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Commonwealth of Kentucky

Court of Appeals

NO. 2008-CA-002266-MR

INTER-TEL, INC.; AND INTER-TEL
TECHNOLOGIES, INC. APPELLANTS

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE IRV MAZE, JUDGE
ACTION NO. 03-CI-005485

LINN STATION PROPERTIES, LLC;
AND INTEGRATED TELECOM
SERVICES CORPORATION APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: CAPERTON AND DIXON, JUDGES; HENRY,[1] SENIOR JUDGE.

[1] Senior Judge Michael L. Henry sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and Kentucky Revised Statutes (KRS) 21.580.

HENRY, SENIOR JUDGE: Inter-Tel, Inc. ("Inter-Tel") and Inter-Tel Technologies, Inc. ("Technologies") appeal from an opinion and order of the Jefferson Circuit Court granting a motion for summary judgment brought by Linn Station Properties, LLC. Inter-Tel is the parent corporation of Technologies, which was in turn the parent corporation of Integrated Telecom Services Corporation ("ITS"). ITS is now defunct. The sole issue on appeal is whether the circuit court correctly determined that the corporate veil of ITS may be pierced and that Inter-Tel and Technologies are consequently liable for a default judgment that Linn Station obtained against ITS. Having reviewed the circuit court's decision, we affirm.

This legal action stems from the breach of the lease of an office building located on Linn Station Road in Louisville, Kentucky. The lease was executed on December 4, 1997, between ITS, a provider of commercial telephone services, and Caldwell R. Willig, the owner of the building. Willig was also the principal shareholder and chairman of ITS. Under the terms of the lease, which ran for six years from January 1, 1998 to December 31, 2003, ITS was obligated to make non-structural repairs to the interior of the building, including maintenance and repair of the building's utility systems. The lease also contained an arbitration clause which governed any dispute under the lease, except the landlord's right to institute legal action with respect to a default in the payment of rent by the tenant.

On July 2, 1998, about seven months after the lease was executed, Technologies, a wholly-owned subsidiary of Inter-Tel, purchased all of the stock of

ITS. The purchase price for ITS was paid by Inter-Tel. Inter-Tel, an Arizona corporation, was a public holding company which conducted business only through its subsidiaries and affiliates. Its business was the manufacture, design, sale and service of telecommunication systems and related services primarily to business, rather than residential or individual, customers. Technologies, a subsidiary of Inter-Tel, was also incorporated in Arizona. It served as the retail branch of Inter-Tel, selling the hardware and software applications that comprise a telephone system. Prior to the acquisition of ITS, Inter-Tel did not have a direct sales office in Kentucky, nor did Technologies. After the July sale, the ITS offices became direct sales offices for Inter-Tel by and through Technologies. As a result of the purchase, ITS employees became employees of Technologies.

Almost one year later, on July 29, 1999, Linn Station Properties LLC purchased the office building and the interest of Willig as the landlord in the lease. Inter-Tel thereafter paid rent on behalf of ITS directly to Linn Station, for a period of approximately three years.

In early January 2002, Linn Station entered into negotiations to sell the property. It contacted Technologies in order to obtain a tenant estoppel certificate. John L. Gardner, general counsel for Inter-Tel and Technologies, wrote to counsel for Linn Station advising him that "Inter-Tel Technologies, Inc. is not a tenant on the lease, and accordingly I cannot sign the tenant estoppel certificate." Gardner nonetheless forwarded a tenant estoppel certificate which he had signed on behalf of ITS.

In February 2002, Linn Station discovered that ITS had failed to repair and maintain the premises as required under the lease. In a letter dated March 1, 2002, Linn Station informed ITS that the cost of the repairs was over $91,000.00. ITS abandoned the premises in May 2002 without performing the repairs or paying for their cost. Linn Station thereafter attempted to invoke the arbitration provision of the lease and sent a letter to ITS regarding the non-payment of rent for the month of May.

Gardner responded by letter dated May 21, 2002, which stated in part as follows:

> Pursuant to your letter of May 8, 2002, please be advised of the following: Inter-Tel Technologies, Inc. is the parent company of [ITS]. ITS, which is the only lessee on the lease dated December 4, 1997, is now a defunct corporation without any assets. ITS abandoned this space on or about May 31, 2002. For the entire period of time that ITS occupied the space, rental was timely paid. Being defunct and having no assets, there is no need for ITS to participate in an arbitration or legal proceeding. Accordingly, you may take a default against ITS in either proceeding. The parent company neither guaranteed the lease nor agreed to assume liability for same and will not pay the damages claimed.

Nonetheless, throughout the summer and fall of 2002, the American Arbitration Association attempted to process Linn Station's request for arbitration. During the same period, Linn Station filed a civil action against ITS in Jefferson Circuit Court seeking damages for delinquent rent and for failure to repair and maintain the leased premises. On August 12, 2002, the trial court entered a default judgment against ITS in the amount of $332,900. In June 2003, Linn Station filed an action against ITS, Technologies and Inter-Tel seeking to pierce the corporate veil of ITS in order to enforce the default judgment against its parent corporations. The trial court initially granted a motion filed by Technologies and Inter-Tel to compel arbitration and stay all further proceedings. Following a hearing, however, it entered a second order, setting aside its prior order compelling arbitration and stating that Linn Station could proceed in its civil action to pierce the corporate veil and collect on the default judgment obtained against ITS. Technologies and Inter-Tel appealed to this Court, which issued an opinion affirming the order of the trial court. *See Inter-Tel, Inc. v. Linn Station Properties, LLC*, 2008 WL 2065858, (Ky. App. 2008)(2007-CA-001185-MR).

Linn Station thereafter moved the circuit court to grant summary judgment against Technologies and Inter-Tel, arguing that the corporate veil should be pierced and that it should be able to collect on the default judgment it had previously obtained against the now-defunct ITS. The trial court agreed and granted the motion in an opinion and order entered on November 11, 2008. Technologies and Inter-Tel were ordered to pay Linn Station the sum of $332,900, plus interest. This appeal followed.

Kentucky courts will disregard the corporate form and impose liability on individual shareholders only where “extraordinary circumstances” exist. *Morgan v. O’Neil*, 652 S.W.2d 83, 85 (Ky. 1983). It should also be noted, however, “that the courts have been more willing to ‘pierce the corporate veil’ when the defendant [as in this case] is a corporation that owns some subsidiary, rather than an individual, controlling shareholder." *White v. Winchester Land Development Corp*., 584 S.W.2d 56, 61, n.6 (Ky. App. 1979). The appellants argue that the record does not support the trial court's grant of summary judgment under any of the theories set forth in that seminal case.

In *White*, the Court of Appeals set forth three approaches to piercing the corporate veil: (1) the instrumentality theory; (2) the alter ego theory; and (3) the equity formulation. *Id*. at 61.

Under the instrumentality theory, three elements must be established in order to warrant a piercing of the corporate veil: (1) that the corporation was a mere instrumentality of the shareholder; (2) that the shareholder exercised control over the corporation in such a way as to defraud or to harm the plaintiff; and (3) that a refusal to disregard the corporate entity would subject the plaintiff to unjust loss. *Id*.

Under the "alter ego" theory, the following elements must be shown: (1) that the corporation is not only influenced by the owners, but also that there is such unity of ownership and interest that their separateness has ceased; and (2) "that the facts are such that an adherence to the normal attributes, Viz, [sic] treatment as a separate entity, of separate corporate existence would sanction a fraud or promote injustice." *Id.* at 61-62 (citations omitted).

Because the elements of these two theories are so similar, many courts use the terms "instrumentality" and "alter ego" interchangeably. "The doctrines behind the tests are basically the same and we regard the tests as interchangeable.

Most courts do." *Dwyer v. ING Inv. Co., Inc.*, 889 S.W.2d 902, 904-05 (Mo. App. 1994) (citing Phillip I. Blumberg, *The Law of Corporate Groups: Substantive Law* § 6.01 (1987)).

These instrumentality and alter ego tests must also be applied with a view to equity. After observing that the two formulations "are helpful as an analytical framework," the *White* court cautioned that "a number of factors are considered in all the cases no matter what 'test' is being applied." *White*, 584 S.W.2d at 62. These factors are: "(1) undercapitalization; (2) a failure to observe the formalities of corporate existence; (3) nonpayment or overpayment of dividends; (4) a siphoning off of funds by the dominant shareholder(s); and (5) the majority shareholders having guaranteed corporate liabilities in their individual capacities." *Id.*

"It should also be understood that a suit against an alter ego, in which the plaintiff seeks to pierce the corporate veil in connection with a previously-obtained judgment against a corporation, is not 'a separate and independent cause of action.'" *Boles v. National Development Co., Inc.*, 175 S.W.3d 226, 251 (Tenn.Ct.App. 2005) (quoting *Matthews Const. Co., Inc. v. Rosen,* 796 S.W.2d 692, 693, n.1 (Tex. 1990)) (footnote omitted). "[P]iercing the corporate veil . . . is . . . a procedural device through which a plaintiff may assert facts and circumstances to persuade the court to impose the parent corporation's obligation on the subsidiary or *vice versa*." *Securities Investor Protection Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 321 (Bankr.S.D.N.Y. 1999).

In invoking the doctrine, the claimant bears the burden of proof. "[T]he one seeking to pierce the corporate veil and disregard the corporate entity has the burden of proving that the corporate form was abused to his injury." *Anderson v. Stewart*, 234 S.W.3d 295, 298 (Ark. 2006).

The trial court granted summary judgment to Linn Station with the following statement, citing *White*, 584 S.W.2d at 61, n.5.

> when the parent company co-mingles its corporate entity with its subsidiary and then tries to hide behind the corporate shield of liability by claiming to have maintained separation from its subsidiary, then the Court has no other alternative but to pierce the corporate shield of liability to prevent the deprivation of remedy that the plaintiff would have enjoyed but for the existence of the corporation.

The trial court concluded that "its [ITS's] property interests were being maintained for 'tax purposes' and not for 'operating purposes.' The effect of such treatment serves to provide a benefit to the Defendants but not to creditors such as Plaintiff Linn Station."

Although the appellants have argued that the opinion of the circuit court was deficient for lack of findings of fact, such findings would not have been appropriate in the context of a motion for summary judgment. *See Goldsmith v. Allied Bldg. Components, Inc.,* 833 S.W.2d 378, 381 (Ky. 1992). On a motion for summary judgment, the trial court is required to determine whether there are any genuine *issues* as to any material fact and whether the moving party was entitled to judgment as a matter of law. *See* Kentucky Rules of Civil Procedure (CR) 56.03.

"The record must be viewed in a light most favorable to the party opposing the motion for summary judgment and all doubts are to be resolved in his favor." *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 480 (Ky. 1991). In this case, extensive discovery was conducted and there appear to be no disputed issues of material fact. Rather, the parties' disagreement concerns the interpretation of those facts. "If a determination concerns whether the evidence showed that something occurred or existed, it is a finding of fact. However, if a determination is made by processes of legal reasoning from, or of interpretation of the legal significance of, the evidentiary facts, it is a conclusion of law." *Poyner v. Lear Siegler, Inc.*, 542 F.2d 955, 959 (6th Cir. 1976). Thus, "[t]he issue whether a corporate arrangement works a hardship which is 'unfair,' and which therefore warrants denial of corporate entity treatment, is a question about the legal consequences which follow from the arrangement. It is therefore a conclusion of law." *Id*.

The following evidence was presented to support Linn Station's contention that ITS was the "instrumentality" or "alter ego" of Technologies and Inter-Tel:

After its acquisition by Technologies on July 2, 1998, and prior to Linn Station's purchase of the property in 1999, ITS was transformed from an independent dealer of communications equipment with offices in Louisville, Lexington, Indianapolis and Charleston, West Virginia, to a group of direct sales offices for Inter-Tel. Susan K. Sherman, a tax accountant first employed by Inter-

Tel in May 2002, described the four regional offices as "branches" of Inter-Tel. John Gardner referred to the Louisville location of ITS as a "branch" of Technologies and as a "branch office" of Inter-Tel. After the acquisition of ITS on July 2, 1998, the Louisville office was described in Inter-Tel documents as "Inter-Tel Louisville," and the Lexington office as "Inter-Tel Lexington." These offices were advertised on Inter-Tel's website as "direct Inter-Tel sales and service locations."

Also as a consequence of the purchase, all employees of ITS became direct employees of Inter-Tel, and all ITS payroll expenses were paid by Inter-Tel from its Arizona headquarters. ITS retained no independent ability to conduct financial transactions. Lyle Erwin, corporate controller for Inter-Tel, testified in his interrogatory that ITS obtained its inventory from Inter-Tel Integrated Systems (another subsidiary of Inter-Tel). Inter-Tel Integrated Systems was compensated for the inventory transferred to ITS "through inter-company transactions, credits and what-not," according to Erwin. When a customer of ITS purchased a telephone system, ITS would not receive or control the payment, which went directly into a "lock box account" or depository account controlled by Inter-Tel. Once placed in this account, the funds belonged to Inter-Tel.

All vendors providing goods and services to ITS were paid directly by Inter-Tel. ITS did not pay any of its bills, was not allowed to hold any funds, and had no bank accounts.

All rental payments required under the 1997 lease agreement were paid by Inter-Tel until the premises were abandoned in May 2002. Under the terms of the lease, the tenant of the building was required to maintain liability and property damage insurance on the premises. After July 2, 1998, this insurance was obtained through an agency in Phoenix, Arizona, which provides most of the insurance for Inter-Tel. The insurance certificates applicable to the property showed the named insureds to be “Inter-Tel, Incorporated” and “Inter-Tel Technologies, Inc.” Both of the insureds were shown as having the same address in Tempe, Arizona. ITS was not named as an insured.

The directors and shareholders of ITS did not hold board meetings in 1998, 1999, 2000, 2001 or 2002, choosing instead to waive annual meetings. Copies of unsigned and undated consents to the waiver were produced by the appellants. Gardner testified that the originals of the consent forms would have been signed and dated, but they had been lost or misplaced in the course of some other litigation. He personally could not recall having seen the documents. Similarly, the appellants were unable to locate signed and dated unanimous written consents to waive annual meetings of the shareholders and directors of Technologies for the period 1998 to 2002.

Evidence was also presented that in years 1999, 2000, 2001 and 2002, the president, vice president/secretary-treasurer and vice president of ITS also served as officers of Technologies and officers of Inter-Tel. During the years 1999 through 2002, Technologies and ITS shared substantially similar boards of directors. Steven G. Mihaylo, chairman and chief executive officer of Inter-Tel, served on the boards of Inter-Tel, Technologies and ITS during the same four-year period. The board of directors of ITS during this period consisted entirely of officers of Inter-Tel.

The tax practices of ITS, Technologies and Inter-Tel also show a commingling of the three corporate entities. According to Susan K. Sherman, the tax manager at Inter-Tel, all Inter-Tel sales and service business performed in Kentucky had been performed by ITS in its own name since at least 2001. Since at least 2000, however, Inter-Tel, Technologies, ITS and at least one other Inter-Tel subsidiary had each reported tax information to the Kentucky Revenue Cabinet. The only tax returns consistently filed in the name of ITS after 2000 related to Kentucky Corporation Income and License Tax Returns.

ITS did not file any Kentucky sales and use tax returns in 2001, 2002 or 2003. Technologies filed eleven (of twelve) such returns in 2001 in its name reporting significant Kentucky sales. In 2002, Inter-Tel reported five months of sales in Kentucky. Technologies reported sales in Kentucky during the remaining seven months of 2002. In 2003, Technologies reported eleven months of Kentucky sales. For the twelfth month, Kentucky sales were reported in the name of "Inter-Tel Datacom, Inc." According to Sherman, all sales in Kentucky reported by any of these entities were generated out of the operations of ITS. Sherman did not know why the sales and use tax returns filed in 2001, 2002 and 2003 were filed under the names of various corporate entities other than ITS.

At the beginning of 2002, the Kentucky Revenue Cabinet began a sales and use tax audit of Technologies, which was intended to cover the period from September 1, 1997 to November 30, 2001. During the course of the audit, the Cabinet announced a tax amnesty program. A tax amnesty application was completed on September 24, 2002, in the name of "Integrated Telecom Services, Inc. d/b/a Inter-Tel Technologies, Inc." The amnesty application was accepted and the amnesty payment was made by Inter-Tel.

Tangible personal and intangible property tax returns were filed with respect to Inter-Tel by Technologies in 2000 and 2001, and by ITS in 2002 and 2003. According to Sherman, the tangible and intangible property tax returns for 2001 filed by Technologies related to property owned by ITS. She did not know why the returns were filed by Technologies.

Kentucky corporation and license tax returns were filed in the name of ITS for the years 1998 to 2002.

Sherman testified that ITS was never liquidated as a corporation and that its assets were never sent to Technologies as dividends or in any other form. She explained that ITS was continued as a separate operating unit doing business as Technologies in order to keep its net operating loss to offset income from other subsidiaries of Inter-Tel. John Gardner confirmed that the corporate existence of ITS after July 1998 (when it was purchased by Technologies) was maintained only for the purpose of the operating loss "carry forward" on its tax return. He confirmed that ITS had no operational capacity at all after July 2, 1998, and conducted no business between July 2, 1998 and December 31, 2003.

Shortly after the default judgment was entered against ITS in the fall of 2002, Technologies filed a financing statement recording a security interest in ITS which covered the following collateral: "All contract rights, accounts, accounts receivable, inventory, leasehold improvements, personal property, cash, proceeds of collateral or equivalents." When he was asked to identify what consideration was received by ITS in exchange for the grant of the security interest, Gardner responded that it was ten dollars and other good and valuable consideration which included but was not limited to assumption of debt by Technologies on behalf of ITS. Gardner explained that the security interest was filed in order to protect assets which were "on the books" as being owned by ITS as opposed to Technologies, "which was the business doing business there [at the Linn Station Road site] and operating there." According to Gardner, the debt assumed by Technologies was the existing maintenance responsibility for equipment and services sold by ITS to its customers. The obligation of ITS to pay rent to Linn Station was not an ITS debt that was assumed by Technologies.

According to Gardner, Technologies had been providing some assets, such as some accounts receivable, inventory and fixed assets to ITS since 1998, in order to take advantage of tax benefits. He stated that the ownership of these assets by ITS was maintained for tax purposes and not for operating purposes. He stated that the financing statement was not filed until October 2002 due to an oversight. He also admitted that even though the financing statement purported to encumber its accounts receivable, ITS had no accounts receivable after July 1998.

The appellants argue that the preceding evidence presented by Linn Station is merely indicative of normal corporate practice and does not rise to the level of wrongdoing that would justify piercing the corporate veil.

As a preliminary issue, however, the appellants argue that the trial court's opinion overlooked a material issue of fact and question of law, namely how Linn Station could, with full knowledge of its potential piercing claim, file suit against only ITS, thus preventing either Inter-Tel or Technologies from asserting a defense on the merits of the underlying lease dispute. Our review of the record shows that this is a claim that could have been brought by the appellants in their first appeal and is therefore barred from our consideration. "The 'law of the case' rule is that parties on a second appeal may not relitigate matters affecting the subject of the litigation which could have been introduced in support of the contention of the parties on the first appeal." *Hutchings v. Louisville Trust Co.*, 276 S.W.2d 461, 466 (Ky. 1954). Moreover, as set forth earlier in this opinion, John Gardner, general counsel for Technologies and Inter-Tel, in his letter of May 21, 2002, invited Linn Station to take a default judgment solely against ITS and denied any liability on the part of his clients.

As to their substantive arguments, the appellants first assert that Inter-Tel cannot be held liable under the instrumentality theory because there is absolutely no evidence that Inter-Tel was a "shareholder" of ITS. It is undisputed, however, that Inter-Tel was the "grandparent" of ITS. Inter-Tel wholly owned Technologies, which in turn wholly owned ITS. Inter-Tel controlled ITS both directly and through its wholly-owned intermediate subsidiary, Technologies. As Gardner stated in his deposition, "by legal terms, a sub of a sub is also a sub of a parent." We are unable to find any legal authority in Kentucky which states that the parent of a parent may not be liable when the corporate veil is pierced, and the case law of other jurisdictions is replete with examples of piercing actions against grandparent holding companies. *See*, *e.g.*, *Milford v. Commercial Carriers, Inc.,* 210 F.Supp.2d 987, 992 (N.D.Ill. 2002) ("Ryder owned 100% of Delavan's and CCI's stock, either directly or through intermediate subsidiaries."); *Brown v. Advantage Engineering, Inc*., 732 F.Supp. 1163, 1167-1168 (N.D.Ga. 1990) ("The court acknowledges that Chemical has offered significant evidence of an alter-ego relationship. For instance, most all of Torlon's Officers and Directors held similar high-level positions at Chemical. Chemical also owns 100% of Torlon's stock, albeit through Amoco Chemical Holding Company, an intermediate subsidiary which is also wholly owned by Chemical. Moreover, Chemical provided extensive administrative and managerial assistance to Torlon throughout the period in question."); *Hando v. PPG Industries, Inc*., 771 P.2d 956, 960 (Mont. 1989) ("On occasion, however, courts may extend the obligations and resulting liabilities of a subsidiary corporation to a parent or grandparent corporation.").

The appellants also argue that the only evidence that ITS was an "instrumentality" of Technologies was the fact that Technologies owned all the stock of ITS. They contend that the trial court improperly omitted Technologies and Inter-Tel, rather than treating them separately in assessing whether they should be afforded the protection of the corporate form. We agree with the appellants that ownership alone is insufficient to establish instrumentality, but it is certainly a critical factor in applying this equitable doctrine. Similarly, the fact that Technologies was the "operating entity" at the leased property is not dispositive, but is a factor to be considered. The appellants rely on a quotation from *Fletcher's Cyclopedia of Private Corporations*, § 43 (2009), which states that "[O]wnership of all the stock of a corporation coupled with common management and direction does not operate as a merger of the two corporations into a single entity." But the same entry goes on to state as follows:

> However, each additional bit of evidence, such as ownership by one corporation of all or a majority of the stock of another, or the fact that the corporations have common officers and directors, or both, may tend to show too close or too direct a relationship between corporations, and disregard by one corporation of the normal corporate process or formalities in regard to the other, undercapitalization of the subsidiaries, commingling of funds or holding out by one that the other is a department of its business or that it stands behind it are all additional bits of evidence that favor a finding of parental liability when viewed together.

In addition to owning all of the stock and functioning as the "operating entity" of ITS, Technologies also had officers and directors in common with ITS, Technologies offered little tangible evidence that it observed normal corporate process or formalities such as annual stockholders meetings, and ITS and

Technologies appeared to be interchangeable when filing state tax returns. "The subsidiary must have some substance, some meat on its bones. The simple rubric of filing charters of incorporation for nonfunctioning subsidiaries will not suffice to insulate parent corporations from liability." *Hargrave v. Fibreboard Corp.*, 710 F.2d 1154, 1163 (5th Cir. 1983) (citing *Edwards Co. v. Monogram Industries, Inc.*, 700 F.2d 994, 1002 (5th Cir. 1983)).

As to the evidence relating to their tax practices, the appellants argue that corporations are expressly allowed to shelter taxable income from a profitable subsidiary by offsetting it against losses from an unprofitable subsidiary. We agree that such conduct in itself does not justify piercing the corporate veil, but undercapitalization of subsidiaries may be considered as a factor in piercing the corporate veil. *See White*, 584 S.W.2d at 62. The appellants also point out that under the federal Internal Revenue Code, a corporation may file consolidated tax returns with its subsidiaries when the parent owns at least eighty percent of the subsidiary. 26 U.S.C. § 1501 (1982). Consolidated tax returns are not in themselves dispositive evidence that the corporate veil of the parent should be pierced, but they certainly may be considered in assessing whether ITS was an instrumentality or alter ego of its parent corporations. This question was addressed by a federal court in Texas, which concluded as follows:

> Under Section 1501 of the Internal Revenue Code, a corporation may file a joint return with its subsidiaries when the parent owns at least eighty percent of the subsidiary. This practice was followed by Merit Ventures with all its subsidiaries. It allows a parent

> corporation to shelter taxable income from a profitable subsidiary by offsetting it against losses from an unprofitable subsidiary. It is a routine business practice; and as defendant's counsel ably pointed out, it is a practice followed by plaintiff Sabine Towing and its parent, Chromalloy Inc. In this context, however, in light of other factors indicating corporate domination, it becomes another factor in proving the alter ego relationship. Indeed, it explains why Merit Ventures retained exactly eighty percent of Merit Transportation when the company was created.

Sabine Towing & Transp. Co., Inc. v. Merit Ventures, Inc., 575 F.Supp. 1442, 1447 (E.D.Tex. 1983). The tax practices and the corporate structure of Inter-Tel and Technologies vis-à-vis ITS lead to the conclusion that ITS was a shell corporation that was used by its parents to avoid various liabilities. As the federal Court of Appeals for the Seventh Circuit recently noted in a comparable case: "The corporate structure that the [defendant's accountants] have created appears to be designed to keep all its assets in corporations that have no liabilities and all its liabilities in corporations that have no assets." *Illinois Bell Telephone Co., Inc. v. Global NAPS Illinois, Inc.*, 551 F.3d 587, 597 (7th Cir. 2008).

Next, the appellants argue that Linn Station failed to establish the second element of the instrumentality theory, which they claim requires a showing of all the elements of a common law fraud claim: "material representation, falsity, scienter, reliance, deception, and injury." *White*, 584 S.W.2d at 61.

We have carefully reviewed the *White* opinion, and subsequent related opinions of this Court, and do not believe that under Kentucky law a finding of strict fraud is required in order to pierce the corporate veil. In setting forth this element of the instrumentality theory, the *White* opinion states that for liability to attach, the shareholder must "exercise[] control over the corporation in such a way as to defraud **or to harm** the plaintiff[.]" *Id.* at 61 (emphasis added). Surely, if a finding of fraud was required, the Court would not have included the "or to harm" language. The *White* court did observe that "our courts have placed a great emphasis upon fraudulent organization and have denied entity treatment upon that basis[,]" *id.*, but it did not go so far as to state that fraud was the sole basis for piercing the corporate veil. Similarly, in observing that the record in the case before it was utterly devoid of the essential elements of fraud, the opinion did not expressly state that a finding of all the elements is mandatory. After discussing the "alter ego" and "instrumentality" tests, the *White* Court ultimately described the formulations as "helpful" as an analytical framework but then cautioned that "issues of 'alter ego' do not lend themselves to strict rules and prima facie cases: whether the corporate veil should be pierced depends upon the innumerable equities of each case." *Id.* at 62.

This broader interpretation was confirmed in a later opinion, where this Court stated that criminal acts, subversion of public policy, and justification of a wrong can all serve as justification to pierce the corporate veil:

> It is settled that a court will ignore a corporate entity where it serves as a shield for fraudulent or criminal acts or where it serves to subvert the public policy of this state. *Big Four Mills v. Commercial Credit Co.,* 307 Ky. 612, 211 S.W.2d 831 (1948). . . . [I]n *Dare to Be Great, Inc. v. Kentucky ex rel Hancock*, Ky., 511 S.W.2d 224 (1974), the Court said: "(G)enerally a corporation will be

> looked upon as a separate legal entity but when the idea of separate legal entity is used to justify wrong, protect fraud or defend crime the law will regard the corporation as an association of persons."

Commonwealth ex rel. Beshear v. ABAC Pest Control, Inc., 621 S.W.2d 705, 708 (Ky. App. 1981).

The appellants also argue that Linn Station was never misled about the situation because it knew all the facts concerning the status of the lease and was informed in early 2002, when seeking a tenant estoppel certificate, that ITS was the sole lessee of the property and that there were no guarantors of the lease. But Inter-Tel had been paying the rent on behalf of ITS consistently for several years; it was not unreasonable for Linn Station to assume that this arrangement would continue. Presumably this is why Linn Station contacted Inter-Tel in order to obtain an estoppel certificate. Furthermore, there was no way for Linn Station to know that ITS was for all practical purposes merely a shell corporation.

The appellants further argue that Linn Station's loss was not "unjust" because Linn Station knowingly accepted monthly rent from Inter-Tel for three years and allowed ITS to operate out of the location without requiring or even requesting that either Inter-Tel or Technologies execute an assignment or guarantee for the ITS lease. It appears that such a request would have been an exercise in futility. It is hard to imagine why Inter-Tel or Technologies would have executed such an assignment or guarantee, when they have gone to such lengths to avoid liability for ITS's debts.

The appellants' next argument concerns the alter-ego theory. They contend, as they did in their discussion of the instrumentality theory, that Inter-Tel was not an owner of ITS and therefore cannot be held liable under the alter-ego theory. They also argue that a showing of fraud is necessary under this theory. We believe that our discussion of this issue as it relates to the instrumentality theory is also dispositive of the arguments presented here.

The appellants next consider the equitable factors set forth by the *White* court. Only three of these factors are pertinent to the facts of this case: (1) undercapitalization; (2) a failure to observe the formalities of corporate existence and (3) a siphoning off of funds by the dominant shareholder(s). *See White*, 584 S.W.2d at 62.

The appellants argue that undercapitalization is not a relevant factor because: (1) under Kentucky law, there is no minimum requirement of paid-in capital before a corporation begins to do business; and (2) inadequate capitalization can only provide a basis for denying corporate entity treatment if it is accompanied by fraudulent reorganization.

As to the first contention, this principle was set forth by the *White* Court. It nonetheless was prepared to apply the undercapitalization element within an equitable context, stating that "[m]ore significant are the policy reasons behind the prohibition of undercapitalization to protect innocent third parties who had no way of knowing that they were dealing with an impecunious entity." *White*, 584 S.W.2d at 62. In *White,* the plaintiff bank had knowledge of the financial status of the corporation to which it extended a loan and could have protected itself by requiring the shareholders of the corporation to guarantee the note as they had done in connection with a prior loan. Under these circumstances, the Court held that the bank was not entitled to complain that the corporation to whom it had lent the money was undercapitalized because the bank itself had knowledge of its financial status and could have protected itself. *Id.* at 63.

The appellants contend that if Linn Station's argument (that ITS was undercapitalized after its acquisition by Technologies in part as a means of avoiding liability) was followed to its logical conclusion, ITS should have started to avoid paying its bills immediately after it was acquired by Technologies, when in fact the rental on the Linn Station property was paid fully and on time for almost three years. We disagree with this analogy. Linn Station was ITS's landlord, not its bank, as was the factual scenario in *White*. The rent continued to be paid by Inter-Tel; there was no reason for Linn Station to believe that Inter-Tel would not continue to do so on behalf of ITS; and as long as the rent was paid, Linn Station had no reason to be concerned with the financial status of ITS.

As to appellants' second contention, undercapitalization must be accompanied by fraudulent reorganization only if undercapitalization is the sole factor presented to justify piercing the corporate veil. In other words, under Kentucky law, undercapitalization on its own is not enough to justify piercing the corporate veil. This point is clearly made in *American Commercial Lines, Inc. v. Ostertag,* 582 S.W.2d 51 (Ky. App. 1979). In that case, Ostertag, an injured barge employee, attempted to pierce the corporate veil of his employer, Inland Tugs, in order to reach its parent corporation, ACL. Inland Tugs was wholly owned by ACL, and Ostertag argued that the gross undercapitalization of Inland Tugs justified piercing its corporate veil. The Court disagreed in part because there was no evidence of fraudulent reorganization, but also because of the lack of any other factors to justify denying corporate entity status:

> There was no evidence that ACL exercised its control as the sole stockholder of Inland Tugs to frustrate recovery for injuries to barge employees regardless of the merits of their claims. The record further revealed that Inland had its own bank accounts, issued its own financial statement, operated out of its own offices, and negotiated its own labor contracts. Furthermore, Inland had approximately 900 employees and appeared from the record to have vast assets of its own that the plaintiff could have sought. The trial court should have noted that common directorships and joint credit agreements are an inevitable consequence of a parent-subsidiary relationship. Thus it should have been clear to the appellee that his de facto employer was the corporation with which he negotiated his terms of employment and by whom he was paid, Inland Tugs, and not ACL.

American Commercial Lines, Inc., 582 S.W.2d at 53.

The appellants also argue that a material issue of fact exists regarding the observance of corporate formalities by ITS. Specifically, they contend that the trial court ignored Gardner's testimony that the original documents waiving shareholder meetings had been duly signed and executed. Gardner testified that the documents would have been signed and executed, but he admitted that he personally could not recall ever having seen these specific documents. The appellants have not explained what other evidence might exist to show that corporate formalities of any kind whatsoever had been observed in connection with ITS such as to create an issue of material fact.

The appellants also contend that there was no evidence that Technologies or Inter-Tel siphoned off the funds of ITS. This equitable factor carries more decisive weight in the context of a corporation owned by individual shareholders who use corporate funds for their personal use. After its acquisition by Technologies and Inter-Tel, ITS essentially ceased to be a viable independent entity; any profits which it made were diverted to Inter-Tel and its expenses were all paid by Inter-Tel. We agree with Linn Station that ITS was used by Inter-Tel and Technologies as an "expedient and chameleonic entity" which assumed whatever form or structure was most advantageous to its parents' current circumstances. We recognize that there is usually nothing sinister or improper in such uses of the corporate form and that "[m]erely pleading that a corporation has insufficient assets to pay a claim is not enough . . . to state a cause of action to pierce the corporate veil." *In re Rave Communications, Inc. v. Entertainment Equities, Inc.,* 138 B.R. 390, 395 (Bankr.S.D.N.Y. 1992). Nonetheless, in this case the totality of the circumstances justifies disregarding the corporate form. There is no disputed issue of material fact that ITS was undercapitalized, that its owners did not observe corporate formalities, that it had no employees, bank accounts or assets, did not pay its own bills and was essentially maintained for the tax advantages it provided to its parents. Although Linn Station was aware that ITS's rent was being paid by Inter-Tel, it had no reason to believe that Inter-Tel would suddenly stop paying the rent, would refuse to pay for damages to the property, or that ITS was insolvent. "If there is no substance at all to a corporation, so that it cannot be made to answer for any of its debts, no rational person would make a contract with it unless he were deceived." *Illinois Bell Telephone Co., Inc.*, 551 F.3d at 597.

Accordingly, the judgment of the Jefferson Circuit Court is affirmed.

ALL CONCUR.

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