Question 3

Molly and Ruth were partners in the operation of a dry cleaning store. Recent government environmental regulations relating to dangers posed by dry cleaning fluids increased their exposure to liability and caused a decline in their business. Molly and Ruth decided to convert their partnership into Dryco, Inc. ("Dryco"), a corporation, to limit their potential personal liability.

Molly and Ruth each contributed $20,000 in cash to Dryco. In return, each received a $15,000 promissory note from Dryco and 5,000 shares of stock with a value of $1 per share.

Prior to incorporation, Molly entered into a contract on behalf of Dryco with Equipment Company ("EC") for the unsecured credit purchase of an environmentally safe dryer for $100,000. EC was aware that Dryco had not yet been formed. EC delivered the dryer one week after the incorporation, and Dryco used it thereafter and made monthly installment payments.

Dryco had been incorporated in compliance with all statutory requirements, and Molly and Ruth observed all corporate formalities during the period of Dryco's existence. One year after incorporation, however, Dryco became insolvent and dissolved. At the time of the dissolution, Dryco's assets were valued at $50,000. Its debts totaled $120,000, consisting of the two $15,000 notes held by Molly and Ruth and a $90,000 balance due EC for the dryer.

1. As among EC, Molly, and Ruth, how should Dryco's $50,000 in assets be distributed? Discuss.

2. On what theory or theories, if any, can Molly and/or Ruth be held liable for the balance owed to EC? Discuss.

Answer A to Question 3

1. Distribution of Dryco's $50,000 in Assets

Valid De Jure Corporation

A corporation is conclusively formed when the articles of incorporation are filed with the state. Here, the facts indicate that Dryco had been incorporated in compliance with all statutory compliances. Therefore, Dryco will be treated as a de jure corporation.

The Equipment Company Contract (EC)

Whether EC will have a claim to Dryco's assets on dissolution depends on whether EC's pre[-]incorporation contract with Molly as a promoter was adopted by Dryco.

A corporation is not liable for pre-incorporation contracts unless the corporation adopts the contract. Since Dryco did not exist at the time the contract was made, it can have liability unless: i) the corporation expressly adopts the contract (i[.]e[.,] through board resolutions or ii) the corporation accepts or retains benefits from the contract and therefore impliedly adopts the contract.

On these facts, Dryco accepted the dryer, used it, and made monthly payments on it. Even though EC was aware that Dryco had not yet been formed, Molly entered the contract on Dryco's behalf. Further the dryer was delivered after incorporation. EC will argue that Dryco's acceptance and use of the dryer constitutes implied adoption, and will likely prevail.

Therefore, EC has a valued unsecured claim against Dryco's assets.

Promissory Note

Promissory Notes are debt securities of a corporation. The holders of these notes have a creditor/debtor relationship with the corporation, and are on equal grounds with other unsecured creditors of the corporation.

Shareholders' Claims

Shareholders own an equity interest in a corporation. Shareholders are not entitled to distribution of a dissolved corporation's assets until all debts of the corporation have been satisfied.

Distribution

EC and Molly and Ruth stand on equal footing as unsecured creditors. As shareholders, Molly and Ruth will receive no part of the $50K, as explained above.

As between unsecured creditors, however, there is a possibility that Molly/Ruth's claim will be subordinated by a court to EC's claim, based on corporate veil piercing principals [sic] due to inadequate capitalization at the outset of the corporation.

Piercing the Corporate Veil

A corporation is a separate legal entity designed to insulate its officers, directors, and shareholders from personal liability. However, the corporate form will be ignored in some circumstances, including when i) the corporation is acting as the alter ego of the shareholders or ii) when there was inadequate capitalization of the corporation at the outset.

Inadequate capitalization is determined by looking at if the corporation had adequate funds to meet its prospective liabilities. The time between incorporation and dissolution is also considered.

Here, Dryco was funded with $40,000, and dissolved within one year. The short time in existence may be an indication that the corporation was not adequately funded. However, it is unclear from these facts what caused Dryco's dissolution. If Molly/Ruth were aware of increasing environmental costs and liability, $40,000 may not have been sufficient. If this is so the corporate veil will be pierced. (Desire to shield from personal liability from environmental regulation is not enough to pierce the veil in and of itself.)

When shareholders use the corporation[']s assets as their own or otherwise ignore corporate formalities, the corporate form may be ignored to hold the SHs personally liable for the corp's debts[.] Here, there is no indication that Ruth/Mary used Dryco's assets as their own, and they did observe all corporate formalities. Therefore, the veil will not be pierced on this theory.

Since the veil can be pierced due to inadequate capitalization, however, Ruth/Mary's claim on the unsecured notes will be subordinated to EC's claim. EC will receive the entire $50,000.

In the event the claims are not subordinated, EC, Mary and Ruth will equally divide the $50,000.

2. Molly and[/] or Ruth's liability

A corporation is a separate legal entity that insulates its SHs from personal liability. As discussed above, Dryco was a de jure corporation. Unless circumstances exist to pierce the corporate veil, Ruth/Mary will not be liable to EC for the excess debt.

Piercing the Veil

As explained above, the corporate veil may be pierced for inadequate capitalization at the outset. Also as explained above, if the veil is pierced, Ruth/Mary will be liable to EC for the $40,000 of unpaid debt.

Promoter Liability

When a promoter raises capital or enters contracts on behalf of a [sic] unformed corporation, the promoter is personally liable on those contracts. Absent novation, this liability remains even if the corporation has adopted the contract.

Here, Molly entered the contract with EC on behalf of Dryco. Therefore, absent novation, she is personally liable. There is no indication of a novation here, so Molly will be liable for the 40K even though Dryco adopted the K.

Ruth may be liable based on vicarious liability. Ruth and Molly were joint venturers, co-promoters, so EC may try to reach Ruth on this theory, or at minimum, Molly may seek contribution from Ruth. Since Ruth did not sign the contract[,] however, this theory will likely fail.

Answer B to Question 3

3)

1. Distribution of $50,000 of Dryco's assets

Dryco has [sic] $120,000 in debt at the time the corporation became insolvent. This includes the $30,000 in promis[s]ory notes to Molly and Ruth, and the $90,000 still owed to EC, for the environmentally safe dryer. Dr [sic]

Pre-incorporation contract

The issue is whether the debt to Equipment is owed by the corporation. Corporations are only liable for pre-incorporation contracts that they adopt. Here before the corporation was formed, Molly entered into a contract for the the [sic] purchase of the dryer. The facts do not indicate that there was an express adoption of this contract. However the fact that after the corporation was formed, the dryer was delivered to Dryco, used by Dryco, and the monthly installment payments totaling $10,000 were made by Dryco, is sufficient to establish that Dryco impliedly adopted this contract. Furthermore without the Dryer the business might not be able to comply with the governmental regulations imposed on the drycleaning industry. Therefore the dryer is an essential piece of equipment to Dryco and its adoption of the purchase contract entered into by Molly[.]

Inside/Outside Debt

Dryco only has $50,000 in assets, and has $120,000 in debt. Therefore it must be determined which creditors have prio[r]ity for satisfaction. In determining which creditors will be satisfied first the court will generally, in the interest of fairness, subvert inside debt, and allow outside debt to be satisfied first. The reason for this is that the insiders, Molly and Ruth, could have given the $15,000 for stock interests, which would only receive distributions after creditors are satisfied.

Here Molly and Ruth elected to make $15,000 of their $20,000 contribution as a loan. They were trying to insulate themselves further from any potential losses, by only putting at risk the $5,000 for their stock. The court will not allow inside shareholders to try to put their equity investment on an equal level with outside creditors who have no equity interest in the corporation.

Therefore EC should be given priority as an outside creditor and should receive the $50,000 that Dryco has. Molly and Ruth's interest will be subverted to EC's interest and their loan will not be satisfied.

2. Molly and Ruth Personal Liability

After the $50,00 in assets are given to EC, EC is still left with $40,000 that has not been satisfied. EC will thus try to hold Molly and Ruth, as sole shareholders in Dryco[,] personally liable for the remaining debts.

Incorporator liability

Prior to incorporation Molly entered into a contract with EC for the dryer. As a general rule, an incorporator is not relieved of liability of the pre-incorporation contract, until there has been a novation, that is[,] an agreement by all parties to relieve the incorporator of personal liability. Here Molly would have to show that both Dryco and EC to relieved[sic] Molly of personal liability. As discussed above, Dryco impliedly adopted the contract, and thus becomes primarily liable for the contract. However there is no indication that EC relieved Molly of her personal liability, and can be held secondarily liable, because there was no novation.

However, Molly can argue that the contract was entered into “on behalf of Dryco[.]” The corporation by estoppel doctrine holds that a party who knew the contrace[sic] was being entered into on behalf of a corporation is estopped from later claiming that the other party is personally liable. Molly can argue that because EC knew that Dryco had not been incorporated yet, but knew that Molly was entering “on behalf of Dryco” they should be estopped from claiming that Molly is personally liable.

Molly will likely be successful in this claim, and EC will be estopped from claiming that Molly was personally liable, because EC knew that Dryco was not yet incorporated, but still signed a contract “on behalf of Dryco”. It would therefore not be equitable for EC to be able to hold Molly personally liable under this theory[.]

Shareholder liability

As a general rule shareholders are not personally liable for the debts of the corporation. The shareholders only put at risk what they invest in the corporation. As discussed above Molly and Ruth each invested $20,000, which will all be treated as equity in Dryco. Therefore under the general rule Molly and Ruth will not be liable for the $40,000 remainder owed to EC.

However where it is necessary to prevent a fundamental unfairness courts may elect to pierce the corporate veil, and hold the shareholders personally liable. Courts generally elect to pierce the corporate where the corporation has attempted to defraud the corporation[‘]s creditors. Courts are much less likely to pierce the corporate veil for tort creditors than for contract creditors. Here EC was a contract creditor, so EC will have to have a very strong claim to succeed.

Courts will pierce the corporate veil where the shareholders of the corporation fail to follow corporate formalities, or where there [sic] corporation was inadequately capitalized at the time of formation.

Here the facts state that Molly and Ruth observed all corporate formalities. There are no facts to indicate that there was any com[m]ingling of personal and corporate funds, or that Molly or Ruth treated any of the corporate assets as their own.

EC will try to argue that Dryco was inadequately capitalized at the time of formation, that is[,] that Dryco would be unable to pay debts at the time they came due. Because the EC is a contract creditor they have to make a strong showing. Here Molly and Ruth put in a total of $40,000 cash. Because the inside claim will be subverted to EC claim the full $40,000 should be considered[.] EC wil[l] fail on this claim because the facts indicate that Dryco was able to make the monthly installment payments.

The court will likely find that there was no fundamental unfairness in this transaction, especially because EC was a contract creditor. EC could have protected itself by entering into a separate agreement with Ruth and Molly to agree to personally assume the debt. Because EC did not do this they cannot later claim Molly and Ruth['s] personal assets. Therefore Molly and Ruth will not be personally liable on this claim.

<u>Director liability</u>

As the sole shareholder[s] of Dryco, Molly and Ruth are probably the directors, and as such owe Dryco fiduciary duties of Loyalty and Due Care. Directors can be held personally liable for injuries caused from breaching this duty. However there are no facts suggesting a violation of these duties, such as self[-]dealing or uninformed decision making and [they] should not be held liable for breaching their fiduciary duties.