareholders attempted to achieve the same effect by periodic loans to the corporation.

From these cases it can be seen that the courts will carefully scrutinize the fairness and good faith of any transaction whereby the shareholders attempt to assert a claim as a creditor of their own corporation and will deny the claim or subordinate it to the claims of outsiders where equity demands.[90] And, as *Arnold v. Phillips* and *Costello v. Fazio* indicate, inadequate capitalization, which is an inherent characteristic of the tax-saving device of thin incorporation, may constitute sufficient grounds for the application of these broad equitable principles.

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88. *Id.* at 670.
89. *Ibid.*
90. For additional cases involving the validity of shareholder claims, see *In re* Madelaine, Inc., 164 F.2d 419 (2d Cir. 1947) (shareholders advances made at the time they purchased corporate stock upheld as valid loans); Goldstein v. Wolfson, 132 F.2d 624 (2d Cir. 1943) (shareholders' claims allowed on ground that "only capital contributions were intended at the time when the advances were made"); *cf.* Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937) (shareholders' claims allowed in priority to outside creditor because outside creditor dealt with corporation with knowledge that the business was in poor financial condition).

B. Denial of Limited Liability

It has been stated that: "An obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in cases denying stockholders their defense of limited liability."[91] However, where the courts have imposed personal liability upon the shareholders for corporate debts, they have seldom rested their decisions solely upon inadequate capitalization. Rather, they have preferred to base their decisions upon the "alter ego"[92] or "instrumentality"[93] theories, using inadequate capitalization only as a contributing factor in determining whether these theories should be applied. But as one writer has stated: "Inadequacy of the capital which is risked by the individuals who avail themselves of the corporate device is of far more vital concern to creditors of the corporation than the failure to observe the many niceties of corporate formalities upon which the courts sometimes appear to base their decisions."[94] In many of the cases no real problem is presented, because the shareholders have failed to create any stated capital by the issuance of stock and the evidence shows that the corporation's liabilities exceeded its assets almost from the outset.[95] In such cases it seems obvious that undercapitalization alone is the real reason for disregarding the corporate entity, irrespective of the courts' discussions of the "alter ego" and "instrumentality" theories.

In the early case of *Luckenbach S. S. Co. v. W. R. Grace & Co.*,[96] where the Luckenbach Company, capitalized at $800,000, had leased steamships worth several million dollars to an affiliated company, capitalized at only $10,000, the larger company was held liable for a claim incurred by the smaller affiliate. In addition to the inadequate capitalization of the lessee corporation, it was shown that the two companies were maintained and managed substantially as one corporation. In holding the larger company liable, the court stated that: "For all practical purposes the two concerns are one, and it would be unconscionable to allow the owner of this fleet of steamers, worth millions of dollars, to escape liability because it had turned them over a year before to a $10,000 corporation, which is simply itself in

91. Douglas, J., in Anderson v. Abbott, 321 U.S. 349, 362 (1944).

92. The "alter ego theory," like the "instrumentality rule," is a verbal formula used by the courts in disregarding the corporate entity. And like the instrumentality rule, the alter ego theory has been criticized by the writers in the field of corporation law. See note 65 *supra*.

93. *Ibid.*

94. Latty, Subsidiaries and Affiliated Corporations 119 (1936).

95. See S. H. Riddle v. Yosemite Creek Co., 322 P.2d 538 (Cal. 1958); Automotriz Del Golfo De Cal. v. Resnick, 47 Cal.2d 792, 306 P.2d 1 (1957); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

96. 267 Fed. 676 (4th Cir. 1920).

another form."[97] This reasoning is typical of that found in many of the cases in this area. Unlike the subordination cases, the courts here require in addition to insufficient capital such factors as fraud, mismanagement or a failure by the shareholders to observe corporate formalities. The more recent cases, however, indicate that the courts are placing greater stress upon inadequate capitalization as a determinative factor in the imposition of personal liability. In *Carlesimo v. Schwebel*,[98] where a corporate creditor sought to hold the shareholders personally liable on the grounds of insufficient capital, the court stated that: "the proper rule is that inadequate financing, where such appears, is a factor, and an important factor, in determining whether to remove the insulation to stockholders normally created by the corporate method of operation."[99] And in *Automotriz Del Golfo De Cal. v. Resnick*,[100] where personal liability was imposed upon the shareholders, the court declared that: "Another factor to be considered in determining whether individuals dealing through a corporation should be held personally responsible for the corporate obligations is whether there was an attempt to provide adequate capitalization for the corporation."[101]

In none of the cases where shareholders have been held personally liable for the corporate debts does it affirmatively appear that the corporation was a "thin corporation," organized as a tax-saving device. This does not mean, however, that the principles and consequences applied in these cases are not also applicable to the participants in a thin corporation. Quite clearly, the ratio of equity to debt in the capital structure of a thinly incorporated enterprise might be so low as to constitute inadequate capitalization within the meaning of these cases. Moreover, where the participants in a thin corporation fail to observe corporate formalities and have themselves neglected to treat the corporation as a separate entity, the low equity capitalization will be of greater weight in determining whether they can continue to avail themselves of the privilege of limited liability.

IV. Conclusion

New ideas and trends in the law are often limited by traditional doctrines. This is especially true in the field of corporation law where "the use of the entity privilege of separate capacities is at all times subject to limitations of an equitable nature to prevent the privilege from being exercised or asserted for illegal, fraudulent or unfair

97. *Id.* at 681.
98. 87 Cal. App. 2d 482, 197 P.2d 167 (1948).
99. 197 P.2d 167, 174.
100. 47 Cal.2d 792, 306 P.2d 1 (1957).
101. 306 P.2d 1, 4.

purposes by those claiming under it . . . ."[102] It is submitted that the practice of thin incorporation as a tax-saving device is limited by the traditional doctrine which requires shareholders to place an adequate amount of equity capital unconditionally at the risk of the business for the protection of corporate creditors.

As the foregoing discussion emphasizes, inadequate capitalization is an abuse of the separate entity privilege which may result in the subordination of shareholders' claims or the denial of the privilege of limited liability. To date, however, the courts have failed to lay down any definite tests for measuring the adequacy of the capitalization of a particular business. Moreover, it is not entirely clear to what extent inadequate capitalization alone is determinative in bringing about these results. In the subordination cases it appears reasonably certain that the factor of inadequate capitalization will be sufficient to support the subordination of shareholders' claims against their insolvent corporation even in the absence of fraud or mismanagement. In the personal liability cases, however, the courts continue to speak in terms of the alter ego theory. Thus, it is difficult to predict how "thin" a corporation may be and yet be considered sufficiently capitalized to prevent the imposition of these non-tax consequences.

The problem of determining a safe ratio of equity to debt for non-tax purposes is considerably narrowed by the practical limits which tax considerations place upon the thinning of a capital structure. One tax writer has indicated that the ratio of equity to shareholder debt may be pushed as low as 1:4 without having the shareholders' debt contributions treated as stock for income tax purposes,[103] but he concludes that "the tax advantages of thinning beyond [one part equity to two parts debt] . . . are small compared to the risk of having the debt treated as stock . . . ."[104] Thus the problem is essentially reduced to a determination of whether ratios of equity to shareholder debt in the range of 1:2 and 1:4, which are considered safe for tax purposes, will be deemed adequate for non-tax purposes.

In the tax field one writer has suggested that the minimum allowable ratio of equity to shareholder debt be fixed by statute and that any indebtedness in excess of the statutory ratio should be treated as an equity investment.[105] Such a statutory solution, if feasible, would have the practical advantage of making the law more certain as to both the tax and non-tax aspects of inadequate capitalization. But it is generally agreed that the answer does not lie in legislative

102. BALLANTINE, CORPORATIONS 292 (rev. ed. 1946).
103. Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?*, 5 U. FLA. L. REV. 355 (1952).
104. *Id.* at 365.
105. Semmel, *Tax Consequences of Inadequate Capitalization*, 48 COLUM. L. REV. 201, 214-18 (1948).

standards, because the need and ability for debt financing varies so widely among different industries and even among different enterprises within a single industry. An one author has stated: "any attempt at specifying a fixed ratio . . . faces an insurmountable obstacle in the vast variety of particular circumstances confronting different corporations at different times."[106] Moreover, while it is convenient to talk in terms of equity to debt ratios, it must be remembered that the courts have not adopted this language in either the tax cases or the non-tax cases. Further, as one writer in the field of close corporations has stated: "an infinite variety of circumstances and considerations in addition to the corporation's [equity-debt] . . . ratio may affect a decision on whether a particular security represents debt or is stock."[107]

The same "insurmountable obstacle" which precludes the formulation of a workable legislative standard also faces the courts in any attempt to lay down a fixed judicial standard of adequate capitalization. The courts, however, are in a position to add at least some certainty to the law in this area by developing more fully the exact nature of the concept of inadequate capitalization. At the present time some confusion exists between the courts' application of this term and its interpretation by certain text writers.[108]

In the final analysis there are no presently reliable criteria for determining what is an adequate ratio of equity to debt in the capitalization of a corporation. The guide can only be stated in general terms. The shareholders should finance their corporation with equity investments sufficient to meet the normal risks attendant on the conduct of a business of the nature and magnitude of the corporate undertaking. Despite these uncertainties, however, the lawyer who organizes a thinly incorporated enterprise should carefully consider the non-tax aspects of low equity capitalization before fixing the ratio of equity capital to debt capital with which the corporation will begin business. It is his task to mold the corporate structure to meet the needs of the business enterprise and to satisfy the legitimate desires of the participants. In order to properly perform this task, the lawyer must be able to predict with some certainty the legal consequences, potential as well as immediate, which can be expected to result from the type of structure created.

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106. ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 10.03 n.72a (3d ed. 1958). See 1 O'NEAL, CLOSE CORPORATIONS § 2.10, at 59 (1958).

107. *Ibid.*

108. See note 83 *supra*.

THIRD PARTY'S RIGHT TO CONTRIBUTION AND INDEMNITY UNDER WORKMEN'S COMPENSATION IN TENNESSEE

The Tennessee Workmen's Compensation Act contains an exclusive liability clause which provides:

> The rights and remedies herein granted to an employee subject to Workmen's Compensation Law on account of personal injury or death by accident shall exclude all other rights and remedies of such employee, his personal representative, dependents, or next of kin, at common law or otherwise, on account of such injury or death.[1]

The problem to which this note is directed is whether this clause in the workmen's compensation act will be a bar to an action by a third party for contribution or indemnity against the negligent employer, where the employee has recovered from the third party who was also negligent. Since the decisions construing the Tennessee statute on this question have been limited to two in number, a large portion of this discussion will be given to a comparison of opinions from jurisdictions having statutory provisions similar to the one quoted above.

I. CASES CONSTRUING THE TENNESSEE STAUTUE

The first case to discuss the exclusive liability section of the Tennessee Workmen's Compensation Act was *Trammell v. Appalachian Electric Cooperative.*[2] The decedent in this case was killed by an explosion of an electric transmission line recloser which was located on a power line owned by the defendant Appalachian Electric Cooperative (hereinafter referred to as Co-op). Action was brought by the administrator against Co-op for the alleged negligence which was said to have caused the decedent's death. The defendant then filed a third-party complaint against the decedent's employer, Smith, seeking full indemnity for any damages which it might be called upon to pay because of decedent's death. The basis for Co-op's complaint was a then existing contract with Smith, which it alleged included a contract for indemnity. Smith then moved that the third-party complaint be dismissed since the decedent was his employee under the Tennessee Workmen's Compensation Act, which thus limited his liability to that provided for by the statute. Whether the exclusive liability section of the Tennessee Act is a bar to an action by a third party on a contract for indemnity was never reached in this case since the contract between Smith and Co-op was interpreted as containing no agreement whatsoever to indemnify Co-op.

1. TENN. CODE ANN. § 50-908 (1956).
2. 135 F. Supp. 512 (E.D. Tenn. 1955).

Equitable indemnity[3] was placed upon the same ground as contribution,[4] and the court felt that neither could be allowed since they would both involve a third-party procedure which was forbidden under the federal rules of procedure.[5] Third-party procedure requisite for an action for contribution or equitable indemnity in the suit against the third party by the employee would also be forbidden under present Tennessee law.[6]

The recent case of *Moretz v. General Electric Company*,[7] is the only other decision which has considered the exclusive liability section of the Tennessee Workmen's Compensation Act, and it is the first to consider the effect which this provision has upon an action for indemnity under Tennessee law.[8] Action was brought in the district court of Virginia by a citizen of Tennessee against General Electric (hereinafter referred to as G.E.), a New York corporation, for negligence in loading a trailer which Moretz drove for Mason and Dixon Lines, Inc. (hereinafter referred to as Mason-Dixon). Over the objection of the plaintiff, Moretz, the defendant was permitted to implead the plaintiff's employer, Mason-Dixon, in an attempt to secure contribution or indemnity for any amount which G.E. might be called upon to pay Moretz. The facts of this case and the opinion subsequently written on appeal deserve close scrutiny. When the "city driver" of Mason-Dixon picked up the trailer which was loaded for Mason-Dixon by G.E., he noticed that the cargo was improperly braced so he made this fact known to the G.E. loading dock personnel. They refused to brace the load and said that even if it did shift no damage would occur. The "city driver" then took the loaded trailer to the Mason-Dixon terminal and informed personnel there of the improper loading. A promise was made to attend to the matter. When Moretz arrived to take the shipment to Kingsport, Tennessee, he made the customary inspection and found that the trailer had been sealed. While on the road the load shifted, the truck overturned, and Moretz was severely injured. Issues of negligence as to all three of the above parties were submitted to a jury. A verdict was rendered in favor of Moretz against

3. Equitable indemnity is distinguished from contractual indemnity and is treated as being merely an enlargement of the remedy of contribution. *Id.* at 515.

4. The court here cites the leading Tennessee cases which seem to recognize contribution between joint tortfeasors. *Id.* at 515.

5. Fontenot v. Roach, 120 F. Supp. 788 (E.D. Tenn. 1954).

6. TENN. CODE ANN. § 20-120 (1956). This section, relating to additional defendants brought in by a cross action, was repealed by Tenn. Acts 1957, ch. 33, § 1.

7. 170 F. Supp. 698 (W.D. Va. 1959).

8. Since the prior case of Trammell v. Appalachian Elec. Co-op., *supra* note 2, was decided on the basis that no contract of indemnity existed, the effect of such a contract upon the exclusive liability clause of the workmen's compensation act was never determined.

G.E. The jury was instructed that they could not find a verdict for the plaintiff against his employer, Mason-Dixon, because of the Tennessee Workmen's Compensation Act; but a special verdict was given to determine the negligence as between G.E. and Mason-Dixon, and it was found that Mason-Dixon was guilty of negligence which was a proximate cause of Moretz's injury. The court felt that normally both G.E. and Mason-Dixon would be jointly liable to Moretz as a result of their concurrent negligence,[9] but since the rights of Moretz against Mason-Dixon were fixed by the Tennessee Workmen's Compensation Act at the time of the accident, this was held to prevent G.E. and Mason-Dixon from being liable as joint tortfeasors.[10] The passive negligence of Mason-Dixon in failing to correct the load after gaining knowledge of the condition was not sufficient to insulate G.E. from liability, since G.E. had been actively negligent in improperly loading the truck. Contribution was governed by a Virginia statute[11] which limits contribution to a situation where the original party plaintiff has a right of action against the alleged joint tortfeasor. Since Moretz had no right of action against Mason-Dixon because of the exclusive liability provision of the Tennessee Workmen's Compensation Act, contribution was refused G.E. For indemnity to lie the court ruled that there must be either an express or an implied contract guaranteeing such, and since neither was found the court granted Mason-Dixon's motion to dismiss.

Upon appeal the above decision of the district court was reversed, and G.E. was allowed indemnity from Mason-Dixon.[12] The court of appeals felt that the district court erred in its conclusion as to the effect of the obligations imposed upon Mason-Dixon by certain interstate commerce regulations,[13] and the court found that the above

9. The jury found G.E. guilty of negligence and by a special verdict the jury also found that Mason-Dixon was guilty of negligence which was a proximate cause of the plaintiff's injury. Under these conditions the court felt that Mason-Dixon and G.E. would be concurrently negligent and jointly liable. Moretz v. General Elec. Co., 170 F. Supp. 698, 703 (W.D. Va. 1959) (citing RESTATEMENT, TORTS § 452 (1934)).

10. The court reasoned that since Mason-Dixon's exclusive liability to Moretz was under the Tennessee Workmen's Compensation Act it could not be liable as a joint tortfeasor with G.E. *Id.* at 703.

11. VA. CODE ANN. § 8-627 (1950).

12. General Elec. v. Moretz, 270 F.2d 780 (4th Cir. 1959).

13. 49 C.F.R. § 192.9 (a), (b) (1959) and 49 C.F.R. § 193.9 (a), (b) (1949) provide that no motor carrier shall permit any motor vehicle to be driven if the load is improperly loaded or secured, and that the load on every motor vehicle shall be properly distributed, secured if necessary, and that all means of fastening the load be properly inspected. 24 Stat. 383 (1887), 49 U.S.C. § 20(11) (1958), made applicable to motor carriers by 49 Stat. 563 (1935), 49 U.S.C. § 319 (1958), provides that any common carrier receiving property for interstate transportation shall issue a bill of lading therefor and shall be liable to the holder for any loss, damage or injury to the property caused by it, and that no contract may be made which will exempt the carrier from this liability.

regulations should be considered as forming a part of the contract between G.E. and Mason-Dixon, with the result that Mason-Dixon was liable to G.E. for any loss caused by its failure to comply with these obligations. Mason-Dixon was not excused from performing its contractual obligation even though G.E. was found to be negligent. Indemnity was thus allowed G.E. on the basis of an express contract by Mason-Dixon to perform its duties with due care. From this express contract the court implied a contract of indemnity for it was felt that such a contract was of the essence of the contract to carry the goods in a safe manner. The court then ruled that indemnity would not be barred in this case by the fact that another case was pending between the employer, Mason-Dixon, and the employee under the Tennessee Workmen's Compensation Act, which statute Mason-Dixon alleged excluded all other remedies against it arising out of the present injury.

Therefore, from the cases interpreting the exclusive liability clause of the Tennessee Workmen's Compensation Act, the result is that this decision by the Court of Appeals for the Fourth Circuit in overruling the decision of the district court discloses at least one inroad which may be used in this circuit to obtain indemnity in the face of the exclusive liability clause of the Tennessee Act. The case of *Trammell v. Appalachian Electric Cooperative*[14] recognizes another instance where the employer's liability is not limited to the amount granted under the Workmen's Compensation Act: namely, where the employer has expressly agreed to indemnify the third party for any loss which he might sustain as a result of the negligence of the employer. The decisions which have been discussed above are at present the only reported opinions dealing with the topic of this note. Since they are federal court decisions, whether or not a third party may require contribution or indemnity from an employer who is covered by the Tennessee Workmen's Compensation Act is still an open question for the Tennessee courts.

II. Contribution and Indemnity in Workmen's Compensation Cases

In all of the decisions to be discussed in this note, the third party is seeking either contribution or indemnity from the employer. He is in effect seeking complete reimbursement from the employer or at least payment of some portion of a judgment which he will have to pay to the employee. The third party may seek indemnity on the grounds of an express contract to indemnify,[15] or he may allege that a contract of indemnity should be implied from an agreement to

14. 135 F. Supp. 512 (E.D. Tenn. 1955).
15. Yearicks v. City of Wildwood, 23 N.J. 379, 92 A.2d 873 (1952).

perform services with reasonable care,[16] or he may seek to recover on the basis of an independent duty which is owed him by the employer.[17] Although some courts have denied indemnity on the basis of contributory negligence,[18] it has been suggested that the requirement of freedom from negligence has no place in an action for indemnity.[19] Although indemnity and contribution have been treated as being of the same genus,[20] certain distinctions are pertinent in this consideration of their effect upon workmen's compensation. Despite the fact that courts often confuse the two,[21] contribution is quite generally denied one of two joint tortfeasors,[22] but the courts are fairly liberal in permitting indemnity[23] which completely reimburses one of the parties. All courts seem to recognize the validity of an express contract of indemnity even though the defense of exclusive liability under a workmen's compensation act is interposed.[24] The conflicting views arise where there is no such contract and the third party requests indemnity on one of the bases which will be discussed subsequently in this article.

III. The Exclusive Liability Clauses

To protect the employer from liability other than that prescribed by the particular workmen's compensation act, the statutes provide an exclusive liability clause.[25] Some of these clauses are quite comprehensive, and if interpreted literally would bar any action by a third party against an employer who has come within the provisions of the act. One such clause is found in the New York statute:

> The liability of an employer . . . shall be exclusive and in place of any other liability whatsoever, to such employee, his personal representatives, husband, parents, dependents or next of kin, or anyone otherwise entitled

16. Metzenbaum v. Golwyne Chem. Corp., 159 F. Supp. 648 (S.D.N.Y. 1958) (indemnity rested on the freight line's implied agreement to perform its contract with reasonable care).
17. McDonnell Aircraft Corp. v. Hartman-Hanks-Walsh Painting Co., 323 S.W.2d 788 (Mo. 1959).
18. See Davis, *Indemnity Between Negligent Tortfeasors: A Proposed Rationale,* 37 Iowa L. Rev. 517, 558 (1952).
19. *Id.* at 557; General Elec. Co. v. Moretz, 270 F.2d 780 (4th Cir. 1959) (third party entitled to indemnity from employer even though both were found to be negligent); American Export Lines v. Revel, 266 F.2d 82 (4th Cir. 1959) (negligence of shipowner in supplying defective equipment not a bar to his contractual right of indemnity).
20. Slattery v. Marra Bros., 186 F.2d 134 (2d Cir. 1951); Trammell v. Appalachian Elec. Co-op., 135 F. Supp. 512 (E.D. Tenn. 1955).
21. Prosser, Torts § 46 n.74 (2d ed. 1955).
22. For a discussion of the confusion which has surrounded this term see Prosser, *op. cit. supra* note 21, at 233; Davis, *supra* note 18, at 537.
23. Prosser, *op. cit. supra* note 21, at 249-50.
24. *E.g.,* Trammell v. Appalachian Elec. Co-op., 135 F. Supp. 512 (E.D. Tenn. 1955); Yearicks v. City of Wildwood, 23 N.J. 379, 92 A.2d 873 (1952).
25. For Tennessee's exclusive liability clause see text at note 1 *supra.*

to recover damages, at common law or otherwise on account of such injury or death . . . .[26]

Although this statute specifically states that the liability of the employer to "anyone otherwise entitled to recover damages" shall be limited by his liability under the act, this has not prevented a third party from obtaining indemnity from an employer covered by this act.[27] Although the Tennessee exclusive remedy clause merely states that the exclusive *remedy* of the *employee* and those claiming through him shall be limited by the act,[28] a similar clause in the North Carolina statute[29] has been held to exclude any claims for indemnity by a third party against the employer.[30] A comparison of the wording and results obtained under these very different clauses demonstrate the general conclusion that the wording of the exclusive remedy or liability clauses is not controlling.[31] There are, however, exceptions to this statement, and the New Mexico court provides a prime example of such. In *Beal v. Southern Union Gas Company*,[32] the Supreme Court of New Mexico refused to allow contribution or indemnity in the absence of an express contract of indemnity. Liability of the employer was governed by the restrictive provisions of the workmen's compensation law:

> Any employer who has elected to and has complied with the provisions of this act, including the provisions relating to insurance, shall not be subject to any other liability whatsoever for the death of or personal injury to any employee, except as in this act provided; and all causes of action, actions at law, suits in equity, and proceedings whatsoever, and all statutory and common-law rights and remedies for and on account of such death of, or personal injury to any such employee and accruing to any and all persons whomsoever, are hereby abolished except as in this act provided.[33]

In dismissing the contention of the third party that the statute should not preclude indemnity, the court said:

> The authorities relied upon by appellant are distinguishable as arising under less restrictive limitation provisions or involving some relationship between the third party and the employer independent of joint negligence. Insofar as they may declare a contrary rule, however, we will not follow them.[34]

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26. N.Y. WORKMEN'S COMP. § 11.
27. Ryan Stevedoring Co. v. Pan-Atlantic S.S. Corp., 350 U.S. 124 (1956).
28. *Supra* note 1.
29. N.C. GEN. STAT. § 97-10 (1950).
30. Lovette v. Lloyd, 236 N.C. 663, 73 S.E.2d 886 (1953).
31. 2 LARSON, WORKMEN'S COMPENSATION § 76.30 (1952); Note, *Contribution and Indemnity: The Effect of Workmen's Compensation Acts,* 42 VA. L. REV. 959 (1956).
32. 62 N.M. 38, 304 P.2d 566 (1956).
33. N.M. STAT. ANN. § 59-10-5 (1953).
34. 304 P.2d at 568.

When the statutory language is as clear and compelling as that in the New Mexico statute the court may feel itself bound by it, but in statutes slightly less restrictive the courts have had little trouble in allowing indemnity.[35]

IV. INDEMNITY AND ITS RELATION TO THE EXCLUSIVE LIABILITY CLAUSES

A statement by Dean Prosser aptly summarizes the futility of attempting to logically explain the indemnity cases involving workmen's compensation:

> It is difficult to state any general rule or principle as to when indemnity will be allowed and when it will not . . . . Probably, as is so often the case in the law of torts, no one explanation can be found which will cover all the cases; and the duty to indemnify, like so many other duties, arises where community opinion would consider that in justice the responsibility should rest upon one tortfeasor rather than another.[36]

The following discussion is not an attempt to rationalize the conflicting results, but to collect and discuss the more recent workmen's compensation decisions which are concerned with the problem of indemnity.[37]

Only where there is an express contract of indemnity do the courts unanimously agree that indemnity may be allowed.[38] Where the United States and a stevedoring firm were joined as third party defendants in a suit by an injured longshoreman against the owner of the vessel which he was loading, the district court allowed the shipowner indemnity from the United States, and on a cross claim by the United States against the employer stevedoring firm it was held that the United States was entitled to indemnity even though the employer had paid workmen's compensation under the Virginia statute.[39] In allowing the United States indemnity the court said that where there was a breach of contract for safe handling no express contract of indemnity is necessary; it may be implied.[40] This leads to the second classification where indemnity may be recovered irrespective of any exclusionary clause in a workmen's compensation act.

Where there is an express contract to perform certain services, the

35. Attella v. General Elec. Co., 21 F.R.D. 372 (D.R.I. 1957); McDonnell Aircraft Corp. v. Hartman-Hanks-Walsh Painting Co., 323 S.W.2d 788 (Mo. 1959).

36. PROSSER, TORTS § 46 (2d ed. 1955).

37. See generally 2 LARSON, WORKMEN'S COMPENSATION § 76 (1952); Note, 42 VA. L. REV. 959 (1956) (collection of pertinent cases through 1955).

38. See note 24 *supra*.

39. Revel v. American Export Lines, 162 F. Supp. 279 (E.D. Va.), *aff'd*, 266 F.2d 82 (1959).

40. But in this case the court ruled that there was an express contract of indemnity. 162 F. Supp. at 288.

court may imply a contract of indemnity if the loss incurred was due to a breach of duty by the party performing the services. Thus where a contract provided, "to paint the new boiler room and equipment for General Electric Company at the Providence base plant and to furnish all necessary equipment and labor, etc., in connection therewith,"[41] the court construed this as a contract to paint the premises in a reasonably safe manner which carried with it an implied contract of indemnity. As a result of this construction General Electric Company was allowed indemnity from the injured painter's employer, who set up the workmen's compensation act as a bar to the third-party complaint. This same rationale was used in *Pearson v. National Trust for Historic Preservation*[42] where the court ruled that even though no express contract of indemnity existed, the case was indistinguishable from *Ryan Stevedoring Company v. Pan-Atlantic Steamship Corporation*,[43] which had implied a contract of indemnity from the express contract to perform the job in a workmanlike manner.

In *San Francisco Unified School District v. California Building Maintenance Company*,[44] an action was brought against a maintenance company, as employer, by the school district to recover the amount paid the employee window-washer in satisfaction of a judgment which he had obtained as a result of injuries sustained when he fell while washing a defective window. The employer maintenance company set up the defense of payment under the workmen's compensation act. In allowing the school district indemnity, the court said that even though there was no express contract of indemnity one would be implied since this action was similar to a breach of warranty; and since the action was not based upon the tortious conduct of the employer, the doctrine of active-passive negligence[45] had no application.

The recent case of *Bowman v. Atlanta Baggage & Cab Company*[46] represents another situation where *limited* indemnity was allowed. The plaintiff was injured while driving a truck for his employer, Western Union Telegraph Company (hereinafter referred to as Western Union), when he collided with the defendant's truck, driven

41. Attella v. General Elec. Co., *supra* note 35, at 373.
42. 145 F. Supp. 378 (D.D.C. 1956).
43. 350 U.S. 124 (1956) (third party complaint based on breach of obligation to shipowner by employer to perform its work in a reasonably safe manner). *Accord:* Metzenbaum v. Golwyne Chemicals Corp., 159 F. Supp. 648 (S.D.N.Y. 1958) (indemnity rested on freight line's implied agreement to perform its contract with reasonable care).
44. 328 P.2d 785 (Cal. App. 1958) (case arose as one might in Tennessee since there was no third party procedure).
45. For a discussion of the doctrine of active-passive negligence in workmen's compensation cases see 2 LARSON, WORKMEN'S COMPENSATION § 76.44 (1952).
46. 176 F. Supp. 575 (N.D. Fla. 1959).

by another employee of Western Union but rented from the defendant. The injured employee collected workmen's compensation from Western Union and then brought this action against the defendant. Indemnity was sought from Western Union who was joined in the action as a third party defendant. The court disallowed Western Union's defense of full satisfaction under the workmen's compensation act, but it did allow the amount paid under the act to be pro tanto satisfaction of any liability to the defendant. The court reasoned that since Western Union had a statutory lien for the amount paid under the workmen's compensation act against any judgment which the plaintiff might receive from the defendant, it should be entitled to a pro tanto set-off against any amount sought by the defendant as indemnity. It would seem that the result obtained by this reasoning is unjustified. The statutory lien was against any amount which the employee recovered from the third party; yet this court allows the amount of the employer's lien to be set off against the third party's suit for indemnity. The court is thereby depriving the third party of full indemnity by permitting the employer to use against the third party a lien which exists against the employee. The results are the same to the employer whether or not this rationale is applied; the difference lies in the amount of indemnity allowed the third party.

In *McDonnell Aircraft Corporation v. Hartman-Hanks-Walsh Painting Company*,[47] the Supreme Court of Missouri spoke of "an independent duty" which the employer owed the third party. In this case an employee obtained workmen's compensation from the employer and a judgment against the third party for injuries which he received while painting the third party's plant. The third party was found to have had a non-delegable duty to warn the employee of the unsafe working conditions, but regardless of this fact the court ruled that if the allegations of the third-party petition were proved to be true the third party would be entitled to full indemnity.[48] It seems that the employer had expressly agreed to perform the non-delegable duty of the third party to warn the employee, and from this the court said that the workmen's compensation act would not bar indemnity since the employer had breached an independent duty to the third party which it had expressly agreed to perform.

The most frequently used reason for refusing indemnity is that the employer's exclusive liability is under the workmen's compensation act. Thus in *Hill Lines, Inc. v. Pittsburg Plate Glass Company*,[49] indemnity and contribution were both denied when the court found that

47. 323 S.W.2d 788 (Mo. 1959).
48. The court adopted RESTATEMENT, RESTITUTION §§ 76, 95, 96 (1937) as the basis for its decision. 323 S.W.2d at 793-94.
49. 222 F.2d 854 (10th Cir. 1955).

certain I.C.C. regulations were not sufficient to form an independent duty on the part of the employer to indemnify the third party.[50] In *Beal v. Southern Union Gas Company*,[51] a contractor's employees brought an action against the gas company for injuries sustained by a gas explosion which occurred in the course of their employment. When the employer-contractor was brought in as a third-party defendant, the court stated that his liability was limited by the workmen's compensation act since no express or implied contract of indemnity had been found. To the same effect are *Migias v. United States*[52] and *Svedlund v. Pepsi Cola Bottling Company of Hawaii*.[53]

Where the insurer of a subcontractor machinery company sought indemnity from the construction contractor and the liability and compensation insurer of the contractor for the amount paid the employee of the subcontractor, the court refused to allow the recovery on a ground which is frequently mentioned by the courts in these cases. The liability of the contractor to the injured employee of the subcontractor was under the Louisiana Workmen's Compensation Act. This liability was remote and *secondary* to the *primary* liability of the subcontractor and its compensation insurer. This doctrine of primary and secondary liability[54] was again discussed in *Sientki v. Haffner*[55] where a defendant third party sought indemnity from the deceased's employer. The court ruled that the claim for indemnity failed to state a cause of action upon which relief could be granted since the employer's negligence was secondary, if any, and that even if a cause of action were stated it would be barred by the exclusive liability clause of the New Jersey Workmen's Compensation Act.

Another ground for refusing indemnity was considered in *Reed v. New England Telephone and Telegraph Company*.[56] The employees of an electric company were injured when a pole on which they were working broke. The pole was owned by the telephone company but occupied jointly with the electric company. When the telephone company was sued it moved to bring in the electric company as a third-party defendant from which it might seek indemnity. The defense that no contribution or indemnity will be allowed joint tortfeasors was raised,[57] but the case was actually decided on the theory

50. *Cf.* General Elec. v. Moretz, 270 F.2d 780 (4th Cir. 1959).
51. 62 N.M. 38, 304 P.2d 566 (1956).
52. 167 F. Supp. 482 (W.D. Pa. 1958) (action by United States for indemnity from contractor covered by Pennsylvania Workmen's Compensation Act).
53. 172 F. Supp. 597 (D. Hawaii 1959) (action for indemnity against Marine Corps Exchange and against United States for amount which Pepsi Cola might be required to pay enlisted man for injuries caused by explosion of drink bottle).
54. See 2 LARSON, *op. cit. supra* note 45, at 238-41; Davis, *supra* note 18, at 539-44.
55. 145 F. Supp. 435 (S.D.N.Y. 1956).
56. 175 F. Supp. 409 (D.N.H. 1958).
57. See PROSSER, TORTS 246-51 (2d ed. 1955).

that to allow indemnity would violate the purpose of the workmen's compensation statute by requiring the employer to pay more than his statutory limit under the act.

Although indemnity was also refused on the basis that exclusive liability was under the workmen's compensation act, the court in *Bertone v. Turco Products*[58] implied that the doctrine of active-passive negligence would not be accepted in New Jersey and that therefor the claim of the defendant failed to state a cause of action.

V. CONTRIBUTION AND ITS RELATION TO THE EXCLUSIVE LIABILITY CLAUSES

The question to be considered in this section is whether a third party who is liable in tort to an employee may recover contribution from the employer whose negligence concurred in causing the injury when the employer is liable to the employee under a workmen's compensation act.[59] Although it is hazardous to make any general statement as to a third party's right to indemnity, absent an express contract to indemnify, it may be safely stated that the majority of the courts even in jurisdictions which permit contribution between joint tortfeasors[60] have refused to allow contribution from the employer who is covered by a workmen's compensation act.[61] A denial of contribution has been founded upon two theories: that the employer's liability is limited by the act, and that no common liability exists between the employer and the third party.

In *Hill Lines, Inc. v. Pittsburg Plate Glass Company*[62] the third-party tortfeasor sought indemnity and contribution from the employer. Even though New Mexico allowed contribution between joint tortfeasors by virtue of a joint tortfeasor's act, it was held that the employer's exclusive liability was under the workmen's compensation act; and indemnity and contribution were refused the third-party tortfeasor. Again in *Beal v. Southern Union Gas Company*[63] contribution was refused on the grounds that the employer's liability was limited by the workmen's compensation act[64] and that since the

58. 252 F.2d 726 (3d Cir. 1958) (manufacturer of cleaning solution sought indemnity on ground that employer was negligent in failing to warn of dangers of cleaning fluid).

59. See generally Annot., 53 A.L.R.2d 977 (1957); 2 LARSON, *op. cit. supra* note 45, at 230; Davis, *supra* note 18, at 963.

60. See note 57 *supra;* Sturdivant, *Joint Tortfeasors in Tennessee and the New Third-Party Statute,* 9 VAND. L. REV. 69, 71 (1955) (contribution allowed in Tennessee except where conduct of parties is such as to deny them use of the courts).

61. See note 59 *supra.*

62. 222 F.2d 854 (10th Cir. 1955).

63. 62 N.M. 38, 304 P.2d 566 (1956).

64. *Accord:* Reed v. New England Tel. & Tel. Co., 175 F. Supp. 409 (D.N.H. 1958) (exclusive liability under the act).

employer's liability was limited by the act he could not be liable in tort, and therefore he was not required to contribute under the tortfeasor's contribution act.

The theory that contribution will be refused on the ground that no common liability exists between the third party and the employer was used by the Supreme Court of Wisconsin in *Wisconsin Power and Light Company v. Dean.*[65] In that case the third party sought contribution from the employer, who had already paid the employee workmen's compensation, on the ground that the employer's driver's negligence was a proximate cause of the injury. Although Wisconsin has a comparative negligence statute, the court ruled that the negligent third party could not hold the employer liable for contribution even though the employer was also negligent. Since the employer's liability was limited by the workmen's compensation act, the court reasoned that there could be no common liability because the act prevented the employee from proceeding against the employer on the ground of negligence.[66]

Pennsylvania seems to be the only jurisdiction which allows the third party contribution against the employer, and even there the amount of contribution is limited. Thus in *Brown v. Dickey*[67] the administrator of a deceased employee brought an action against a third-party tortfeasor, and the employer was joined as a third-party defendant. The jury found both the third party and the employer equally guilty of negligence. Following the decision in *Maio v. Fahs*[68] the Supreme Court of Pennsylvania allowed the third party contribution, but the amount of contribution was restricted to the limit placed upon the employer by the workmen's compensation act. In so holding, the court stated:

> There is no common liability based on tort, for the employer is simply not liable in tort. He retains only the statutory liability. To allow the third party tortfeasor even the limited right of contribution up to the amount of the employer's Workmen's Compensation liability, as we do in Pennsylvania, is most generous indeed. He is not so well treated in other jurisdictions. . . . The limited right of contribution that does exist in Pennsylvania is based on the equitable principle that the plaintiff should not recover twice for the same wrong. (Citations omitted)[69]

Although a third party may not obtain contribution or indemnity

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65. 275 Wis. 236, 81 N.W.2d 486 (1957).

66. *Accord:* Bertone v. Turco Products, 252 F.2d 726 (3d Cir. 1958) (because employee could not maintain action against employer the employer was not liable in tort).

67. 397 Pa. 454, 155 A.2d 836 (1959).

68. 339 Pa. 180, 14 A.2d 105 (1940) (employer held liable to third party for contribution).

69. 155 A.2d at 840.

from the employer as a third party defendant in North Carolina,[70] a similar result of limited contribution as allowed in Pennsylvania is reached by permitting the third party to set up the contributory negligence of the employer as a defense pro tanto to the latter's recovery in a subrogation suit.[71] In discussing the method of contribution used in North Carolina, the district court in *Moretz v. General Electric Company*[72] concluded:

> The legislature of the state of Tennessee has not seen fit to introduce this doctrine into the Tennessee Workmen's Compensation Law. Equitable considerations to the contrary notwithstanding, modification of the law of a state is a prerogative of the legislature of the state and not within the province of this Court.[73]

VI. Policy Considerations

As the equities vary with the facts from case to case, it is easy to appreciate the difficulties which have faced the courts as they have attempted to determine whether or not a negligent employer should be compelled to bear the entire loss through indemnity or whether he should share the cost through contribution to a negligent third party. When the facts are like those in *Brown v. Dickey*,[74] it would be extremely harsh to compel the third party to bear the entire loss. For in that case the third party and the employer were found to be equally guilty of negligence. Must a court say in a situation such as this that the workmen's compensation act forbids contribution or indemnity to a third party? The argument has been made quite forcibly that the third party who is a stranger to the act and who receives no quid pro quo should not be excluded from contribution or indemnity merely because he happened to injure an employee who was covered by the act.[75]

On the other hand, it would hardly be equitable to require an employer to submit to a common-law liability without having the benefit of any of his common-law defenses such as contributory negligence, assumpton of risk and the fellow servant rule. For in a case involving injury to an employee covered by the act, the employer is deprived of these common-law defenses. If the employee then recovers from

70. Brown v. Southern Ry, 202 N.C. 256, 162 S.E. 613 (1932) (exclusive liability clause of workmen's compensation act barred action to hold employer liable as joint tortfeasor).

71. Lovette v. Lloyd, 236 N.C. 663, 73 S.E.2d 886 (1933).

72. 170 F. Supp. 698 (W.D. Va. 1959).

73. *Id.* at 707.

74. 397 Pa. 454, 155 A.2d 836 (1959).

75. McDonnell Aircraft Corp. v. Hartman-Hanks-Walsh Painting Co., 323 S.W.2d 788 (Mo. 1959).

the third party and the employer is required to give contribution or indemnity, he will be required to do so without ever having had the opportunity to use any defense which he might have had against the employee.[76] But perhaps the most frequently expounded defense for exclusive liability is that proffered in *Reed v. New England Telephone and Telegraph Company*[77] where the court said:

> The policy of this law would be circumvented if the employee may obtain a possibly larger verdict from a third party, and if the third party is permitted to obtain indemnity from the employer. The result would be that the employee might ultimately obtain on account of his injuries an amount from his employer larger than that recoverable under the Workmen's Compensation Law.[78]

As previously demonstrated, the policy considerations are quite evenly balanced both for and against allowing contribution or indemnity in the face of an exclusive liability clause. The divergence of views can be rationalized on this basis: "The conflicting opinions among circuits dealing with these situations can best be explained as one of legal resourcefulness, used to reach the just result called for by the facts. . . ."[79]

VII. Conclusion

As noted above, the question of whether contribution or indemnity will be allowed in Tennessee in the face of the exclusive liability section of the workmen's compensation act is still open for decision. The inroads into exclusive liability have been sufficiently established so that the court will have some precedent for any decision which it makes. Absent legislation, Tennessee's course will probably depend upon the weight of persuasiveness which the facts present for allowing the third party relief against the employer. It would certainly seem desirable for a party to know in advance the measure of contribution or indemnity which he might be allowed from a negligent employer when the third party has been so unfortunate as to injure an employee covered by the workmen's compensation act. At least two writers[80] have suggested that this problem is one for the legislature to determine, and such a situation as that which

76. See Brown v. Dickey, *supra* note 74, at 838.

77. 175 F. Supp. 409 (D.N.H. 1958).

78. *Id.* at 410.

79. Svedlund v. Pepsi Cola Bottling Co. of Hawaii, 172 F. Supp. 597, 601 (D. Hawaii 1959).

80. 2 Larson, Workmen's Compensation § 76.63 (1952); Note, *Contribution and Indemnity: The Effect of Workmen's Compensation Acts*, 42 Va. L. Rev. 959, 976 (1956).

existed in *Brown v. Dickey*[81] clearly illustrates that court decisions alone are insufficient in this area.

THOMAS H. RAINEY, JR.

81. While concurring in the decision to allow the third party the limited right of contribution up to the amount of the employer's workmen's compensation liability, Justice Jones presented this view of the existing state of the law:

> "While I believe that in the present posture of the law the result reached by the majority of this Court is correct, yet I strongly believe that the result is inequitable and unfair. The jury found Brown and Dickey *equally* liable to the injured person: under the result reached Brown must pay in discharge of this *equal* liability more than 90% of the amount of the verdict, a most shocking situation. To correct such a situation appropriate legislation is required." 155 A.2d at 838.