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In Suit by Contract Creditor, Corporate Entity May Be Disregarded upon Showing of Constructive Fraud When Entity Used as Sham to Perpetrate Fraud.

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Colorado v. Bertine, ___ U.S. ___, ___, 107 S. Ct. 738, 742, 93 L. Ed. 2d 739, 747 (1987). Thus after *Bertine*, the focus of an inventory search review has seemingly shifted from a strict analysis of the overall reasonableness of the search in light of the interest protected, to a determination of whether the search was conducted within the ambit of the controlling standard police procedure.

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CORPORATIONS—DISREGARDING CORPORATE ENTITY—IN SUIT BY CONTRACT CREDITOR, CORPORATE ENTITY MAY BE DISREGARDED UPON SHOWING OF CONSTRUCTIVE FRAUD WHEN ENTITY USED AS SHAM TO PERPETRATE FRAUD. *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986).

Joe Castleberry sued Texas Transfer, Inc., and Byron Branscum and Michael Byboth, individually, on a promissory note executed by Texas Transfer. Castleberry alleged that Texas Transfer was the alter ego of Branscum and Byboth and that their manipulations of Texas Transfer caused the corporation to default on the note.

Originally, Castleberry, Branscum, and Byboth formed a partnership which was engaged in the business of furniture moving. In September 1980, the business was incorporated as Texas Transfer, Inc., with each of the principals owning one-third of the corporation's shares. A dispute arose when Castleberry discovered that Branscum had subsequently formed a competing business, Elite Moving. In July 1981, as a means of resolving the dispute, the parties agreed that Texas Transfer would purchase Castleberry's stock in return for cash and an unsecured corporate promissory note for approximately $42,000. From that point on, Texas Transfer's business declined until it eventually defaulted on the note after making only one payment. During this time period, Elite Moving began to take over a majority of Texas Transfer's business. For the eighteen months prior to the stock purchase agreement, Texas Transfer had a net income of $65,479. Following the stock-purchase agreement, Texas Transfer's net income rapidly declined until 1982, when the corporation eventually lost more than $16,000. Elite Moving's business, however, prospered during this time.

In April 1982, Castleberry filed suit on the promissory note. As a result of the lawsuit, Byboth and Branscum formed another furniture company, Custom Carriers, Inc., which proceeded to acquire the business of both Texas

Transfer and Elite moving. The trial court held Branscum and Byboth personally liable upon a jury finding that they had used Texas Transfer as a sham to perpetrate a fraud against Castleberry. The court of appeals reversed and rendered, holding that there was no evidence to support the jury's findings on the sham theory. The Texas Supreme Court reversed the court of appeals and affirmed the trial court judgment, stating that there was some evidence of a sham to perpetrate a fraud, which justifies the disregarding of the corporate entity. Thus, Branscum and Byboth were both held personally liable.

Generally, courts will not ignore the corporate entity and impose personal liability on the individual stockholders unless there has been an abuse of the corporate privilege. *See, e.g.*, *Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975) (in tort action, corporate fiction may be disregarded to prevent fraud or injustice); *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336, 340 (Tex. 1968) (in disregarding corporate form, corporation must be employed as unfair device to perpetrate fraud); *Pace Corp. v. Jackson*, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955) (courts will not disregard corporate existence in absence of fraud or other exceptional situations). Specifically, the corporate entity may be disregarded when it is: (1) used as a means of perpetrating fraud; (2) organized as a mere tool or conduit of another business or corporation; (3) used as a means of evading an existing legal obligation; (4) employed to achieve a monopoly; (5) used to circumvent a statute; (6) relied upon as a protection of crime or to justify a wrong; or (7) inadequately capitalized. *See, e.g.*, *Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1973) (disregarding corporate form on alter ego theory); *Roy E. Thomas Constr. Co. v. Arbs*, 692 S.W.2d 926, 938 (Tex. App.—Fort Worth) (reversing trial court finding that corporation had become alter ego of shareholder), *writ ref'd n.r.e. per curiam*, 700 S.W.2d 919 (Tex. 1985); *Roylex, Inc. v. Langson Bros. Constr. Co.*, 585 S.W.2d 768, 771 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ ref'd n.r.e.) (listing theories which will support disregarding corporate form); *William B. Roberts, Inc. v. McDrilling Co.*, 579 S.W.2d 335, 345 (Tex. Civ. App.—Corpus Christi 1979, no writ) (stating elements which must be proven in order to disregard corporate entity on alter ego theory); *Tigrett v. Pointer*, 580 S.W.2d 375, 381-82 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.) (disregarding corporate form in case of "grossly inadequate capitalization"); *Sutton v. Reagan & Gee*, 405 S.W.2d 828, 837 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.) (corporate form should be disregarded when used to "bring about results which are condemned by general statements of public policy"); *Pacific Am. Gasoline Co. v. Miller*, 76 S.W.2d 833, 851 (Tex. Civ. App.—Amarillo 1934, writ ref'd) (corporate entity should be disregarded to prevent fraud and protect third party's legal rights). *See generally* 2 HORNSTEIN, CORPORATION LAW AND PRACTICE §§ 752-58 (1959) (discussing grounds which justify disregarding corporate form). However, the standard used in determining when

to disregard the corporate form depends on whether the underlying cause of action is based in tort or contract. *Compare Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984) (requiring deception or fraud in contract cases) *with Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975) (unnecessary to establish fraud in tort case; corporate fiction may be disregarded to prevent injustice); *see also Tigrett v. Pointer*, 580 S.W.2d 375, 394 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.) (Akin, J., dissenting) (contract-tort distinction justified because contract claimants choose to deal with corporation). In a tort action, it is generally not necessary to find an intent to defraud. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984); *Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975). The problem in such a case is essentially one of allocating the loss. *See Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975). Generally, all the plaintiff must prove is that he was the victim of an unfair action in which a corporate entity was used to achieve an inequitable result. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984); *Preston Farm & Ranch Supply, Inc. v. Bio-Zyme Enters.*, 615 S.W.2d 258, 263 (Tex. Civ. App.—Dallas), *aff'd*, 625 S.W.2d 295 (Tex. 1981). Furthermore, in a tort action, the financial strength or weakness of the corporate tortfeasor is an important consideration in determining the allocation of damages. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984); *Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975).

In a contract case, however, a plaintiff has the burden of justifying a recovery against the individual he seeks to hold personally liable when he has willingly contracted with the corporation. *See Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975). To satisfy this burden, a plaintiff must introduce evidence which shows deception or fraud. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984). If this burden is not met, the risk of loss is distributed according to the relative bargaining power of the parties. *See id.*; *see also Atomic Fuel Extraction Corp. v. Slick's Estate*, 386 S.W.2d 180, 190-91 (Tex. Civ. App.—San Antonio 1965, writ ref'd n.r.e.); *Moore & Moore Drilling Co. v. White*, 345 S.W.2d 550, 551-52 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.). The reasoning behind this rule is that a plaintiff in a contract case has had prior dealings with the corporation, and in most instances, has had an opportunity to investigate its financial strength. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex. 1984); *see also Castleberry v. Branscum*, 721 S.W.2d 270, 279 (Tex. 1986) (Gonzalez, J., dissenting). Therefore, a party who has contracted with a financially unstable corporation, who does not seek satisfaction of his claim, cannot look to individual shareholders in the absence of some additional compelling facts. *See Tigrett v. Pointer*, 580 S.W.2d 375, 382-83 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

In *Castleberry v. Branscum*, the Supreme Court of Texas disregarded the

corporate entity and allowed an unsecured creditor to recover the balance of a promissory note from the individual shareholders of a corporation. *See Castleberry v. Branscum*, 721 S.W.2d 270, 275 (Tex. 1986). In disregarding the corporate entity, the court held that the corporation was used as a sham to perpetrate a fraud. *See id.* at 272-75. The court relied upon the fact that "neither fraud nor an intent to defraud need be shown as a prerequisite to disregarding the corporate entity; it is sufficient if recognizing the separate corporate existence would bring about an inequitable result." *Id.* at 272-73 (quoting FLETCHER, CYCLOPEDIA CORPORATIONS § 41.30, at 30 (Supp. 1985)). Moreover, the court stated that it was unnecessary that the creditor prove an intent to defraud. *See id.* at 273; *see also Tigrett v. Pointer*, 580 S.W.2d 375, 385 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.) (disregarding corporate entity in contract case without showing specific fraudulent intent). When attempting to prove that there has been a sham to perpetrate a fraud, the court stated that contract creditors and tort claimants need only show constructive fraud. *See Castleberry v. Branscum*, 721 S.W.2d 270, 273 (Tex. 1986); *see also Pacific Am. Gasoline Co. v. Miller*, 76 S.W.2d 833, 849 (Tex. Civ. App.—Amarillo 1934, writ ref'd) (disregarding corporate entity in favor of note holders when circumstances amount to constructive fraud). While actual fraud normally involves an intent to deceive, constructive fraud has been defined as "the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests." *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964). Based upon this concept of constructive fraud, and the notion that disregarding the corporate entity is an equitable doctrine in which Texas takes a fact-specific approach, the supreme court permitted the corporate entity to be disregarded based upon its finding that the corporate form had been used as a sham to perpetrate a fraud. *See Castleberry v. Branscum*, 721 S.W.2d 270, 273 (Tex. 1986). This conclusion was reached despite the fact that the plaintiff had only pled an alter ego theory. *See id.* at 278.

In his dissenting opinion, Justice Gonzalez agreed that Castleberry had incurred a legal injury; however, he did not believe that Castleberry should have been allowed to recover based upon the theories which were submitted to the jury. *See id.* at 277 (Gonzalez, J., dissenting). The dissent stated that inasmuch as Castleberry had only pled for recovery under the alter ego theory, and since no evidence was introduced as support, his recovery on this ground should have been denied. *See id.* at 278-80 (Gonzalez, J., dissenting). The dissent stated that the evidence which was introduced would have possibly supported a cause of action based upon the trust fund doctrine or a theory of denuding the corporate assets, but in no way did the theory of recovery pled support the idea that Texas Transfer was used as a sham to perpetrate a fraud on Castleberry. *See id.* at 279 (Gonzalez, J., dissenting).

The dissent further stated that the majority's standard for disregarding the corporate entity in the case of a sham to perpetrate a fraud is far too broad. *See id.* at 277 (Gonzalez, J., dissenting). Under the proposed analysis, it is feared that, in the future, the corporate entity might be disregarded under the theory of being a sham to perpetrate a fraud whenever recognition of the corporate form would lead to an inequitable result. *See id.* (Gonzalez, J., dissenting); *see also Gentry v. Credit Plan Corp.*, 528 S.W.2d 571, 573 (Tex. 1975) (corporate form may be disregarded to prevent fraud or injustice). Under such an approach, a court could disregard the corporate entity, regardless of the type of misconduct involved, whenever it sought an equitable or "fair" result. *See Castleberry v. Branscum*, 721 S.W.2d 270, 277 (Tex. 1986) (Gonzalez, J., dissenting). This type of approach directly contravenes a long line of Texas cases which hold that personal liability should be imposed on a shareholder only in extraordinary circumstances. *See, e.g., Lucas v. Texas Indus., Inc., 696 S.W.2d 372, 374 (Tex. 1984) (disregarding corporate entity is exception to general rule); Sagebrush Sales Co. v. Strauss*, 605 S.W.2d 857, 860 (Tex. 1980); *Torregrossa v. Szelc*, 603 S.W.2d 803, 804 (Tex. 1980); *Bell Oil & Gas Co. v. Allied Chem. Corp.*, 431 S.W.2d 336, 340 (Tex. 1968); *Pace Corp. v. Jackson*, 155 Tex. 179, 195, 284 S.W.2d 340, 351 (1955); *First Nat'l Bank v. Gamble*, 134 Tex. 112, 119-20, 132 S.W.2d 100, 103 (1939); *Tigrett v. Pointer*, 580 S.W.2d 375, 381-82 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.). In summary, the dissent maintains that disregarding the corporate entity "whenever a party does not receive a 'complete' or 'fair' recovery is an unworkable approach." *Castleberry v. Branscum*, 721 S.W.2d 270, 277 (Tex. 1986) (Gonzalez, J., dissenting).

Whether the *Castleberry* decision has created an "unworkable approach" to the question of disregarding the corporate entity can only be seen from future Texas Supreme Court decisions. What is noteworthy at this time, however, is that the *Castleberry* decision may be subject to two markedly different interpretations. It may be seen as a mere continuation of the general approach Texas courts have taken when attempting to disregard the corporate entity. Conversely, it may be interpreted as a new standard in which the corporate form will be disregarded anytime a recognition of the separate corporate existence would lead to injustice or an inequitable result. Moreover, under a recent Texas Supreme Court case, it is conceivable that the traditional tort/contract distinction for disregarding the corporate entity is no longer viable insofar as bad faith contractual dealings are actionable in tort. *See Arnold v. National County Mut. Fire Ins. Co.*, 30 Tex. Sup. Ct. J. 177, 178 (Jan. 28, 1987).

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