DON’T MISTAKE THE PROXY FOR THE RULE: ALTER EGO LIABILITY IN TENNESSEE

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I. INTRODUCTION

New, small businesses commonly choose to organize as a corporation or limited liability company. It is the policy of the state of Tennessee to encourage businesses to incorporate and pay the franchise and excise tax applicable to corporations.¹ In exchange, the incorporators gain limited liability, subject to, among other things, the alter ego doctrine and piercing of the corporate veil in the appropriate case. This article takes the position that it should be the policy of the courts in Tennessee to encourage businesses to incorporate by providing clear guidance regarding the choice of law standard and the purpose and policy underlying Tennessee’s alter ego doctrine. Otherwise, one of the principal benefits of incorporation – limited liability – will be perceived as uncertain, undermining this form of organization.

Current statements of the standards for alter ego liability in Tennessee often recite the 11-factor test created by the Federal District Court for the Eastern District of Tennessee in FDIC v. Allen:²

[The f]actors to be considered in determining whether to disregard the corporate veil include not only whether the entity has been used to work a fraud or injustice in contravention of public policy, but also: (1) whether there was a failure to collect paid in capital; (2) whether the corporation was grossly undercapitalized; (3) the nonissuance of stock certificates; (4) the sole ownership of stock by one individual; (5) the use of the same office or business location; (6)

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the employment of the same employees or attorneys; (7) the use of the corporation as an instrumentality or business conduit for an individual or another corporation; (8) the diversion of corporate assets by or to a stockholder or other entity to the detriment of creditors, or the manipulation of assets and liabilities in another; (9) the use of the corporation as a subterfuge in illegal transactions; (10) the formation and use of the corporation to transfer to it the existing liability of another person or entity; and (11) the failure to maintain arms length relationships between related entities.3

Due, perhaps, to this handy grab-bag of factors, FDIC v. Allen is commonly cited in more recent decisions as a summary of the alter ego doctrine.4 This approach provides little guidance on how these factors should be weighed or applied. Moreover, a vast number of legitimate businesses satisfy some of the FDIC v. Allen factors, such as the sole ownership of stock by one individual, a subsidiary’s use of the same office or business location as its corporate parent, and the employment of the same employees or attorneys. It would be much better if courts and commentators returned their focus to the leading Tennessee Supreme Court opinion of Continental Bankers Life Ins. Co. v. Bank of Alamo.5 If that pronouncement from the state’s highest court is forgotten or under-emphasized, the alter ego doctrine in Tennessee devolves into a vague, nonexclusive, multi-factor analysis that creates increased uncertainty and needless litigation and expense for businesses. Refocusing on the three-required-element-based test of Continental Bankers, which the FDIC v. Allen factors were created to address, provides a better, more certain framework than the FDIC v. Allen factors alone.

II. CHOICE OF LAW FOR ALTER EGO CLAIMS

Interestingly, Tennessee has not definitively determined whether the law of the state of incorporation or the law of the state in which the alter ego action is

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3 Id.


5 578 S.W.2d 625, 631-32 (Tenn. 1979).
brought should be applied.6 This being the case, it may be that Tennessee should adopt the approach of the *Restatement (Second) of Conflict of Laws* (1971) (“Restatement”).7 The Restatement’s position, found in Sections 306, 307, and 309, is that (a) officer and director liability to the corporation and its creditors and majority shareholder liability to the corporation and minority shareholders is to be determined by the law of the jurisdiction of incorporation unless “some other state has a more significant relationship under the principles stated in [the Restatement’s section six];” and (b) that the “local law of the state of incorporation will be applied to determine the existence and extent of a shareholder’s liability to the corporation for assessments or contributions and to its creditors for corporate debts.”8 Section six of the Restatement, referred to in Sections 307 and 309, lists certain “Choice of Law Principles” that courts may use to determine whether some other state has a more significant relationship to the parties and the transaction.9 Relevant factors include “the relevant policies of the forum,” “the protection of justified expectations,” and “certainty, predictability and uniformity of result.”10

In other words, in the Restatement’s view, alter ego actions should be based upon the law of the state of incorporation when brought against a shareholder qua shareholder and should generally be based upon that same law unless choice of law principles militate otherwise when the action is against an officer or director qua officer or director.11 These standards provide a framework for analysis of the choice of law that makes it possible to determine, or at least forecast with some degree of confidence, what laws a shareholder, director, or officer will face with regard to liability for corporate debts.

**III. TENNESSEE’S ALTER EGO DOCTRINE**

*FDIC v. Allen*, while accurately collecting 11 of the many factors and criteria that have been held to be relevant to the alter ego inquiry in a number of

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6 *Boles*, 175 S.W.3d at 232 (stating that the trial court applied Tennessee law rather than the law of the defendant’s state of incorporation, but not stating that there was any test or precedent requiring this).

7 *Restatement (Second) of Conflict of Laws* (1971).

8 Id. §§ 306-07, 309.

9 See id. § 6.

10 Id. § 6.

jurisdictions, including Tennessee, and the at-the-time most recent Supreme Court opinion on the topic, fail to provide guidance as to how these factors should be weighed and balanced. 12 Without a clear statement of the purpose and policy behind the alter ego doctrine in Tennessee, this list of 11 non-exclusive factors really creates no standard for decision at all.

As a general rule of corporate law, parent and subsidiary corporations are presumed to be separate and distinct entities, and thus parent corporations are not liable for the acts of their subsidiaries. 13 “[T]o disregard the corporate entities requires, in the case of parent and subsidiary, more than a showing that they have similar corporate names and locations and the exercise of dominion through common officers and directors.” 14

In Continental Bankers, the Tennessee Supreme Court noted with concern that the law regarding piercing the corporate veil varied widely and lacked clarity. 15 The court stated: “[i]n the considerable body of American case law, all of the numerous theories, such as alter ego, instrumentality, identity, agency and estoppel, have been articulated in widely varying language, and each theory has been criticized by one or more authoritative sources.” 16 The court concluded:

Our research has led us to the same conclusion as that expressed by the author of the annotation in 38 A.L.R.3d 1102 § 2 at 1110 (1971):

“There have been a number of formulations of rules of parental liability, varying from the short to the long, but unfortunately the concept is still as enshrouded in the ‘mists of metaphor’ as it was in 1926 when Judge Cardoz[o] made that observation.” 17

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13 Cont'l Bankers Life Ins. Co. v. Bank of Alamo, 578 S.W.2d 625, 631 (Tenn. 1979); see also Cambio Health Solutions, LLC v. Reardon, 213 S.W.3d 785, 790 (Tenn. 2006) (recognizing Continental Bankers as the Tennessee authority regarding “piercing the corporate veil”).
14 Cont'l Bankers, 578 S.W.2d at 631.
15 Id. at 631-32.
16 Id. at 631.
17 Id. at 631-32 (quoting J.A. Bryant, Jr., Liability of Corporation for Contracts of Subsidiary, 38 A.L.R.3d 1102, § 2 at 1110 (1971)); see Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926) (“The whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the
As a result, the court in *Continental Bankers* elected to articulate a bright-line rule that applies whenever a plaintiff seeks to impose liability on a subsidiary’s parent corporation.\(^{18}\) This rule requires the plaintiff to prove the following three elements:

(1) The parent corporation, at the time of the transaction complained of, exercises complete dominion over its subsidiary, not only of finances, but of policy and business practice in respect to the transaction under attack, so that the corporate entity, as to that transaction, had no separate mind, will or existence of its own.

(2) Such control must have been used to commit fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of third parties’ rights.

(3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.\(^{19}\)

As described in *FDIC v. Allen*, a federal district court case that canvassed opinions from Tennessee and other state and federal jurisdictions, the 11 factors the court listed may be looked to when determining whether the three required *Continental Bankers* elements are present in a particular case.\(^{20}\) Thus, under Tennessee law:

\(^{18}\) *Cont’l Bankers*, 578 S.W.2d at 632.

\(^{19}\) *Id*; see also Cambio Health Solutions, L.L.C v. Reardon, 213 S.W.3d 785, 790 (Tenn. 2006) (summarizing *Continental Bankers*’ three elements); Elec. Power Bd. of Chattanooga v. St. Joseph Valley Structural Steel Corp., 691 S.W.2d 522, 526 (Tenn. 1985) (listing the *Continental Bankers* elements); Pamperin v. Streamline Mfg., 276 S.W.3d 428, 437-38 (Tenn. Ct. App. 2008) (applying the *Continental Bankers* rule in a case where plaintiff sought to impose liability upon a corporation’s shareholders); see generally Douglas C. Michael, *To Know a Veil*, 26 J. CORP. L. 41, 46 (2000) (providing a critical history of the doctrine of piercing the corporate veil and identifying what is essentially the *Continental Bankers* three-part test as “the one now most frequently used as the touchstone for veil-piercing analysis” in American jurisdictions).

\(^{20}\) The factors, for ease of reference, are

(1) whether there was a failure to collect paid in capital; (2) whether the corporation was grossly undercapitalized; (3) the non-issuance of stock certificates; (4) the sole ownership of stock by one individual; (5) the use of the same office or business location; (6) the employment of the same employees or attorneys; (7) the use of the
[C]orporate veils are pierced – that is, the legal entity disregarded and the true owners of the entity held personally liable – when the corporation is liable for the debt but is without funds due to the skullduggery or downright fraud on the part of the directors and officers, who have pillaged the corporate treasury or used the corporation to engage in criminal or quasi-criminal activities.\(^{21}\)

However, one must bear in mind, as observed by the United States Supreme Court, that the normal control that a corporation’s sole shareholder or parent corporation has by virtue of its stock ownership is insufficient to pierce the corporate veil:\(^ {22}\)

It is a general principle of corporate law deeply “ingrained in our economic and legal systems” that a parent corporation (so-called because of control through ownership of another corporation’s stock) is not liable for the acts of its subsidiaries . . . . Ordinarily, a corporation which chooses to facilitate the operation of its business by employment of another corporation as a subsidiary will not be penalized by a judicial determination of liability for the legal obligations of the subsidiary . . . . Thus, it is hornbook law that:

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\text{The exercise of the ‘control’ which stock ownership gives to the stockholders…will not create liability beyond the assets of the subsidiary. That ‘control’ includes the election of directors, the making of by-laws…and the doing of all other acts incident to the corporation as an instrumentality or business conduit for an individual or another corporation; (8) the diversion of corporate assets by or to a stockholder or other entity to the detriment of creditors, or the manipulation of assets and liabilities in another; (9) the use of the corporation as a subterfuge in illegal transactions; (10) the formation and use of the corporation to transfer to it the existing liability of another person or entity; and (11) the failure to maintain arms length relationships among related entities.”}
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legal status of stockholders. Nor will a duplication of some or all of the directors or executive officers be fatal.23

An example from Tennessee is found in the unpublished case of Moses v. Scruggs,24 which Professor Stephen B. Presser of Northwestern University School of Law, in his book Piercing the Corporate Veil, characterized as follows:

[T]here is reason to believe that the Court of Appeals of Tennessee, Eastern Section, takes the Continental [Bankers] rule more seriously. For example, in Moses v. Scruggs, (1988), the court cited the “three elements” from Continental [Bankers] and refused to permit piercing of the veil, since the plaintiff had “failed to produce any evidence of [the parent corporation’s] exercise of complete dominion over [the subsidiary’s] ‘finance, policy and business practice’ as to this transaction such that [the subsidiary] ‘had no separate mind, will or existence of its own.’” There was evidence that the parent was one hundred percent owner of the subsidiary, and that the subsidiary had been permitted to use a portion of the parent’s premises from which to conduct business, including the use of the parent’s mailing address, but this was held to be insufficient for veil-piercing purposes.25

Thus, in order to satisfy the first requirement of complete dominion and control, a plaintiff must show that the parent corporation exercised “complete dominion” and control over the subsidiary’s “finances . . . policy and business practice” such that, as to the transaction or events at issue, the subsidiary “had no separate mind, will or existence of its own.”26

This standard should require a significant showing.27 Continental Bankers involved a bank’s attempt to set off a subsidiary’s certificate of deposit against the parent’s unpaid debt owed to the bank.28 The subsidiary was People’s Protective Life Insurance (“PPLI”), and the court noted that, as a life insurance company, PPLI

23 Id. at 61-62 (citations and internal quotations omitted).
27 See id. at 636-37.
28 Id. at 627.
was subject to strict state statutory restrictions on its investments of assets, which militated against allowing the bank to claim that it viewed the subsidiary’s cash reserves as assets that could be pledged to secure the parent’s corporate debt. The court then held that even if the parent exercised dominion over PPLI through common officers and directors, as to the transaction at issue – PPLI’s establishment of a certificate of deposit – “PPLI had a mind of its own.”

Further, in Continental Bankers, although there is no indication of whether or not the parent corporation was the sole shareholder of the subsidiary, the opinion notes that the two corporations had “common officers and directors, [and] used the same building, address, telephone number, etc.,” which the trial and appellate courts found to be significant, but which the Tennessee Supreme Court did not.

An example of the significant showing required to satisfy the complete dominion and control elements is found in Electric Power Bd. of Chattanooga v. St. Joseph Valley Structural Steel Corp., a products liability action involving the collapse of an aerial hoist (“cherry picker”) manufactured by its subsidiary, Strato-Tower. At the time of the accident, (1) the subsidiary was insolvent and owed its parent $725,000; (2) one person, Dean Kelly, was the president of both the parent, St. Joseph, and the subsidiary, and ran both corporations; and (3) Kelly’s wife was the corporate secretary of both the parent and the subsidiary. After the cherry picker was sold and delivered to a dealer, a new hydraulic system needed to be installed. Shannon Clements, the cherry picker’s inventor and vice president of the subsidiary, was set to go to Chattanooga and supervise the installation, but Kelly, the president of both companies, told Clements not to go. Kelly’s order had tragic results:

29 Id. at 636.
30 Id. at 637.
31 Id. at 636.
33 Id. at 523–24.
34 Id. at 525.
35 Id. at 524.
36 Id.
Wilson[,] the dealer[,] had considerable difficulty with the new hydraulic system and he telephoned Mr. Clements and informed him that the hydraulic unit had been manufactured upside down, in response to which Clements advised Wilson to turn the device over. In a second telephone call, Wilson explained to Clements that the hydraulic lift would not fit the cherry picker and later, in a third telephone conversation, Wilson advised Clements that a weld would not permit the shaft of the hydraulic device to fit between the parallel pieces of steel described as “ears.” Mr. Clements instructed Wilson to trim off enough of the sides of the ears so that the weld and the cylinder shaft would have room to fit. Wilson proceeded to cut off approximately ½ of the ears, eliminating three of the four holes in each ear. Wilson testified that he trimmed the ears down to the level of the bed of the truck because he felt it looked neater.

On June 12, 1979, [plaintiffs] were operating the hoist when it collapsed and fell to the ground. There was expert testimony that the removal of the holes from the ears weakened the structure and caused a separation from the frame of the truck. Shannon Clements testified that if he had gone to Chattanooga for the installation of the leveling device, the ears on the device would not have been cut to the extent they were cut by Wilson. There was also other expert testimony that the manner in which the modifications were made and the installation of the hydraulic system caused a binding of the leveling device against the bed of the truck thereby causing the metal to break.37

After the cherry picker collapsed, Kelly ordered Dr. Clifford Aides, an engineer employed by the parent and “farmed out” to the subsidiary, to go to Chattanooga, investigate the equipment failure, and produce a stress analysis.38 After his investigations, Dr. Aides “fabricated and back dated ‘specifications’ consistent with the actual construction of the aerial device which ‘specifications’ differed from the true specifications.”39

37 Id. at 524-25.
38 Id. at 525.
39 Id.
Judgment was entered against the parent, and the court affirmed, stating:

[W]e think it is particularly significant that at the time of this accident Strato-Tower owed St. Joseph $725,000.00, or more, and was insolvent. The jury may well have concluded that Strato-Tower was operating as a mere division or department of St. Joseph, and had been doing so for some time, and was being totally dominated by St. Joseph. That conclusion is further supported by the fact that when the cherry picker collapsed, Dean Kelly, as President of St. Joseph, dispatched a St. Joseph employee, Dr. Aides, to go to Chattanooga and investigate the collapse and produce a stress analysis, that Aides did so, fabricating and back dating phony “specifications” that complied with the actual construction of the cherry picker which had not been constructed in accordance with the true specifications.\(^{40}\)

Even if a parent exercised complete dominion and control over the subsidiary, that control must be used to commit fraud, illegality, or wrongdoing in order to disregard the corporations’ separateness.\(^{41}\) Thus, the Supreme Court in \textit{Continental Bankers} rejected the conclusion of the Court of Appeals that the bank in that case should be allowed to use the subsidiary’s certificate of deposit as a set-off against the parent’s unpaid debt, because “denying recovery ‘would work an injustice and cause an injury to the Bank.’”\(^{42}\) The \textit{Continental Bankers} court held that the control exercised by the parent “was not used to commit fraud, misrepresentation or a dishonest or unjust act upon the bank.”\(^{43}\) The requirement that control be used to commit a fraud, illegality, or wrongdoing has been characterized as “skullduggery or downright fraud on the part of the directors and officers, who have pillaged the corporate treasury or used the corporation to engage in criminal or quasi-criminal activities.”\(^{44}\)

\(^{40}\) \textit{Id.} at 527.

\(^{41}\) \textit{Cont’l Bankers Life Ins. Co. v. Bank of Alamo}, 578 S.W.2d 625, 632 (Tenn. 1979) (“Such control must have been used to commit fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of third parties’ rights”).

\(^{42}\) \textit{Id.} at 636.

\(^{43}\) \textit{Id.} at 637.

Even when a parent exercises complete dominion and control over the subsidiary, and that control was used to commit fraud, illegality, or wrongdoing, “[t]he aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of” in order to disregard the separateness of the corporations. For example, returning to Electric Power Bd., the president of both the parent and the subsidiary told the cherry picker’s inventor, an employee of the subsidiary, not to travel and supervise the installation of the hydraulic system. The system was installed improperly as a direct result, and the improper installation was a significant cause of the accident.

IV. CONCLUSION

Scanning the Tennessee cases regarding alter ego liability might suggest to some that the standard for piercing the corporate veil is found in the 11 factor test of FDIC v. Allen, but that test is comprised of so many factors it is really no standard at all. When looking at alter ego law in Tennessee, courts should apply the three-element test that the Supreme Court of Tennessee established in Continental Bakers. That is the real test. FDIC v. Allen’s 11 factors are merely things to consider when determining if Continental Bakers’ three required elements have been met.

45 Cont’l Bankers, 578 S.W.2d at 632.
47 Id.