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THE DOCTRINE OF DEFECTIVE INCORPORATION  
AND ITS TENUOUS COEXISTENCE WITH THE MODEL  
BUSINESS CORPORATION ACT

INTRODUCTION

One of the most important characteristics of a corporation is its limited-liability status.<sup>1</sup> Recent years have seen the rise of noncorporate entities that can also be granted limited liability.<sup>2</sup> However, even before the appearance of these other organizations, limited liability could extend to entities that were not formally incorporated. The equitable concepts of “de facto corporation” and “corporation by estoppel” arose at common law to shield individual investors from personal liability despite the fact that the entity was not properly incorporated, if dictated by fairness concerns.<sup>3</sup> These concepts are described herein under the general doctrine of “defective incorporation.”

An empirical study of defective-incorporation cases conducted in 1952 concluded that the doctrine was applied inconsistently and that the courts rarely provided “either real reasons or good reasons” for granting limited liability or imposing personal liability,<sup>4</sup> and therefore that it was “not possible to foretell with assurance” whether the courts would grant limited liability in any given case.<sup>5</sup> The study concluded that the defective-incorporation doctrine “ought to be abandoned”<sup>6</sup> and suggested that increasing adoption of the Model Business Corporation Act (“MBCA”)<sup>7</sup> was already “minimizing the area of defective incorporation” so that the doctrine’s elimination was foreseeable.<sup>8</sup> The prevailing view since that time has been that the application of the defective-incorporation doctrine was inconsistent and unpredictable and that it was eliminated by the MBCA.<sup>9</sup>

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1. JEFFREY D. BAUMAN, ALAN R. PALMITER & FRANK PARTNOY, CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 20 (6th ed. 2007).

2. *Id.* at 133–35.

3. *Id.* at 171–72.

4. Alexander Hamilton Frey, *Legal Analysis and the “De Facto” Doctrine*, 100 U. PA. L. REV. 1153, 1180 (1952).

5. *Id.* at 1156.

6. *Id.* at 1178.

7. MODEL BUS. CORP. ACT (1950).

8. Frey, *supra* note 4, at 1180.

9. See Ernest L. Folk III, *Corporation Statutes: 1959–1966*, 1966 DUKE L.J. 875, 882 (noting that before the MBCA “simplified the incorporation

However, a subsequent empirical study of the same cases concluded, using a multiple-regression analysis, that the outcomes were *highly* predictable,<sup>10</sup> but not necessarily because courts adhered to the doctrinal elements of defective incorporation. Rather, “other factors that are mentioned [in the opinions] but supposedly are not determinative (dicta) . . . have a predictable and significant influence on what judges actually decide.”<sup>11</sup> Therefore, this subsequent study suggested that adoption of the MBCA could only inject confusion and unpredictability into a branch of cases that had previously been highly predictable.<sup>12</sup>

A further empirical study of defective-incorporation cases in the 1970s and 1980s seemed to confirm that defective-incorporation cases were highly unpredictable after adoption of the MBCA.<sup>13</sup> “Far from being eliminated” by the MBCA, the study concluded, “the defective-incorporation doctrines are alive and well.”<sup>14</sup> These findings are somewhat contradictory—if the defective-incorporation doctrine is still being applied by the courts, then one would expect the outcome of cases to be predicted by the presence or absence of the elements of (and exceptions to) either *de facto* corporation or corporation by estoppel.<sup>15</sup> The unpredictable or “fuzzy” nature of these cases was attributed to courts retaining “the flexibility necessary to reach equitable results.”<sup>16</sup>

The Study presented herein seeks to determine whether defective-incorporation cases are predictable or not and what impact the MBCA legislation has had on judicial application of the

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process,” courts faced with a defective-incorporation case required “recourse to the cloudy and uncertain *de facto* doctrine with its various distinctions”); William L. Stocks, *Corporations—De Facto Corporations—Estoppel—Model Business Corporation Act*, 43 N.C. L. REV. 206, 207 (1964) (noting that the MBCA “abolish[ed] any significance of *de facto* corporateness” and thus “aid[ed] in ending a confusing and unpredictable state of the law”).

10. Fred S. McChesney, *Doctrinal Analysis and Statistical Modeling in Law: The Case of Defective Incorporation*, 71 WASH. U. L.Q. 493, 526–29 (1993).

11. *Id.* at 532.

12. *Id.* at 520 nn.98–99 (“[W]as the common law of defective incorporation so unprincipled that statutory intervention was warranted in the first place? . . . [T]he passage of statutes designed to remove judicial discretion in defective-incorporation situations already complicates, perhaps to the point of impossibility, the task of predicting modern decisions.”).

13. Wayne N. Bradley, *An Empirical Study of Defective Incorporation*, 39 EMORY L.J. 523, 534 (1990) (“In some cases, these provisions were interpreted literally, and courts found that there could never be limited liability without the issuance of a certificate of incorporation. . . . In other states, courts simply ignored these provisions, despite their unequivocal intent, wherever the result would have been inequitable.”).

14. *Id.* at 574.

15. McChesney, *supra* note 10, at 532.

16. Bradley, *supra* note 13, at 574.

equitable doctrines. I begin with an examination of the two studies conducted on the pre-MBCA cases, and I attempt to resolve their apparently inconsistent findings. I then examine a large sample of post-MBCA cases, using the multiple-regression technique, to determine what factors influenced the outcome of the cases. One of the factors considered is time, which indicates the influence of various incarnations of the MBCA over the years.

I conclude that, for the situation where the shareholders of a defective corporation seek limited liability, the concepts of “de facto corporation” and “corporation by estoppel” are largely indistinguishable and are really two different ways of stating the unitary common-law doctrine of defective incorporation. The outcomes of these cases are highly predictable if one considers whether the shareholder of the defectively incorporated entity is acting in good faith—a factor that has been neglected by previous commentators. I also conclude that, while the attempted abolition of the defective-incorporation doctrine by the MBCA injected some uncertainty into the outcomes of cases, the courts largely ignored the MBCA on this point. In fact, the judicial backlash against attempts to legislate defective incorporation out of existence may actually have strengthened the doctrine.

#### I. BACKGROUND

At common law where an entity had failed to incorporate, its shareholders could still obtain limited liability if the courts elected to apply one of two equitable concepts.<sup>17</sup> The courts could find the unincorporated entity to be a “de facto corporation,” and thus grant it limited liability, where there was “(1) some colorable, good-faith attempt to incorporate and (2) actual use of the corporate form, such as carrying on the business as a corporation or contracting in the corporate name.”<sup>18</sup> Alternatively, the courts could find the unincorporated entity to be a “corporation by estoppel,” where another party who had dealt with the entity as a corporation would be estopped from denying its limited liability.<sup>19</sup> However, there was an exception in the event of fraud in that limited liability would not extend to entities where the shareholder did not in good faith believe that the corporation was valid.<sup>20</sup>

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17. ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS 508 (5th ed. 2006).

18. *Id.*

19. *Id.* at 509.

20. Bradley, *supra* note 13, at 530; *see also* Douglas C. Waddoups, American Vending Services, Inc. v. Morse: *The Problem of Defective Incorporation in Utah*, 1995 BYU L. REV. 303, 319 (“[C]orporation by estoppel should be applied to protect those who have acted in good faith, but should never be applied when it would be inequitable or would benefit a party who has acted negligently or in bad faith.”).

The MBCA was intended, in part, to streamline the process of incorporation and remove a variety of incorporation requirements that had arisen in some states.<sup>21</sup> Believing that most of the reasons that an entity could fail to become incorporated would be thereby eliminated, the code drafters also attempted to do away entirely with the equitable notion of limited liability for defective incorporation.<sup>22</sup> In the 1950 version of the MBCA, section 139 read, "All persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof."<sup>23</sup> An official comment to the 1950 MBCA indicated that the doctrine of de facto corporation had been eliminated by the streamlined corporation process:

Because a colorable and apparent compliance with the law is generally a requisite of "de facto" corporate existence, and because it is unlikely that any steps short of securing a certificate of incorporation would be held to constitute apparent compliance, there is little, if any, difference between "de facto" and "de jure" corporation[s] under [section 50].<sup>24</sup>

The 1969 Revised MBCA made it more explicit that the drafters intended "to prohibit the application of any theory of de facto incorporation."<sup>25</sup> An official comment stated that "a de facto corporation cannot exist under the [MBCA]" because "any steps short of securing a certificate of incorporation would not constitute apparent compliance."<sup>26</sup>

However, the 1984 Revised MBCA appeared to back away somewhat from strict adherence to the incorporation requirements. MBCA section 2.04 (formerly section 139) was modified to read, "All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting."<sup>27</sup> An official comment noted that the change was the result of "a review of the underlying policies represented in earlier versions of the [MBCA]" as well as a review of case law after the 1969 revisions.<sup>28</sup>

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21. Frey, *supra* note 4, at 1180 n.95.

22. Bradley, *supra* note 13, at 533.

23. MODEL BUS. CORP. ACT § 139 (1950).

24. *Id.* § 50 cmt.

25. MODEL BUS. CORP. ACT. § 146 cmt. (1969).

26. *Id.* § 56 cmt.

27. MODEL BUS. CORP. ACT § 2.04 (1984).

28. *Id.* § 2.04 cmt.

## II. PREVIOUS STUDIES

A. *Frey's Analysis of the Pre-MBCA Defective-Incorporation Cases*

In 1952, Alexander Hamilton Frey delivered what has been described as “a devastating attack on the ‘de facto’ doctrine.”<sup>29</sup> Frey noted that the real issue in defective-incorporation cases is not the technical label assigned to the entity (that is, de jure corporation, de facto corporation, or corporation by estoppel), but whether the court grants it limited liability.<sup>30</sup>

If a business association purports to be incorporated under a given general incorporation statute but literal and complete compliance with the provisions of that statute has not occurred, what are the legal incidents of the resulting association? Is the liability of the members of the association for its obligations limited? . . . The answers to some of these questions may be in the affirmative and to others in the negative, depending upon the nature of the defect in the attempt to incorporate and other relevant circumstances.<sup>31</sup>

Despite the implication that limited liability could be determined by the factual circumstances of each case, Frey hypothesized that it was not possible to predict, “merely by dwelling upon the factual content of a particular defect in the attempt to incorporate,” whether courts would grant limited liability to the association.<sup>32</sup> This was because the common-law defective-incorporation concepts were bound up in standards such as “substantial’ compliance” and “colorable’ or ‘apparent’ attempt” to incorporate, which were not well defined, and the common law was not clear about what legal consequences should arise where those standards were not achieved.<sup>33</sup>

To prove his hypothesis, Frey attempted to gather all published cases where an entity had sought limited liability despite not being properly incorporated.<sup>34</sup> He identified 211 such cases between 1818 and 1945.<sup>35</sup> He categorized each case according to the nature of the incorporation defect and other relevant facts, including whether the individual defendants were active in the management of the entity and whether the plaintiff dealt with the entity on a corporate

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29. F. Hodge O’Neal, *Alexander Hamilton Frey: His Contributions to the Law of Corporations and Business Associations*, 116 U. PA. L. REV. 1140, 1148 (1968).

30. Frey, *supra* note 4, at 1154, 1178.

31. *Id.* at 1155.

32. *Id.* at 1156.

33. *Id.*

34. *Id.* at 1156–57.

35. *Id.* at 1173; McChesney, *supra* note 10, at 520 n.96.

basis.<sup>36</sup>

### 1. *Frey's Findings*

Surprisingly, Frey found that the court's determination of limited liability did not significantly depend on whether the individual defendant was active in management.<sup>37</sup> (This factor is labeled  $D_{\text{active}}$  in the regression analyses later in this Study.) He determined that the defendant was active in management in only ninety-seven (46.0%) of the 211 cases.<sup>38</sup> The court granted limited liability in forty-nine (50.5%) of the ninety-seven cases where the defendant was active in management and granted limited liability in sixty-three (55.3%) of the 114 cases where the defendant was not active in management.<sup>39</sup> However, Frey acknowledged that there was "often a matter of considerable doubt" as to whether to classify a particular defendant as active or inactive, "especially if they did not participate in the formation of the association or in the particular transaction sued upon."<sup>40</sup>

Much more significant in Frey's analysis was whether the plaintiff dealt with the entity on a corporate basis.<sup>41</sup> (This factor is labeled  $P_{\text{belief}}$  in the regression analyses later in this Study.) Dealings were not on a corporate basis in only thirty-two (15.2%) of the 211 cases, and the courts granted limited liability in only two (6.3%) of those thirty-two cases.<sup>42</sup> However, in the vast majority of cases where dealings were on a corporate basis the outcome was less predictable but tended to favor the defectively incorporated entity; limited liability was found in 110 (61.5%) of the 179 cases where dealings were on a corporate basis.<sup>43</sup> Frey felt this was inconsistent with the doctrine of de facto corporation, where the emphasis "is entirely upon the character of the defect ('colorable' attempt) and not at all upon the nature of the dealings between the parties."<sup>44</sup>

Frey identified and focused his analysis on five primary categories of incorporation defects: (I) where there was no attempt to

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36. Frey, *supra* note 4, at 1157, 1175.

37. *Id.* at 1178 ("[O]ne is not justified in concluding that participation in management is an important factor in predicting the probable impact of a defect in incorporation upon the liability of the members.").

38. *Id.* at 1174 tbl.

39. *Id.*

40. *Id.* at 1176.

41. *Id.* at 1175-76 ("In recapitulation of the results of this entire body of two hundred and eleven cases, it appears that the factor of dealings on a corporate basis is of major importance. . . . If the plaintiff did not accept the association as a corporation . . . he is virtually certain to succeed, in so far as the issue of [the] personal liability [of its members] is concerned . . .").

42. *Id.* at 1174 tbl.

43. *Id.*

44. *Id.* at 1176.

incorporate (seventeen cases),<sup>45</sup> (II) where the articles of incorporation were not recorded with any government body (thirty-five cases),<sup>46</sup> (III) where the articles were recorded with the local government body but not the state (sixteen cases),<sup>47</sup> (IV) where the articles were recorded with the state but not the local government body (eighteen cases),<sup>48</sup> and (V) where the articles were recorded with the state but the statutory requirements for capitalization were not satisfied (thirty-eight cases).<sup>49</sup> Eighty-seven (41.2%) of the 211 cases did not fall under any of those categories: instead, incorporation had failed for some other reason, such as the entity's neglect of the statutory requirements for publicity (fourteen cases).<sup>50</sup>

The courts granted limited liability in only two (11.8%) of the seventeen Category I cases, where there was no attempt to incorporate.<sup>51</sup> However, in the Category II cases, where the articles of incorporation had not been recorded with any government body, and dealings were on a corporate basis, "an action by the plaintiff to hold the members of the association personally liable to him has little more than an even chance of success. Recordation of the articles locally but not with the secretary of state [Category III] produced only a minor variation in this outcome."<sup>52</sup> Frey found it "startling" that courts would grant limited liability in approximately half of the Category II and III cases, because he considered failure to record with the state "as not constituting a 'colorable' attempt to incorporate."<sup>53</sup> Because the entity in these cases did not meet the requirements of a de facto corporation, Frey reasoned, there must be another doctrine at work that resulted in limited liability in those cases (for example, express limitation of liability in contract).<sup>54</sup>

Frey famously concluded "that the traditional doctrine of a 'de facto' corporation is just so much jargon and ought to be abandoned."<sup>55</sup> He observed that states were increasingly adopting model corporation codes that eliminated limited liability for entities not in strict compliance with the state's incorporation requirements.<sup>56</sup> He connected this legislative trend with the judicial

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45. *Id.* at 1163–64.

46. *Id.* at 1158.

47. *Id.* at 1165.

48. *Id.* at 1167.

49. *Id.* at 1169–70.

50. *Id.* at 1173.

51. *Id.* at 1163–64, 1174 tbl.

52. *Id.* at 1176.

53. *Id.*

54. *Id.* at 1177.

55. *Id.* at 1178; accord Norwood P. Beveridge, *Corporate Puzzles: Being a True and Complete Explanation of De Facto Corporations and Corporations by Estoppel, Their Historical Development, Attempted Abolition, and Eventual Rehabilitation*, 22 OKLA. CITY U. L. REV. 935, 938 (1997).

56. Frey, *supra* note 4, at 1180 n.95 ("Statutes expressly establishing the

trend of a decline in the number of reported cases involving defective incorporation.<sup>57</sup> He predicted that “in time the doctrine of the ‘de facto’ corporation may become merely an historic example of legal conceptualism at its worst.”<sup>58</sup>

## 2. *Criticism of Frey*

A number of Frey’s conclusions are questionable. First of all, a judicial grant of limited liability where the plaintiff deals with the entity on a corporate basis is not inconsistent with the doctrine of de facto corporation. While Frey may have been correct that there is no logical correlation between the nature of dealings between the parties and the “colorable attempt” element of de facto incorporation, there is a *direct* connection between the nature of dealings between the parties and the second element of de facto corporation: “exercise of corporate powers.” Where an entity has acted as a corporation, it follows that other parties will deal with the entity as a corporation.

Second, the fact that entities were accorded limited liability even where articles of incorporation had not been recorded with the state does not necessarily mean that courts ignored the “colorable attempt” element of de facto incorporation. Frey wanted to define “colorable attempt to incorporate” strictly as recording articles with the state,<sup>59</sup> and he therefore expected to see a bright-line distinction drawn between Category III cases, where articles were not recorded with the state, and Category IV cases, where they were. Instead, the bright-line distinction among the cases was between those in Category I, where there was no attempt by the defendant to incorporate, and those in Category II, where the defendant had made some preliminary steps toward incorporation but, for whatever reason, the state had no record of the articles of incorporation.<sup>60</sup> There is an obvious reason why courts would favor the Category II defendant over the Category I defendant—namely, it is more likely that the Category II defendant was acting in good

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personal liability of designated persons for failure to comply with mandatory requirements are becoming more common.”).

57. *Id.* at n.96.

58. *Id.* at 1180; accord Marc R. Lieberman, *The Happy Demise of Constructive Incorporation*, 22 ARIZ. B.J. 22, 25 (1986).

59. Frey, *supra* note 4, at 1178 (proposing that “an association which has recorded articles of incorporation with the secretary of state is a ‘de facto’ corporation, and the shareholders have limited liability if the dealings were on a corporate basis”).

60. *Id.* at 1158 (“One might further suppose that where no public record of the purported incorporation has been made, the courts will almost uniformly hold that the associates have not gone far enough to achieve the attribute of limited liability. But in twelve of the thirty-five cases the associates are held not to be personally liable to the ‘corporate’ creditor . . .”).



faith with the belief that the entity was properly incorporated. Rather than indicate that courts were ignoring the “colorable attempt” element of de facto incorporation, this simply indicates that the courts defined “colorable attempt to incorporate” differently than Frey did, that is, accounting for the defendant’s good-faith belief that the entity was incorporated.

Third, Frey’s determination that the defendant’s activity in management is irrelevant to limited liability is based on his problematic determination that more than half of the cases involved inactive defendants. It does not seem likely that, in more than half of the cases where a plaintiff has a claim against those acting on behalf of a defective incorporation, he would file suit against an individual who was neither active in management nor active “in the formation of the association or in the particular transaction sued upon.”<sup>61</sup> Reexamination of Frey’s data by other commentators indicates that the cases involving active defendants actually outnumber those involving inactive defendants by greater than a five-to-one ratio.<sup>62</sup>

Finally, Frey’s conclusion that the trend was toward minimizing judicial application of the defective-incorporation doctrine was not supported by his observation that the cases were being reported in decreasing frequency.<sup>63</sup> In fact, his data indicated that the trend in the courts was increasingly toward granting limited liability in these cases.<sup>64</sup>

#### B. *McChesney’s Analysis of the Pre-MBCA Defective-Incorporation Cases*

Fred S. McChesney’s reexamination of Frey’s study in 1993 raised even more questions about the defective-incorporation doctrine. McChesney divided Frey’s cases into “de facto corporation” cases and “corporation by estoppel” cases.<sup>65</sup> McChesney’s de facto

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61. *Id.* at 1176.

62. McChesney, *supra* note 10, at 521 tbl.1 (indicating that, in seventy-nine cases where the reported case explicitly stated the defendant’s role in the firm, the defendant was active in management in sixty-seven of those cases, and inactive in only twelve); *see also* Bradley, *supra* note 13, at 538 n.109 (indicating that Frey’s classification method of distinguishing between “active” and “inactive” defendants was “spurious” because, in some cases classified as “inactive” by Frey, “it seems these defendants were actually active associates”).

63. Frey, *supra* note 4, at 1180 & n.96.

64. McChesney, *supra* note 10, at 506 (“[T]he cumulative percentage of defective-incorporation cases in which limited liability was granted. . . generally increases during the period of the Frey sample.”); *see also, e.g.,* Aetna Life Ins. Co. of Hartford, Conn. v. Weatherhogg, 4 N.E.2d 679, 683 (Ind. Ct. App. 1936) (“The doctrine that members of a corporation de facto are protected from liability as partners seems to be generally adopted in more recent cases . . .”), *cited in* Frey, *supra* note 4, at 1167 n.62.

65. McChesney, *supra* note 10, at 501–02.

corporation cases were the seventy-two cases “involving acts that seemingly constituted good-faith attempts at compliance with the applicable statute”—namely, Frey’s Category III, IV, and V cases, where the articles of incorporation had been recorded with some government body.<sup>66</sup> (McChesney, therefore, expanded the possible range of “colorable attempt at incorporation” beyond Frey’s definition to include cases where the articles were filed locally but not with the state.) McChesney’s “pure” corporation by estoppel cases were those where no articles had been filed with any government body (that is, Category I and II cases) but where Frey determined that the plaintiff dealt with the entity on a corporate basis.<sup>67</sup>

### 1. *McChesney’s Findings*

McChesney noted that, in the de facto corporation cases, “courts awarded limited liability only when the plaintiff was already dealing with the firm as a corporation. . . . [I]n all of the cases where courts invoked the de facto corporation doctrine to uphold limited liability, defendants had satisfied the test for corporation by estoppel anyway.”<sup>68</sup> Furthermore, in the “pure” corporation by estoppel cases, McChesney contended that the plaintiffs should be estopped from denying limited liability regardless of steps taken to incorporate.<sup>69</sup> However, limited liability was granted in “about half” of such cases under Category II, where there were some preliminary steps toward incorporation but the articles were not recorded with any government body,<sup>70</sup> “but almost never” in the cases under Category I, where there was no attempt to incorporate.<sup>71</sup> “Thus,” concluded McChesney, “just as estoppel elements appear important in the de facto corporation cases, the elements of de facto corporate status (attempted compliance) apparently influence judges to decree corporations by estoppel.”<sup>72</sup>

In order to try to shed some light on the doctrinal issues, McChesney reexamined Frey’s cases to uncover more facts that may have influenced the courts’ decisions. Specifically, he examined the cases for evidence of factors traditionally cited by courts to pierce the corporate veil: whether the entity required several dispersed shareholders, whether it involved a parent-subsidary relationship, whether the case involved a tort claim, whether there was evidence of fraud, whether the entity was inadequately capitalized, and

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66. *Id.* at 501.

67. *Id.* at 502–03.

68. *Id.* at 502.

69. *Id.* at 502–03.

70. Frey, *supra* note 4, at 1177.

71. McChesney, *supra* note 10, at 503.

72. *Id.*

whether there was evidence of risky acts.<sup>73</sup> However, he determined that an insignificant percentage of the cases involved parent-subsidary relationships, tort claims, inadequate capitalization, or risky acts, so those factors were discarded.<sup>74</sup> The remaining veil-piercing factors considered by McChesney were whether the entity required several dispersed shareholders (this factor is labeled  $D_{\text{disperse}}$  in this Study) and whether there was evidence of fraud on the part of the individual defendant ( $D_{\text{fraud}}$ ). McChesney also considered three additional factors: whether the individual defendant actually believed the entity was properly incorporated<sup>75</sup> ( $D_{\text{belief}}$ ), whether the lower court granted limited liability<sup>76</sup> ( $LL_{\text{below}}$ ), and a time factor (“TF”) to account for the date of the decision.<sup>77</sup>

In the process of reexamining Frey’s database of 211 cases, McChesney discarded a number of the cases. His analysis does not include the eighty-seven cases in Frey’s “miscellaneous” category.<sup>78</sup> Of the remaining 123 cases,<sup>79</sup> McChesney determined that twenty-one did not actually involve defective incorporation.<sup>80</sup> He therefore reduced Frey’s original sample of 211 cases down to 102 cases.

McChesney also apparently reassessed Frey’s characterization of whether the defendant was active in firm management ( $D_{\text{active}}$ ). Whereas Frey found that the defendant was inactive in management in sixty-eight (55.3%) of the 123 cases in Categories I–V, McChesney found that the defendant was inactive in only twelve (11.8%) of his reduced sample of 102 cases.<sup>81</sup> As stated previously, McChesney’s characterization seems more logical, because it is not clear why most plaintiffs who have done business with a defectively incorporated entity would seek relief from someone who was not actively involved with that entity.<sup>82</sup>

McChesney also took a different approach than Frey on the issue of deriving data from court opinions that do not explicitly mention the factor sought. Frey treated each parameter (for example,  $D_{\text{active}}$ ,  $P_{\text{belief}}$ ) as binary, where the value is either true or

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73. *Id.* at 512–14.

74. *Id.* at 523–24.

75. *Id.* at 522.

76. *Id.*

77. *Id.* at 529.

78. *Id.* at 520.

79. It should be noted that although Frey purported to use 124 cases in his study, one case, *Field v. Cooks*, 16 La. Ann. 153 (1861), was actually counted twice—once as an instance of an entity doing business on a corporate basis and a second time as an instance of an entity *not* doing business on a corporate basis. See Frey, *supra* note 4, at 1158–59 nn. 20–21; see also McChesney, *supra* note 10, at 520 (“Frey cited 123 cases of supposed defective incorporation . . .”).

80. *Id.*

81. *Id.* at 521 tbl.1.

82. See *supra* notes 61–62 and accompanying text.

false for a given case.<sup>83</sup> However, Frey admitted that some of the court opinions did not explicitly mention the parameters and that his estimate of the parameter was “arbitrary” in some cases.<sup>84</sup> McChesney, on the other hand, treated only three of the parameters as binary. The “outcome” or dependent parameter,  $LL_{\text{decision}}$ , was true (that is, coded to a value of one) if the court granted limited liability and false (that is, coded to a value of zero) if personal liability was imposed on the defendant.<sup>85</sup> Likewise, if the lower court had granted limited liability,  $LL_{\text{below}}$  was set to one, and it was set to zero if the lower court had imposed personal liability.<sup>86</sup> McChesney considered the defendant to have achieved colorable compliance if articles of incorporation had been recorded with any governing body<sup>87</sup> and therefore set  $D_{\text{comply}}$  to a value of one for the fifty-eight cases falling under Categories III, IV, and V.<sup>88</sup> Because McChesney treated  $D_{\text{comply}}$  as a binary parameter, it follows that if the articles had not been recorded with any governing body (Categories I and II), he set  $D_{\text{comply}}$  to zero.

For all other parameters, McChesney recognized that there were three possible states, not two.<sup>89</sup> For example, if the court explicitly found that the defendant was active in management, then  $D_{\text{active}}$  was assigned a value of one.<sup>90</sup> McChesney created another parameter (represented here as  $!D_{\text{active}}$ ), which would be assigned a value of one where the court explicitly found that the defendant was not active in management.<sup>91</sup> Obviously, both parameters could not equal one for a given case. Where the court did not make any finding with respect to the defendant’s belief, both parameters would be assigned a value of zero.<sup>92</sup>

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83. Frey, *supra* note 4, at 1175–76.

84. *Id.*

85. McChesney, *supra* note 10, at 521 tbl.1, 528.

86. *Id.* at 521 tbl.1, 522.

87. *Id.* at 501–02.

88. *Id.* at 521 tbl.1.

89. *Id.* at 516.

90. *Id.* at 521–22 n.101.

91. *Id.*

92. *Id.*

TABLE 1. MCCHESENEY'S REGRESSION ANALYSIS OF THE PRE-MBCA DEFECTIVE-INCORPORATION CASES. (ABSOLUTE *T*-STATISTICS IN PARENTHESES.)

Iteration	1	2	3
Intercept	-1.871 (2.92)	-1.863 (3.32)	-1.866 (3.59)
D <sub>comply</sub>	1.177 (2.89)	1.126 (2.87)	1.248 (3.36)
P <sub>belief</sub>	1.022 (2.57)	1.004 (2.56)	1.050 (2.78)
! P <sub>belief</sub>	-2.115 (1.72)	-1.883 (1.69)	-1.599 (1.48)
D <sub>belief</sub>	0.325 (0.82)	0.383 (1.00)	
! D <sub>belief</sub>	-0.849 (0.94)	-1.129 (1.28)	
D <sub>active</sub>	-0.487 (1.12)	-0.580 (1.42)	-0.517 (1.33)
! D <sub>active</sub>	1.634 (2.05)	1.462 (1.94)	1.759 (2.41)
D <sub>disperse</sub>	0.238 (0.49)		
! D <sub>disperse</sub>	-0.371 (0.80)		
D <sub>fraud</sub>	-1.662 (1.55)	-1.524 (1.76)	-2.194 (1.95)
! D <sub>fraud</sub>	1.741 (2.08)	1.576 (1.98)	1.488 (2.10)
LL <sub>below</sub>	1.008 (2.69)	1.017 (2.76)	0.958 (2.72)
Prediction Success	87 / 102 (85.3%)	85 / 102 (83.3%)	87 / 102 (85.3%)

After assigning values to the parameters for all cases, McChesney performed a linear-regression analysis, the results of which are shown in Table 1. On the first iteration (Column 1), McChesney determined that it was insignificant whether or not the entity required disperse investments (D<sub>disperse</sub>).<sup>93</sup> After removing that parameter (and its inverse, !D<sub>disperse</sub>) from the analysis, he performed the regression again. On this second iteration (Column 2), he determined that it was insignificant whether or not the individual defendants believed the corporation was valid (D<sub>belief</sub>).<sup>94</sup> After

93. *Id.* at 526.

94. *Id.* at 528 (“[D]efendants’ own beliefs about whether they were incorporated have marginal influence empirically on judges’ limited-liability decisions. . . . [D]efendants’ independent understanding about whether their firm is a corporation apparently count for naught, statistically, in what judges

removing this parameter (and its inverse,  $!D_{\text{belief}}$ ) from the analysis, he performed the regression a third time. The results of this iteration are shown in Column 3. He then performed a fourth iteration of the analysis, adding a time factor TF to account for the date of the decision. This fourth iteration determined that time was not a significant factor, indicating that there was not a trend in favor of limited liability.<sup>95</sup> Therefore, Column 3 represents the final regression.

This regression can be thought of as an equation that predicts whether the court will grant limited liability, where the equation would be written as:

EQUATION 1

$$LL_{\text{decision}} = -1.866 + 1.248 \times D_{\text{comply}} + 1.050 \times P_{\text{belief}} - 1.599 \times (!P_{\text{belief}}) \\ - 0.517 \times D_{\text{active}} + 1.759 \times (!D_{\text{active}}) - 2.194 \times D_{\text{fraud}} + 1.488 \times (!D_{\text{fraud}}) \\ + 0.958 \times LL_{\text{below}}$$

The output parameter ( $LL_{\text{decision}}$ ) would be expected to return a value of one where the court finds limited liability, and a value of zero where the court imposes individual liability. According to McChesney, this equation accurately predicted eighty-seven (85.3%) of the 102 cases in his analysis.<sup>96</sup>

The positive coefficients for  $D_{\text{comply}}$  and  $P_{\text{belief}}$  indicate that the defendant's attempted compliance with incorporation statute and the plaintiff's dealings with the entity as a corporation were independent factors that both favored a finding of limited liability. McChesney found this inconsistent with the distinct concepts of de facto corporation and corporation by estoppel, which he said deal with different "factual situations" and "grow out of two unrelated strains of contract law."<sup>97</sup> He concluded that the doctrines of de facto corporation and corporation by estoppel "are really not two doctrines at all,"<sup>98</sup> but rather "that *both* factors affect judges' decisions in common-law defective-incorporation situations."<sup>99</sup>

The regression also indicates a strong influence of other factors, such as whether the defendant was active in management and whether the court found that the defendant had committed fraud.<sup>100</sup> Although the courts were moderately less likely to find limited

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do.").

95. *Id.* at 529.

96. *Id.* at 527 tbl.3.

97. *Id.* at 529.

98. *Id.* at 531.

99. *Id.* at 530.

100. *Id.* at 531.

liability where the defendant was active in management ( $D_{\text{active}}$ ), where the court explicitly found that the individual defendant was *not* active in management ( $!D_{\text{active}}$ ), it strongly favored limited liability. The coefficient on  $!D_{\text{active}}$  is so large (1.759) compared to the range of expected output values (zero to one) that it was almost certain that a defendant not active in management would not be subject to personal liability.<sup>101</sup> Likewise, where the court explicitly found that the defendant engaged in fraud ( $D_{\text{fraud}}$ ), the sign and magnitude of the coefficient (-2.194) indicate that it was almost certain that courts would impose personal liability. McChesney suggested that the influence of these other factors indicates that, in practice, courts treated defective-incorporation cases much as they would a veil-piercing case.<sup>102</sup>

## 2. Criticism of McChesney

McChesney's conclusion that defective incorporation was little more than a subset of piercing the corporate veil<sup>103</sup> would seem to be contradicted by his finding that most of the traditional veil-piercing factors (dispersed shareholders, parent-subsidiary relationship, tort claim, evidence of fraud, adequate capitalization, and risky acts) were not significant factors in the defective-incorporation cases.<sup>104</sup> Furthermore, although McChesney determined that the court's explicit finding of fraud was an overwhelmingly significant indicator of how the court would rule in these cases, he also found that the factors  $D_{\text{fraud}}$  and  $!D_{\text{fraud}}$  were only present in twenty-eight (27%) of the 102 cases.<sup>105</sup> In other words, the only veil-piercing factor that would have a significant impact on the outcome was not implicated in most of the defective-incorporation cases.

Even more troubling is McChesney's conclusion that it was insignificant whether the defendant actually believed the entity was incorporated.<sup>106</sup> This finding is not supported by the data. There was a very strong correlation between the defendant's disbelief ( $!D_{\text{belief}}$ ) and whether the defendant was found to have committed fraud ( $D_{\text{fraud}}$ ).<sup>107</sup> This is to be expected—where the defendant does not believe the corporation is valid but attempts to act on behalf of the entity, the transaction would seem to be fraudulent.<sup>108</sup> Yet despite finding that the defendant's belief was not significant, McChesney found that the closely correlated factor of fraud was very significant. Rather than remove  $D_{\text{belief}}$  and  $!D_{\text{belief}}$  (which were

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101. *Id.* at 527 tbl.3.

102. *Id.* at 531.

103. *Id.*

104. *See supra* notes 73–74, 92–93 and accompanying text.

105. McChesney, *supra* note 10, at 521 tbl.1.

106. *Id.* at 528.

107. *Id.* at 524–26.

108. *Id.* at 524, 526.

explicitly identified in seventy-one of the cases) from the regression analysis in his third iteration, McChesney should have removed  $D_{\text{fraud}}$  and  $!D_{\text{fraud}}$  (which were explicitly identified in only twenty-eight of the cases) from the analysis.<sup>109</sup> The resulting equation should have had about the same predictive value as Equation 1 and would have been applicable in more cases because the courts were more likely to indicate whether or not the defendant believed the corporation was valid than whether or not the defendant had committed fraud.

Likewise, there was a strong negative correlation in McChesney's regression analysis between the defendant's disbelief and attempted compliance ( $D_{\text{comply}}$ ).<sup>110</sup> As McChesney noted, many commentators assume that a defendant's good-faith belief is one factor of the "colorable compliance" element of de facto incorporation.<sup>111</sup> However, as did Frey, McChesney measured attempted compliance solely based on the nature of the defect in each case and not based on whether the defendant knew of the defect. The effect of this was that attempted compliance was treated in the regression analysis from the standpoint of the government body—by just mechanically calculating how many steps of the state's incorporation statute were obeyed—and ignoring the "good-faith" aspect of the de facto-incorporation concept that was articulated in the common law.

McChesney's downsizing of Frey's sample also raises questions. Frey found that the courts granted limited liability in 112 (53.1%) of the 211 cases, but in only fifty-six (45.5%) of the 123 cases in Categories I–V.<sup>112</sup> After eliminating the eighty-seven "miscellaneous" cases, and then eliminating twenty-one cases in Categories I–V that supposedly did not involve defective incorporation, McChesney found that courts granted limited liability in forty-three (42.2%) of the remaining 102 cases. That means that the courts still imposed personal liability in eight (38.1%) of the twenty-one cases supposedly not involving defective incorporation (that is, where the corporation was supposedly valid). Since one would expect the court to grant limited liability in almost every case where there is a de jure corporation, the effect of discarding these twenty-one cases was to remove several highly unpredictable cases from the analysis.

A closer look at the cases eliminated by McChesney reveals that they actually involved significant incorporation defects. For example, in *First National Bank of Salem v. Almy*, the transaction at issue took place "before the full amount of the capital stock was subscribed, and before the full amount had been paid in, no

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109. *Id.* at 521 tbl.1, 528.

110. *Id.* at 525–26.

111. *Id.* at 499, 522 n.102.

112. Frey, *supra* note 4, at 1174 tbl.



certificate [of incorporation] having then or since been filed.”<sup>113</sup> McChesney discarded this case “because the court held that the firm was a de jure corporation.”<sup>114</sup> However, as Frey noted, the technical label that the court chooses to apply in these defective-incorporation cases is less an assessment of the incorporation defect than a restatement of its holding with respect to limited liability.<sup>115</sup> The fact that these cases involved defects in the incorporation process and that the court in each case was making a determination about whether the defective corporation should enjoy limited liability means that the cases were relevant to the study, regardless of the technical label applied by the court.

TABLE 2. REGRESSION ANALYSIS OF FREY’S CHARACTERIZATION OF THE PRE-MBCA CASES. (ABSOLUTE *T*-STATISTICS IN PARENTHESES.)

Iteration	1	2	3
Intercept	0.059 (0.50)	0.050 (0.50)	0.072 (0.81)
D <sub>comply</sub>	-0.021 (0.14)		
P <sub>belief</sub>	0.438 (4.32)	0.437 (4.34)	0.435 (4.33)
D <sub>active</sub>	0.042 (0.53)	0.040 (0.51)	
TF	0.753 (2.32)	0.715 (3.86)	0.722 (3.92)
Prediction Success	90 / 124 (72.6%)	91 / 124 (73.4%)	91 / 124 (73.4%)

There is also evidence that the downsizing of Frey’s sample biased McChesney’s analysis. To test this idea, I applied McChesney’s regression method to Frey’s characterization of the 123 cases in Categories I–V. The results are shown in Table 2. For direct-comparison purposes, D<sub>comply</sub> was determined using McChesney’s method: D<sub>comply</sub> was set to a value of one for cases in Categories III, IV, and V, and to a value of zero for cases in Categories I and II. D<sub>active</sub> was set to one where Frey determined that the defendant was active in management, and P<sub>belief</sub> was set to one where Frey determined that the plaintiff dealt with the entity on a corporate basis. Because Frey treated these parameters as

113. First Nat’l Bank of Salem v. Almy, 117 Mass. 476, 477 (1874).

114. McChesney, *supra* note 10, at 522.

115. Frey, *supra* note 4, at 1178 (“[N]othing is gained or clarified by including the statement that the association ‘is a “de facto” corporation’ or that it ‘is not a “de facto” corporation.’ . . . [The label] is literally nothing more than a somewhat obscure way of stating that the associates do or do not enjoy limited liability.”).

binary, there was no need to include the inverse parameters  $!D_{\text{active}}$  and  $!P_{\text{belief}}$ . For example, where  $D_{\text{active}}$  equals zero,  $!D_{\text{active}}$  will necessarily equal one, and vice versa. Therefore the inverse parameters have a perfect (negative) correlation with the primary parameters and would be duplicative in the regression analysis.

Time was accounted for in the regression, with the time factor TF computed for each case as:

EQUATION 2

$$TF = \frac{Date - 1900}{100}$$

Therefore, for a case decided in 1900, the value of TF would be zero. For a case decided in 2000, the value of TF would be one. This kept the magnitude of the time factor in the same general range as other factors in the analysis, which typically have a value of either zero or one, to permit direct comparison between the correlation coefficients for time and other factors.

The first iteration, shown in Column 1, indicates that, contrary to McChesney's observation, the nature of the defect (measured by  $D_{\text{comply}}$ ) was largely insignificant to the court's ultimate determination of whether to grant limited liability.<sup>116</sup> That parameter was removed from the analysis, and the regression was performed again. On the second iteration, shown in Column 2, the influence of whether the defendant was active in management ( $D_{\text{active}}$ ) was statistically insignificantly different than zero.<sup>117</sup> That parameter was removed for the final iteration, shown in Column 3. The regression analysis can be reduced to the following equation:

EQUATION 3

$$LL_{\text{decision}} = 0.072 + 0.435 \times P_{\text{belief}} + 0.722 \times \left( \frac{Date - 1900}{100} \right)$$

The output parameter ( $LL_{\text{decision}}$ ) would be expected to return a

116. However, Frey's own analysis showed significant differences in the court's award of limited liability depending on the nature of the defect. *See supra* notes 51–53 and accompanying text. The insignificance of  $D_{\text{comply}}$  in the regression analysis is probably the result of adopting McChesney's approach of modeling a range of defects using a single binary parameter.

117. The insignificance of  $D_{\text{active}}$  in the regression analysis is probably the result of Frey's questionable determinations of what constitutes a defendant active in management. *See supra* notes 61–62 and accompanying text.

value of one where the court finds limited liability and a value of zero where the court imposes individual liability. Note that, for a case in the year 1900 ( $TF = 0$ ), where the plaintiff deals with the entity on a corporate basis ( $P_{\text{belief}} = 1$ ), the value of  $LL_{\text{decision}}$  would be 0.507, or essentially a coin toss as to whether the court will award limited liability. According to Equation 3, courts would be expected to grant limited liability in such cases after 1900 and would be expected to impose individual liability in such cases before 1900.

The equation was assessed for each case: a result of 0.5 or greater was treated as predicting limited liability, and a result less than 0.5 was treated as predicting individual liability. The equation correctly predicted the outcome in ninety-one (73.4%) of the 124 cases.<sup>118</sup> McChesney reported a higher rate of success for his equation (85.3%), but he did so by eliminating a number of highly unpredictable cases.<sup>119</sup> Also, one of the factors in McChesney's analysis was whether the lower court granted limited liability.<sup>120</sup> It is not at all surprising that the lower-court decision would be correlated with the appellate-court decision—two courts confronted with the identical factual scenario and legal question would be expected to arrive at similar conclusions frequently. But there is of course no suggestion that the lower-court ruling is an element of the defective-incorporation doctrine.

More interestingly, using McChesney's regression method with Frey's characterization of the same data, one concludes that there is a significant influence of time on the outcome of the cases. The positive coefficient on the time factor  $TF$  indicates that courts were increasingly likely to find limited liability over the time period covered by the cases, contrary to McChesney's finding (examining the same cases!) that the influence of time was insignificant or even slightly negative.<sup>121</sup>

### C. Bradley's Analysis of the 1970–1989 Defective-Incorporation Cases

Warranting mention is an empirical study of 131 defective-incorporation cases conducted by Wayne Bradley in 1990.<sup>122</sup> Bradley attempted to gather all defective-incorporation cases from 1970 through 1989 and repeat Frey's analysis to determine whether subsequent adoption of the MBCA had the influence predicted by Frey.<sup>123</sup>

Bradley observed that Frey's study only covered one factual situation in which courts might apply the defective-incorporation

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118. See *supra* note 79.

119. McChesney, *supra* note 10, at 527–28.

120. *Id.* at 522.

121. *Id.* at 529.

122. Bradley, *supra* note 13, at 540 n.110.

123. *Id.*

doctrine (that is, where the shareholders of a defectively incorporated entity sought limited liability).<sup>124</sup> Sixty-seven (51.1%) of the 131 cases between 1970 and 1989 involved this situation<sup>125</sup> (Situation A). Thirty-one (23.7%) of the 131 cases involved the situation where shareholders of a defectively incorporated entity sought corporate status not to avoid liability, but rather to hold another party liable (for example, to enforce a contract entered into by the defectively incorporated entity)<sup>126</sup> (Situation B). Nine (6.9%) of the 131 cases involved the situation where the owners of the defectively incorporated entity denied its corporate status in order to avoid the obligations of the entity<sup>127</sup> (Situation C). Seven (5.3%) of the 131 cases dealt with challenges to municipal incorporation<sup>128</sup> (Situation D). Two (1.5%) of the cases involved criminal charges, where the defendant challenged the corporate status of the victim<sup>129</sup> (Situation E). Bradley's study focused on Situation A, where the shareholders sought limited liability, which was the situation analyzed by Frey and McChesney.

Because adoption of the MBCA had removed some impediments to incorporation (for example, registration with a local government body (Category IV) and minimum paid-in capital (Category V) had largely been eliminated as requirements for incorporation),<sup>130</sup> there was not as wide a range of possible incorporation defects in these 1970–1989 cases. Therefore, Bradley attempted to categorize the cases based on a combination of the nature of the defect and its timing.<sup>131</sup> Bradley divided the cases in Frey's Category I (where there was no attempt to incorporate) into two subcategories: where there was never any attempt to incorporate<sup>132</sup> and where there was no attempt to incorporate at the time of the transaction in question, but the entity was successfully incorporated later.<sup>133</sup> Bradley divided the cases in Frey's Categories II and III (where some steps toward incorporation had been taken but incorporation was not complete at the time of transaction) into two subcategories: where the incorporation process had begun at the time of the transaction but was never completed<sup>134</sup> and where the incorporation process had begun at the time of the transaction but was not completed until

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124. *Id.* at 559.

125. *Id.* at 542 tbl.2.

126. *Id.* at 560.

127. *Id.* at 565.

128. *Id.* at 566.

129. *Id.* at 567.

130. Frey, *supra* note 4, at 1180 n.95.

131. Bradley, *supra* note 13, at 548.

132. *Id.* at 543, 548 (describing the "No Attempt to Incorporate" category).

133. *Id.* at 550.

134. *Id.* at 551.

later.<sup>135</sup> Finally, Bradley identified a category of defective incorporation not identified by Frey: where a formerly valid corporation had become defective at the time of the transaction<sup>136</sup> (referred to in this Study as Category VI). Bradley divided the cases in this category into two subcategories: where the certificate of incorporation had been revoked<sup>137</sup> and where the corporation's certificate to do business had been revoked.<sup>138</sup>

Bradley also attempted to characterize each case according to the Frey factors: whether or not the defendant was active in management ( $D_{\text{active}}$ ) and whether or not the transaction was conducted on a corporate basis ( $P_{\text{belief}}$ ).<sup>139</sup> However, he observed that in many of the 1970–1989 cases, “the defective corporation ha[d] few shareholders”<sup>140</sup> ( $D_{\text{disperse}} = 0$ ). “Consequently, all shareholders may be deemed ‘active’ . . . .”<sup>141</sup> ( $D_{\text{active}} = 1$ ). Bradley identified only two (3.0%) of the sixty-seven cases in which the defendant was not active in management ( $D_{\text{active}} = 0$ ).<sup>142</sup> Furthermore, he identified only nine (13.4%) of the sixty-seven cases in which the plaintiff did not deal with the entity on a corporate basis ( $P_{\text{belief}} = 0$ ).<sup>143</sup>

### 1. Bradley's Findings

Bradley observed that, contrary to Frey's prediction, modern corporate legislation did not eliminate, or even reduce, application of the defective-incorporation doctrine: “The steady decline that Frey found in the number of cases referencing the defective-incorporation doctrines has not continued. The number of cases has in fact greatly increased in the [1980s].”<sup>144</sup> “Far from being eliminated, or even on the decline as Professor Frey predicted, the defective-incorporation doctrines are alive and well,” he concluded.<sup>145</sup>

However, a number of Bradley's findings seem to be contrary to the defective-incorporation doctrines. Most remarkably, Bradley observed a complete reversal in the influence of  $P_{\text{belief}}$  from the Frey cases. Where dealings were on a corporate basis ( $P_{\text{belief}} = 1$ ), personal liability was imposed 51.7% of the time in Bradley's cases and only 38.5% of the time in Frey's cases.<sup>146</sup> On the other hand, where dealings were not on a corporate basis ( $P_{\text{belief}} = 0$ ), personal liability

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135. *Id.* at 552.

136. *Id.* at 548.

137. *Id.* at 556.

138. *Id.* at 559.

139. *Id.* at 543, 557.

140. *Id.* at 531–32.

141. *Id.*

142. *Id.* at 557.

143. *Id.* at 541.

144. *Id.* at 572.

145. *Id.* at 574.

146. *Id.* at 541.

was imposed only 55.6% of the time in Bradley's cases but 93.8% of the time in Frey's cases.<sup>147</sup> Therefore, Bradley observed that, contrary to the doctrine of corporation by estoppel, the plaintiff's intention to deal with the entity as a corporation was not a significant factor in determining whether limited liability would be imposed.

Bradley's other findings called into question whether courts pay attention to the de facto-corporation element of colorable compliance. He observed that limited liability was more likely to be granted if the incorporation process did not begin until after the transaction at issue in the case, and personal liability was more likely to be imposed if incorporation had begun but was not complete at the time of the transaction.<sup>148</sup> Limited liability was even less likely to be granted where the entity had been validly incorporated at one time but was not in good standing at the time of transaction.<sup>149</sup> These findings are counterintuitive to the de facto-corporation notion of "colorable compliance" because limited liability was less likely to be granted where there had been some attempt to comply with the incorporation statute before the transaction at issue in the case.

Bradley also observed that courts were not impressed by continuing efforts by the defendant to comply with the incorporation statute after the occurrence of the transaction at issue in the case. Where incorporation was incomplete at the time of the transaction, individual liability "was imposed in about the same percentage of cases . . . regardless of whether the incorporation process was ever completed."<sup>150</sup>

## 2. Criticism of Bradley

In order to try to shed some light on Bradley's contradictory findings, I repeated McChesney's multiple-linear-regression analysis for Bradley's characterization of the 1970-1989 cases. For the two cases that Bradley identified as involving defendants who were not active in management,  $D_{\text{active}}$  was set to a value of zero. For the nine cases that Bradley identified as involving plaintiffs who did not deal with the entity on a corporate basis,  $P_{\text{belief}}$  was set to a value of zero. For all other cases,  $D_{\text{active}}$  and  $P_{\text{belief}}$  were set to a value of one.

Clearly, for the Category I cases, where there was no attempt to incorporate at the time of the transaction,  $D_{\text{comply}}$  was set to zero. For the Category VI cases, where the entity had been validly incorporated at one time,  $D_{\text{comply}}$  was set to one. For the remaining

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147. *Id.*

148. *Id.* at 572-73.

149. *Id.* at 573 ("In cases where valid corporate charters were revoked, individual liability was imposed in a high percentage of cases relative to other categories of cases.").

150. *Id.*

cases, where the articles of incorporation had not been filed with the state despite some preliminary activity toward incorporation, it was assumed that the defendant attempted to comply ( $D_{\text{comply}} = 1$ ) if the entity eventually became incorporated, and it is assumed that there was not a good-faith attempt at compliance ( $D_{\text{comply}} = 0$ ) if the entity remained unincorporated after the transaction.

TABLE 3. REGRESSION ANALYSIS OF BRADLEY'S CHARACTERIZATION OF THE 1970–1989 DEFECTIVE-INCORPORATION CASES. (ABSOLUTE *T*-STATISTICS IN PARENTHESES.)

Iteration	1	2	3
Intercept	1.336 (1.02)	1.316 (1.31)	0.754 (2.06)
$D_{\text{comply}}$	0.264 (2.07)	0.259 (2.08)	0.246 (2.02)
$P_{\text{belief}}$	-0.042 (0.23)		
$D_{\text{active}}$	-0.444 (1.24)	-0.441 (1.24)	-0.432 (1.22)
TF	-0.661 (0.58)	-0.680 (0.60)	
Prediction Success	42 / 67 (62.7%)	42 / 67 (62.7%)	42 / 67 (62.7%)

The results are shown in Table 3. The regression largely corroborates Bradley's observation that the plaintiff's intention to deal with the entity as a corporation was not a significant factor in determining whether limited liability would be imposed.<sup>151</sup> The first iteration, shown in Column 1, indicates that  $P_{\text{belief}}$  was insignificant to the court's ultimate determination of whether to grant limited liability. That parameter was removed from the analysis and the regression was performed again. The second iteration, shown in Column 2, indicated that there was not a significant trend over time. This is to be expected, since the database of cases used by Bradley only covered a twenty-year period. Therefore, the time factor TF was removed for the final iteration, shown in Column 3. The regression analysis can be reduced to the following equation:

EQUATION 4

$$LL_{\text{decision}} = 0.754 + 0.246 \times D_{\text{comply}} - 0.432 \times D_{\text{active}}$$

For the typical case where the defendant was active in management, if there was no attempt to comply with the incorporation statute the equation results in a prediction of 0.322, or

151. *Id.* at 553–54.

a very low likelihood of being granted limited liability. However, if there was evidence of some attempt to comply, such as being validly incorporated at some time prior to the transaction or completing incorporation after the transaction, the equation indicates a tendency to grant limited liability ( $LL_{\text{decision}} = 0.568$ ).

However, there are serious questions about Bradley's classification of the data.<sup>152</sup> A number of the cases that he categorized as Situation A, where the shareholder seeks corporate status to avoid personal liability, actually belong in Situation C, where the entity's opponent is trying to impose corporate status on the entity.<sup>153</sup>

Also troubling is his determination of whether the plaintiff dealt with the entity on a corporate basis ( $P_{\text{belief}}$ ). In a number of cases that Bradley categorizes as "corporate basis," the court explicitly found that the dealings were *not* on a corporate basis.<sup>154</sup> Likewise, in a number of the cases that Bradley characterizes as "not on a corporate basis," the court explicitly found that the dealings *were* on a corporate basis.<sup>155</sup>

Due to the unreliable characterization of data in the Bradley study, it should not be relied upon to support the claim that the defective-incorporation doctrine remained viable after the MBCA

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152. See *supra* notes 128–29 and accompanying text.

153. See, e.g., *In re Appeal of Armed Forces Coop. Insuring Ass'n*, 625 P.2d 11, 17 (Kan. Ct. App. 1981) (holding that entity was not a de facto corporation and therefore avoided tax liability); *Henderson v. Sprout Bros.*, 440 N.W.2d 629, 634 (Mich. Ct. App. 1989) (holding the entity could be liable for its contractual obligations if it were found to have been a de facto corporation at the time of the contract); *Shakra v. Benedictine Sisters of Bedford, N.H., Inc.*, 553 A.2d 1327, 1330 (N.H. 1989) (holding that entity was not liable under its contract, even if it was a de facto corporation, because contract was not signed by an authorized agent).

154. See, e.g., *Tan-Line Sun Studios, Inc. v. Bradley*, No. 84–5925, 1986 WL 3764, at \*11 (E.D. Pa. Mar. 25, 1986) ("Plaintiff did nothing that would make it inequitable for it to deny the existence of that pseudo corporation" where there was no finalized contract.); *Harris v. Stephens Wholesale Bldg. Supply Co.*, 309 So. 2d 115, 118 (Ala. Civ. App. 1975) ("[T]he evidence fully supports the trial court's belief that [plaintiff] considered that it was dealing with [defendant] in an individual capacity."); *Weiss v. Anderson*, 341 N.W.2d 367, 372 (N.D. 1983) (where "after learning of [defendant's] plans to incorporate the business, [plaintiffs] were still doing business with him as an individual").

155. See, e.g., *Loveridge v. Dreagoux*, 678 F.2d 870, 878 (10th Cir. 1982) ("[T]he plaintiffs were not interested in buying securities in a de facto corporation. When they talked about a corporation, they were speaking of one that was established and financially sound."); *Micicche v. Billings*, 727 P.2d 367, 373 (Colo. 1986) (Erickson, J., specially concurring) ("[T]he corporation continued its operations and was doing business as a corporation on . . . the date that [plaintiff] was employed" with the entity.); *Cleary v. N. Del. A-OK Campground, Inc.*, 1987 WL 28317, at \*4 (Del. Super. Ct. Dec. 9, 1987) ("The business did exercise its corporate power here . . .").



attempted to end it. The unreliable characterization of the data is reflected by the relatively low predictive character of the regression analysis of Bradley's data.

### III. ANALYSIS

#### A. *Method*

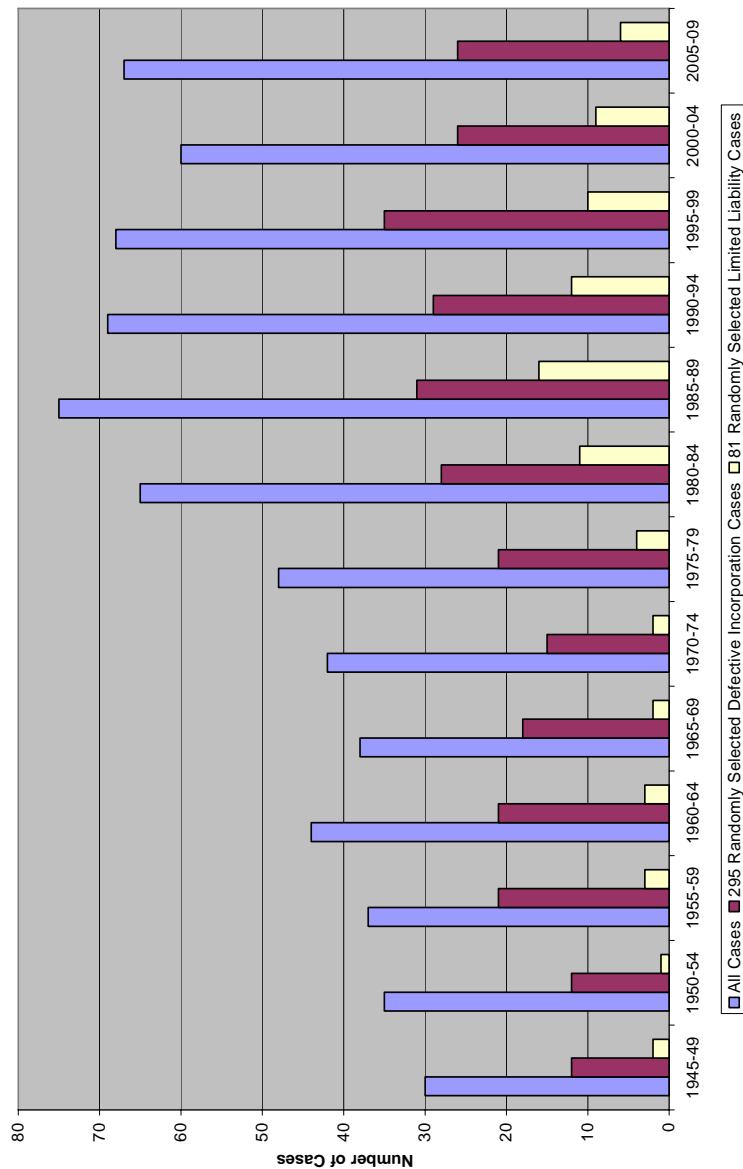
The database of cases for this Study was selected by searching on Westlaw for all state and federal cases using the terms "de facto corporation" or "corporation by estoppel" between 1945 and 2008. Six hundred seventy-eight such cases were identified. From this total, 350 cases were selected at random. Each of those cases was examined to determine whether it fell within Situation A, where the shareholders sought corporate status as a shield for limited liability.

In fifty-five (15.7%) of the 350 cases, defective incorporation was not an issue.<sup>156</sup> Of the remaining 295 defective-incorporation cases, eighty-one (27.5%) dealt with Situation A, where individuals sought corporate status for the purposes of limited liability. Fifty-five (18.6%) of the 295 cases dealt with Situation C, where shareholders of the defective corporation sought to deny its corporate status to avoid an obligation, and its opponent desired that the court treat it as a de facto corporation. Forty (13.6%) of the 295 cases dealt with Situation D, where a defectively formed municipal corporation sought de facto status. Eight (2.7%) of the cases dealt with Situation E, where a criminal defendant challenged the corporate status of the victim. The remaining 111 cases (37.6% of the 295 defective-incorporation cases) dealt with Situation B, where the shareholders of the defective corporation sought corporate status for some reason other than limited liability. Typical examples include where the contractual rights of the defective corporation were challenged, where the defective corporation sought standing to maintain a lawsuit against another party, or where the defective corporation sought corporate status for tax reasons.

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156. These are often cases where defective incorporation is not an issue, but the legal issue of the case is analogized to defective incorporation. *See, e.g.*, *Tyson v. Shoemaker*, 65 S.E.2d 701, 704 (Ga. Ct. App. 1951) ("Why is it any more of an infringement on the legislative province to recognize a de facto stop sign than it is to recognize a de facto corporation?" (quoting Brief of Plaintiff in Error)).

FIGURE 1. DISTRIBUTION OF CASES USED IN STUDY.



The distribution of cases over time is shown in Figure 1. Of the 295 randomly selected defective-incorporation cases, 120 (40.7%) are from the thirty-five year period from 1945 until 1980. The remaining 175 (59.3%) are from the thirty-year period from 1980 until the present. This bias toward post-1980 cases in the sample is to be expected, given the increase in reported cases generally since 1980, and does not necessarily reflect an increasing frequency of defective-incorporation cases. However, it is interesting to note that

of the 120 defective-incorporation cases prior to 1980, only seventeen (14.2%) dealt with the limited-liability issue (Situation A). Contrast this with twenty-seven limited-liability cases in the 1980s, or 45.8% of the fifty-nine defective-incorporation cases randomly selected from that decade. (This is roughly consistent with Bradley's observation that 51.1% of the defective-incorporation cases between 1970 and 1989 dealt with Situation A.)<sup>157</sup> The remaining thirty-seven limited-liability cases are from 1990 to the present, representing 31.9% of the 116 defective-incorporation cases randomly selected from that time period.

The real emergence of limited liability as a major litigation issue in the 1980s is interesting considering that the spike in litigation occurred after the 1969 revision of the MBCA attempted to unequivocally abolish the judicial application of any theory of de facto corporation. This apparently incongruous outcome (where courts were more likely to consider the issue of defective incorporation after it had been legislated out of existence) is consistent with Bradley's suggestion that there may have been a judicial backlash in the 1980s against the unequivocal language of the 1969 revision.<sup>158</sup> Likewise, the relative judicial moderation since that time coincides with many states' adoption of the 1984 revision of the MBCA, which replaced the outright abolition of de facto corporation with a clarification that individual liability was to be imposed upon "persons purporting to act as or on behalf of a corporation, knowing there was no incorporation."<sup>159</sup> As Bradley noted in 1990, the flexible standard provided by the drafters "allows courts to take into account equitable considerations, in recognition of the fact that many courts were already doing this."<sup>160</sup>

Only the eighty-one limited-liability cases (Situation A) are considered in the following regression analyses.<sup>161</sup> Five of the cases actually each involve two distinct defective-incorporation fact patterns, and therefore two distinct decisions by the court.<sup>162</sup>

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157. See Bradley, *supra* note 13, at 536 & n. 95.

158. Bradley, *supra* note 13, at 534.

159. *Id.* at 535 (quoting MODEL BUS. CORP. ACT § 2.04 (1984)).

160. *Id.*

161. Courts indicate that there are different considerations in determining whether an entity should be accorded corporate status for limited liability and whether it should be accorded corporate status for other reasons, such as standing or contract rights. See, e.g., *Pharm. Sales Consulting Corp. v. Accucorp Packaging, Inc.*, No. 95-5961 (MLC), 2007 WL 4259998, at \*4 (D.N.J. Nov. 30, 2007) ("The Court's ruling on [plaintiff's] corporate status was for purposes of determining [the entity's] capacity to sue and be sued, and not determinative of whether [the partners in the entity] could use the non-existent corporation as a shield to the consequences of their actions.").

162. *Fonda Group, Inc. v. Lewison*, 133 F. Supp. 2d 350, 351 n.2 (D. Vt. 2001) (involving two defective corporations, one of which had never been incorporated in New Jersey and one of which had been incorporated in New

Therefore, each of those cases is treated as two separate decisions in the following regression analyses, which results in a total of eighty-six limited-liability decisions. Limited liability was granted, or the court declined to impose personal liability, in thirty-four (39.5%) of the decisions.<sup>163</sup>

Jersey but had since been voided by the state); *Prentice Corp. v. Martin*, 624 F. Supp. 1114, 1115–16 (E.D.N.Y. 1986) (denying summary judgment for plaintiff (thus not imposing personal liability on defendant) because defendant claimed he was unaware of corporation's dissolution and also denying summary judgment for defendant (thus not granting limited liability) because plaintiff alleged that defendant fraudulently misrepresented corporation's status); *Cranwood Dev. Co. v. Friedman*, No. 56196, 1989 WL 139575, at \*4–5 (Ohio Ct. App. Nov. 16, 1989) (affirming the lower court's denial of summary judgment for the plaintiff (thus not imposing personal liability) because the plaintiff had not proven fraud and also overturning the lower court's dismissal (thus not granting limited liability) because the plaintiff *alleged* fraud); *Hicks v. Cont'l Carbon Paper Mfg. Co. of Dallas*, 380 S.W.2d 737, 740 (Tex. Civ. App. 1964) (holding officers and directors personally liable but not imposing personal liability on a defendant who was not active in management of the defective corporation at the time the debt was incurred); *Murphy v. Crosland*, 886 P.2d 74, 75–76 (Utah Ct. App. 1994) (involving two defendant officers of the defective corporation—the president who had been granted limited liability by the lower court, and the vice president who had been held personally liable by the lower court).

163. *L-Tec Elecs. Corp. v. Cougar Elec. Org., Inc.*, 198 F.3d 85, 87 (2d Cir. 1999); *Prentice Corp.*, 624 F. Supp. at 1116; *U.S. Fid. & Guar. Corp. v. Putzy*, 613 F. Supp. 594, 595 (N.D. Ill. 1985); *Cargill, Inc. v. Am. Pork Producers, Inc.*, 415 F. Supp. 876, 880 (D.S.D. 1976); *United States v. Shoreline Packing Co.*, 130 F. Supp. 888, 890 (D. Conn. 1955); *Collins v. Pub Dennis of Hadley, Inc. (In re David's & Unique Eatery)*, 82 B.R. 652, 657 (Bankr. D. Mass. 1987); *Clark-Franklin-Kingston Press, Inc. v. Romano*, 529 A.2d 240, 244 (Conn. App. Ct. 1987); *Gallagher v. Whitteaker*, No. PJRFSTCV075004857S, 2008 WL 344574, at \*1 (Conn. Super. Ct. Jan. 11, 2008); *Murphy v. Danbury Car-Cam Uni Corp.*, No. CV990336766S, 2001 WL 358862, at \*4 (Conn. Super. Ct. Mar. 27, 2001); *Duncan v. Junior Achievement, Inc.*, No. CV96 0335878, 1998 WL 437325, at \*2 (Conn. Super. Ct. July 9, 1998); *Karp v. Am. Legion Dep't of Conn., Inc.*, No. CV 930462879S, 1996 WL 457012, at \*2 (Conn. Super. Ct. June 18, 1996); *Huchro v. Strategic Acquisition Co.*, No. CV 93 0134171, 1995 WL 152116 (Conn. Super. Ct. Mar. 28, 1995); *Shawmut Bank of Conn. N.A. v. Ciccone*, No. CV91 0120548 S, 1993 WL 445833, at \*1 (Conn. Super. Ct. Oct. 13, 1993); *Caudill v. Sinex Pools, Inc.*, No. 04C-10-090 WCC, 2006 WL 258302, at \*3 (Del. Super. Ct. Jan. 18, 2006); *Cleary v. N. Del. A-OK Campground, Inc.*, 1987 WL 28317, at \*4 (Del. Super. Ct. Dec. 9, 1987); *Harry Rich Corp. v. Feinberg*, 518 So. 2d 377, 382 (Fla. Dist. Ct. App. 1987); *Spector v. Hart*, 139 So. 2d 923, 927 (Fla. Dist. Ct. App. 1962); *Pinson v. Hartsfield Int'l Commerce Ctr., Ltd.*, 382 S.E.2d 136, 139 (Ga. Ct. App. 1989); *Goodwyne v. Moore*, 316 S.E.2d 601, 604 (Ga. Ct. App. 1984); *Fike v. Bauer*, 412 P.2d 819, 820–21 (Idaho 1966); *Barker-Chadsey Co. v. W.C. Fuller Co.*, 448 N.E.2d 1283, 1287 (Mass. App. Ct. 1983); *Bergy Bros., Inc. v. Zeeland Feeder Pig, Inc.*, 327 N.W.2d 305, 311 (Mich. 1982); *Almac, Inc. v. JRH Dev., Inc.*, 391 N.W.2d 919, 925 (Minn. Ct. App. 1986); *Guilford Builders Supply*

The eighty-six Situation A decisions were categorized according to the nature of the incorporation defect. Nine (10.5%) of the decisions fell under Category I, where there was no attempt to incorporate.<sup>164</sup> Twenty-eight (32.6%) of the decisions fell under Category II, where the individual defendant had taken some steps toward incorporation, such as hiring an attorney to incorporate, but the articles of incorporation were not recorded with a governing body at the time of the transaction at issue in the case.<sup>165</sup> In

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Co. v. Reynolds, 249 N.C. 612, 616, 107 S.E.2d 80, 83 (1959); Charles A. Torrence Co. v. Clary, 121 N.C. App. 211, 213 464 S.E.2d 502, 504 (N.C. Ct. App. 1995); *Cranwood Dev. Co.*, 1989 WL 139575, at \*5 (“Cranwood’s motion documents fail to demonstrate that [defendant] is personally liable for the judgment rendered in the lease . . .”); *Cooper v. Stetler*, No. 42885, 1981 WL 10353, at \*4–5 (Ohio Ct. App. June 18, 1981); *Sherwood & Roberts-Or., Inc. v. Alexander*, 525 P.2d 135, 138–39 (Or. 1974); *Sivers v. R & F Capital Corp.*, 858 P.2d 895, 897–99 (Or. Ct. App. 1993); *Paper Prods. Co. v. Doggrell*, 261 S.W.2d 127, 129 (Tenn. 1953); *Co. Stores Dev. Corp. v. Pottery Warehouse, Inc.*, 733 S.W.2d 886, 888 (Tenn. Ct. App. 1987); *Hicks*, 380 S.W.2d at 740 (“Defendant . . . not being a director or officer at the time the debt claimed by the plaintiff was created, no liability can be charged to him.”); *Guest Servs. Co. of Va. v. Della Ratta*, No. 101281, 1992 WL 884625, at \*4 (Va. Cir. Ct. Apr. 8, 1992); *Bean v. McDonald’s Corp.*, No. 8640, 1990 WL 751365, at \*1–2 (Va. Cir. Ct. Nov. 27, 1990).

164. *Pharm. Sales*, 2007 WL 4259998, at \*4; *Pharm. Sales & Consulting Corp. v. J.W.S. Delavau Co.*, 59 F. Supp. 2d 408, 410 (D.N.J. 1999); *Tan-Line Sun Studios, Inc. v. Bradley*, No. 84–5925, 1986 WL 3764, at \*11 (E.D. Pa. Mar. 25, 1986); *Shoreline Packing Co.*, 130 F. Supp. at 888; *Reiman v. Int’l Hospitality Group, Ltd.*, 614 A.2d 925, 929 (D.C. 1992); *Artech Info. Sys., LLC v. Tee*, 721 N.Y.S.2d 321, 326 (App. Div. 2001); *Huntington Bank of Wash. Court House v. Cartwright*, No. 79–CA–3, 1982 WL 3235, at \*2 (Ohio Ct. App. Oct. 6, 1982); *Sherwood & Roberts-Or., Inc.*, 525 P.2d at 137; *Del. Sys. Corp. v. Greenfield*, 636 A.2d 1318, 1319 (R.I. 1994). In all of these cases, the individual defendant is charged with knowledge that the corporation is defective ( $D_{\text{belief}} = 0$ ).

165. In fifteen of the cases, the individual defendant believes the corporation is valid despite the lack of recordation ( $D_{\text{belief}} = 1$ ). *In re David’s & Unique Eatery*, 82 B.R. at 653; *Bowers Bldg. Co. v. Altura Glass Co.*, 694 P.2d 876, 877 (Colo. Ct. App. 1984); *Gallagher*, 2008 WL 344574, at \*1; *Briga v. D’Amico*, No. CV040083317S, 2004 WL 772065, at \*1 (Conn. Super. Ct. Mar. 24, 2004); *Huchro*, 1995 WL 152116, at \*3; *Caudill*, 2006 WL 258302, at \*2–3; *Cleary*, 1987 WL 28317, at \*4; *Harry Rich Corp.*, 518 So. 2d at 382; *Dep’t. of Revenue v. Roman S. Dombrowski Enters.*, 560 N.E.2d 881, 882 (Ill. App. Ct. 1990); *Almac, Inc.*, 391 N.W.2d at 924; *Conway v. Samet*, 300 N.Y.S.2d 243, 246 (Sup. Ct. 1969); *Cooper*, 1981 WL 10353, at \*2–3; *Timberline Equip. Co. v. Davenport*, 514 P.2d 1109, 1110 (Or. 1973); *Sivers*, 858 P.2d at 899; *Thompson & Green Mach. Co. v. Music City Lumber Co.*, 683 S.W.2d 340, 341 (Tenn. Ct. App. 1984).

In the remaining thirteen cases in this category, the defendant is aware that the corporation is invalid at the time of the transaction at issue in the case ( $D_{\text{belief}} = 0$ ). *Shelter Mortgage Corp. v. Castle Mortgage Co.*, 117 F. App’x. 6, 9

general, if no articles were ever recorded, it was assumed herein that there was no attempt to incorporate unless there was evidence that the defendant took some preliminary steps. Where a certificate of incorporation issued close in time to the transaction in question, that was treated as evidence that some steps had been taken to set the incorporation process in motion at the time of the transaction.

No cases matched Frey's Category III, where the articles of incorporation were recorded locally but not with the state. Only three cases (3.5%) fell under Category IV, where the articles of incorporation had been recorded with the state but not with the local governing body,<sup>166</sup> and only two cases (2.3%) fell under Category V, where the articles had been recorded with the state but incorporation failed from the outset due to failure to observe initial corporate formalities, such as sufficient capitalization.<sup>167</sup>

Forty-four (51.2%) of the decisions dealt with Bradley's Category VI, where the articles of incorporation had been valid at one time, but the entity had either failed to maintain corporate status or was not cleared to do business in the state.<sup>168</sup> These cases

n.3 (10th Cir. 2004); *Loveridge v. Dreagoux*, 678 F.2d 870, 874–76 (10th Cir. 1982); *Fonda Group, Inc. v. Lewison*, 162 F. Supp. 2d 292, 297 & n.7 (D. Vt. 2001); *Fonda Group, Inc.*, 133 F. Supp. 2d at 351; U.S. *ex rel.* Elec. Supply Corp. v. Bergen Constr. Corp., No. 78 C 602, 1985 WL 1936, at \*2 (N.D. Ill. June 21, 1985); *Ex parte* AmSouth Bank of Ala., 669 So. 2d 154, 156 (Ala. 1995); *Harris v. Stephens Wholesale Bldg. Supply Co.*, 309 So. 2d 115, 117–18 (Ala. Civ. App. 1975); *Fike*, 412 P.2d at 820–21; *Hill v. County Concrete Co.*, 672 A.2d 667, 668–69 (Md. Ct. Spec. App. 1996); *Weiss v. Anderson*, 341 N.W.2d 367, 371–72 (N.D. 1983); *Quality Interiors, Inc. v. Am. Mgmt. & Dev. Corp.*, No. 89–T–4303, 1990 WL 199248, at \*1–2 (Ohio Ct. App. Dec. 7, 1990); *Co. Stores Dev. Corp.*, 733 S.W.2d at 887; *Am. Vending Servs., Inc. v. Morse*, 881 P.2d 917, 918 (Utah Ct. App. 1994).

166. *Minich v. Gem State Devs., Inc.*, 591 P.2d 1078, 1080–81 (Idaho 1979); *State ex rel. McCain v. Constr. Enters., Inc.*, 631 P.2d 1240, 1241–42 (Kan. Ct. App. 1981); *Paper Prods. Co.*, 261 S.W.2d at 128. In all of these cases, the defendant acted with the belief that the corporation was valid ( $D_{\text{belief}} = 1$ ).

167. In *Cohen v. Miller*, 68 A.2d 421, 423–25 (N.J. Super. Ct. Ch. Div. 1949), the defendant believed the corporation was valid ( $D_{\text{belief}} = 1$ ). In *Mobridge Cmty. Indus., Inc. v. Toure, Ltd.*, 273 N.W.2d 128, 132–33 (S.D. 1978), the defendant was found to have fraudulently represented its corporate status ( $D_{\text{belief}} = 0$ ).

168. In twenty-seven of the decisions, the defendant is aware that the corporation is defective ( $D_{\text{belief}} = 0$ ). *McLesky v. Davis Boat Works, Inc.*, 225 F.3d 654, 2000 WL 1008793, at \*2 (4th Cir. 2000); *Orix Fin. Servs., Inc. v. LeClair*, No. 05–CV–9405KMK, 2007 WL 633706, at \*4 (S.D.N.Y. Feb. 26, 2007); *Pound v. Airosol Co.*, 368 F. Supp. 2d 1210, 1212 (D. Kan. 2005); *Fonda Group, Inc.*, 133 F. Supp. 2d at 351; *Prentice Corp.*, 624 F. Supp. at 1116 (“Plaintiff alleges that defendant deliberately misrepresented [its] corporate status to [plaintiff] and to the court.”); *Cargill, Inc.*, 415 F. Supp. at 877; *Billings v. Micciche*, 691 P.2d 1155, 1156 (Colo. Ct. App. 1984); *J.M. Lynne Co. v. Geraghty*, 528 A.2d 786, 789 (Conn. 1987); *Fox Run Mall Assocs. v. Lawler*, No. CVH–5842, 2001 WL 65592, at \*1, \*3 (Conn. Super. Ct. Jan. 15, 2001); *Karp*, 1996 WL 457012, at \*2; *Shelton Ctr. Assocs. v. Zalumous*, No. CV91 03 64 50, 1992 WL 389922, at \*1 (Conn. Super. Ct. Dec. 11, 1992); *Haddad v. Francis*, 537 A.2d 174, 176–77

typically involved a corporation that had either been dissolved or suspended by the state for failure to pay taxes or failure to file annual reports.

In the following regression analyses,  $D_{\text{comply}}$  was coded to zero where there had never been articles recorded with the state (Categories I and II). Where articles had been recorded with the state,  $D_{\text{comply}}$  was coded to one.

Each case was also characterized according to Frey's other two factors: whether or not the individual defendant was active in management ( $D_{\text{active}}$ ) and whether or not the plaintiff dealt with the defendant as a corporation ( $P_{\text{belief}}$ ). Only ten (11.6%) of the decisions involved a defendant who was not active in management of the defective incorporation;<sup>169</sup> the rest of the cases involved active

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(Conn. Super. Ct. 1986); *Spector*, 139 So. 2d at 924; *Bergy Bros., Inc.*, 327 N.W.2d at 306; *Bergy Bros., Inc. v. Zeeland Feeder Pig, Inc.*, 292 N.W.2d 493, 494 (Mich. Ct. App. 1980); *Leibson v. Henry*, 204 S.W.2d 310, 311–12 (Mo. 1947); *Lodato v. Greyhawk N. Am., LLC*, 807 N.Y.S.2d 818, 819–20, 827 (Sup. Ct. 2005); *WorldCom, Inc. v. Sandoval*, 701 N.Y.S.2d 834, 835 (Sup. Ct. 1999); *Lester Bros., Inc. v. Pope Realty & Ins. Co.*, 250 N.C. 565, 567, 109 S.E.2d 263, 265 (1959); *Guilford Builders Supply Co.*, 249 N.C. at 614, 107 S.E.2d at 81; *Cranwood Dev. Co.*, 1989 WL 139575, at \*1, 4 (“[Plaintiff’s] allegations that [defendant] acted fraudulently in executing the lease would, if proven, subject [defendant] to personal liability.”); *Harris v. Turchetta*, 622 A.2d 487, 488–89 (R.I. 1993); *Bulova Watch Co. v. Roberts Jewelers of Rock Hill, Inc.*, 125 S.E.2d 643, 644 (S.C. 1962); *Hicks*, 380 S.W.2d at 738 (“[D]ue notice of the delinquency [was sent] to the corporation pursuant to the [statute].”); *Murphy v. Crosland*, 915 P.2d 491, 491–92 (Utah 1996); *Murphy v. Crosland*, 886 P.2d 74, 85 (Utah Ct. App. 1994) (affirming one officer’s personal liability and overturning judgment for another, see *supra* note 162 and accompanying text).

In the remaining seventeen decisions in this category, the defendant acts with the belief that the corporation is valid ( $D_{\text{belief}} = 1$ ). *L-Tec Elecs. Corp.*, 198 F.3d at 86, 88; *Prentice Corp.*, 624 F. Supp. at 1115 (“[Defendant] says that he did not know of [the corporation]’s dissolution until . . . after [the] court’s judgment.”); *U.S. Fid. & Guar. Corp.*, 613 F. Supp. at 596, 601; *Clark-Franklin-Kingston Press, Inc. v. Romano*, 529 A.2d at 241 (Conn. App. Ct. 1987); *Murphy*, 2001 WL 358862, at \*3–4; *Conn. Light & Power Co. v. Patel*, No. CV990429899, 2000 WL 1391739, at \*1–2 (Conn. Super. Ct. Sept. 12, 2000); *Duncan*, 1998 WL 437325, at \*2; *Shawmut Bank of Conn. N.A.*, 1993 WL 445833, at \*1; *Pinson*, 382 S.E.2d at 137–38; *Goodwyne*, 316 S.E.2d at 603; *Barker-Chadsey Co.*, 448 N.E.2d at 1284; *Springer v. Opsahl*, 744 P.2d 884, 888–90 (Mont. 1987); *Charles A. Torrence Co.*, 121 N.C. App. at 213–14, 464 S.E.2d at 503–04; *Cranwood Dev. Co.*, 1989 WL 139575, at \*4–5 (“[Plaintiff’s] motion documents fail to demonstrate that [defendant] is personally liable for the judgment rendered in the lease, or that he acted fraudulently as alleged.”); *Hicks*, 380 S.W.2d at 739 (“Defendant . . . was not a director at the time the account in question accrued and no knowledge of accrual of such debt can be charged to him.”); *Guest Servs. Co. of Va.*, 1992 WL 884625, at \*2; *Bean*, 1990 WL 751365, at \*1.

169. *U.S. Fid. & Guar. Corp.*, 613 F. Supp. at 600; *Duncan*, 1998 WL 437325, at \*1; *Karp*, 1996 WL 457012, at \*2; *Cleary*, 1987 WL 28317, at \*1, 3; *Fike*, 412 P.2d at 820; *Bergy Bros., Inc.*, 327 N.W.2d at 306; *Cohen*, 68 A.2d at 424–25; *Sivers*, 858 P.2d at 898; *Paper Prods. Co.*, 261 S.W.2d at 128; *Hicks*, 380 S.W.2d at 740 (noting that because one of the four defendants “[was] not . . . a director or officer at the time the debt claimed by the plaintiff was created, no

defendants. This is consistent with the observations of both McChesney and Bradley of low percentages of cases involving inactive defendants in the pre-1945 cases and the 1970–1989 cases, respectively.<sup>170</sup> Likewise, only twenty-four (27.9%) of the decisions involved the situation where the plaintiff did not deal with the entity on a corporate basis;<sup>171</sup> the rest involved corporate transactions. Again, this ratio of non-corporate-basis cases to corporate-basis cases is consistent with the findings of McChesney and Bradley.

In addition, each case was characterized according to some of the factors identified by McChesney: whether or not ownership was dispersed ( $D_{\text{disperse}}$ ) and whether or not the individual defendant was aware that the corporation was defective ( $D_{\text{belief}}$ ). Almost all of the cases involved small, closely held entities. In only fifteen (17.4%) of the decisions does ownership seem to be spread among more than three non-family members.<sup>172</sup> Again, this is consistent with the findings of both McChesney and Bradley as to the low percentage of

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liability can be charged to him”).

170. McChesney, *supra* note 10, at 521; Bradley, *supra* note 13, at 557.

171. *Orix Fin. Servs., Inc.*, 2007 WL 633706, at \*4; *Pound*, 368 F. Supp. 2d at 1211; *Tan-Line Sun Studios, Inc. v. Bradley*, No. 84–5925, 1986 WL 3764, at \*11 (E.D. Pa. Mar. 25, 1986); *U.S. ex rel. Elec. Supply Corp. v. Bergen Constr. Corp.*, No. 78 C 602, 1985 WL 1936, at \*3 (N.D. Ill. June 21, 1985); *United States v. Shoreline Packing Co.*, 130 F. Supp. 888, 888 (D. Conn. 1955); *Ex parte AmSouth Bank of Ala.*, 669 So. 2d 154, 158 (Ala. 1995); *Harris v. Stephens Wholesale Bldg. Supply Co.*, 309 So. 2d 115, 118 (Ala. Civ. App. 1975); *Gallagher v. Whitteaker*, No. PJRFSTCV075004857S, 2008 WL 344574, at \*1 (Conn. Super. Ct. Jan. 11, 2008); *Briga v. D’Amico*, No. CV040083317S, 2004 WL 772065, at \*1 (Conn. Super. Ct. Mar. 24, 2004); *Murphy*, 2001 WL 358862, at \*1; *Fox Run Mall Assocs. Ltd.*, 2001 WL 65592, at \*2–3; *Karp*, 1996 WL 457012, at \*1; *Shelton Ctr. Assocs.*, 1992 WL 389922, at \*5; *Dep’t of Revenue v. Roman S. Dombrowski Enters.*, 560 N.E.2d 881, 885 (Ill. App. Ct. 1990); *State ex rel. McCain*, 631 P.2d at 1241; *Leibson*, 204 S.W.2d at 311; *Springer*, 744 P.2d at 889; *Guilford Builders Supply Co.*, 249 N.C. at 616, 107 S.E.2d at 83; *Weiss v. Anderson*, 341 N.W.2d 367, 371 (N.D. 1983); *Sherwood & Roberts-Or., Inc. v. Alexander*, 525 P.2d 135, 137 (Or. 1974) (“Plaintiff knew that at this time there was no corporate entity.”); *Timberline Equip. Co. v. Davenport*, 514 P.2d 1109, 1113 (Or. 1973); *Bulova Watch Co.*, 125 S.E.2d at 645; *Co. Stores Dev. Corp. v. Pottery Warehouse, Inc.*, 733 S.W.2d 886, 888 (Tenn. Ct. App. 1987) (“[P]laintiff was aware of the nonexistence of the corporate entity . . . .”); *Bean*, 1990 WL 751365, at \*1.

172. *Loveridge v. Dreagoux*, 678 F.2d 870, 870, 873 (10th Cir. 1982); *Tan-Line Sun Studios, Inc.*, 1986 WL 3764, at \*1; *U.S. Fid. & Guar. Corp.*, 613 F. Supp. at 595–96; *Cargill, Inc.*, 415 F. Supp. 876; *Clark-Franklin-Kingston Press, Inc.*, 529 A.2d at 241; *Murphy*, 2001 WL 358862, at \*1; *Duncan*, 1998 WL 437325, at \*1; *Karp*, 1996 WL 457012, at \*1; *Huchro v. Strategic Acquisition Co.*, No. CV 93 0134171, 1995 WL 152116, at \*1 (Conn. Super. Ct. Mar. 28, 1995); *Harry Rich Corp. v. Feinberg*, 518 So. 2d 377, 378 (Fla. Dist. Ct. App. 1987); *Springer*, 744 P.2d at 886; *Mobridge Cmty. Indus., Inc.*, 273 N.W.2d at 130; *Paper Prods. Co.*, 261 S.W.2d at 128; *Hicks*, 380 S.W.2d at 739 (see *supra* note 162 and accompanying text).



cases involving dispersed ownership.<sup>173</sup>

The biggest contrast with the pre-1945 cases relates to what the individual defendant believed regarding the corporate status of the entity. In the eighty-six randomly selected defective-incorporation decisions after 1945, the defendant believed the corporation was valid in thirty-six (41.9%) of the decisions and was aware that the entity was not properly incorporated in fifty (58.1%) of the decisions.<sup>174</sup> In McChesney's characterization of the pre-1945 cases, there were fifty cases where the defendant believed the entity was properly incorporated and only twenty-one cases where the defendant knew the entity was not valid.<sup>175</sup>

Each of the aforementioned parameters was treated as binary in the regression analyses that follow: the defendant was either active in management or not; the plaintiff either dealt with the business as a corporation or not. Unlike McChesney's observation of the pre-1945 cases, in the post-1945 cases, the court almost always makes explicit findings (or, at least, strong suggestions) as to the factors listed above. In the rare case where there was no explicit finding and it was not obvious from the facts of the case, I made the following assumptions<sup>176</sup>: that the defendant was active in management ( $D_{\text{active}} = 1$ ); that ownership was not dispersed ( $D_{\text{disperse}} = 0$ ); and that it is fair to charge the individual defendant with constructive knowledge of the defect ( $D_{\text{belief}} = 0$ ) if the defendant was active in management, unless the defendant had taken reasonable steps toward incorporation (such as hiring an attorney to file the articles). I further assumed that the plaintiff dealt with the business as a corporation ( $P_{\text{belief}} = 1$ ) if the transaction in question was contractual (and conversely, that the plaintiff did not deal with the business as a corporation ( $P_{\text{belief}} = 0$ ) if there was no contractual relationship or if the contractual relationship was with an individual rather than a business) and that the plaintiff did not deal with the business as a corporation ( $P_{\text{belief}} = 0$ ) if the court found that the plaintiff contracted with a business entity knowing that it was not yet properly incorporated or requiring a personal guarantee from one of the prospective incorporators.<sup>177</sup>

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173. McChesney, *supra* note 10, at 521 tbl.1; Bradley, *supra* note 13, at 531–32.

174. *See supra* notes 164–168.

175. McChesney, *supra* note 10, at 521 tbl.1.

176. An empirical study of this sort inevitably involves some subjective classification of the data. *See, e.g.*, Frey, *supra* note 4, at 1175–76 (noting that the classification of the cases may be “arbitrary,” “not clear cut,” or “often a matter of considerable doubt” with respect to certain factors); McChesney, *supra* note 10, at 522–23 (noting that in some cases, “it was difficult to tell whether or not the court had actually considered a certain factor”). The assumptions listed here represent an attempt to make the classification process as objective as possible.

177. These assumptions are believed to better reflect the original meaning of

As Bradley noticed, timing is important.<sup>178</sup> For example, in the case where a once-valid corporation failed to maintain its corporate status, it is critical for limited-liability purposes to determine whether the transaction at issue in the case occurred before or after the defect arose. Likewise, a corporation that was defectively formed when it started conducting business may cure its defects at some later time. In all of these cases, the challenged defect was present at the time of the transaction in question. However, in forty-four (51.2%) of the decisions, the defect was cured before trial. Rather than subdivide the “defect” categories as Bradley did, I added another parameter ( $D_{\text{cured}}$ ) to account for whether or not the defect was cured after the fact. Again, this was a binary parameter: if the entity cured its defect sometime between the transaction and the trial,  $D_{\text{cured}}$  was set to a value of one. Unless the court explicitly found that the defect was cured, it was assumed that the corporation was still in a defective state at the time of trial ( $D_{\text{cured}} = 0$ ).

Some of McChesney’s other parameters do not lend themselves so easily to binary interpretation. For example, courts rarely made a determination as to whether or not fraud was present. In only eight (9.3%) of the decisions did the court suggest fraud,<sup>179</sup> and in twelve (14.0%) of the decisions the court indicated that there was no evidence of fraud.<sup>180</sup> In almost all cases where the court suggested

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Frey’s “dealings on a corporate basis” parameter than simply dividing the cases into contract and tort situations. As Frey defined the term:

Throughout this article the plaintiff and the association are said to have had “dealings on a corporate basis” if the association had been represented to him as incorporated and if, in his dealings with the association, he did not contest the accuracy of this representation; the parties are said not to have had “dealings on a corporate basis” either if the plaintiff had not dealt with the association, as in the normal tort case, or if the designation of the association is ambiguous and, in his dealings with the association, the plaintiff justifiably assumed it was unincorporated or showed no concern with its legal status.

Frey, *supra* note 4, at 1157–58 n. 18; *see also* McChesney, *supra* note 10, at 523 n. 107 (“[M]ost of [Frey’s] cases designated as “not on a corporate basis” were ones in which the plaintiffs contracted with the firm without knowing whether it was a corporation.”).

178. Bradley, *supra* note 13, at 572–73.

179. *Loveridge*, 678 F.2d at 876; *Tan-Line Sun Studios, Inc. v. Bradley*, No. 84–5925, 1986 WL 3764 (E.D. Pa. Mar. 25, 1986); *Prentice Corp. v. Martin*, 624 F. Supp. 1114, 1116 (E.D.N.Y. 1986); *Cohen v. Miller*, 68 A.2d 421, 425 (N.J. Super. Ct. Ch. Div. 1949); *Quality Interiors, Inc. v. Am. Mgmt. & Dev. Corp.*, No. 89–T–4303, 1990 WL 199248 (Ohio Ct. App. Dec. 7, 1990); *Cranwood Dev. Co. v. Friedman*, No. 56196, 1989 WL 139575, at \*4 (Ohio Ct. App. Nov. 16, 1989); *Huntington Bank of Wash. Court House v. Cartwright*, No. 79–CA–3, 1982 WL 3235 (Ohio Ct. App. Oct. 6, 1982); *Mobridge Cmty. Indus., Inc. v. Toure, Ltd.*, 273 N.W.2d 128, 132–33 (S.D. 1978).

180. *L-Tec Elecs. Corp. v. Cougar Elec. Org.*, 198 F.3d 85, 88 (2d Cir. 1999); *Orix Fin. Servs., Inc. v. LeClair*, No. 05–CV–9405KMK, 2007 WL 633706 (S.D.N.Y. Feb. 26, 2007); *U.S. Fid. & Guar. Corp. v. Putzy*, 613 F. Supp. 594,

fraud, it also indicated that the defendant was aware that the entity was not incorporated; in fact, the fraud suggested by the court was typically that the defendant acted on behalf of the entity with the knowledge that it was not incorporated.<sup>181</sup> Therefore, the  $D_{\text{fraud}}$  parameter was not considered in the following regression analyses due to its infrequent appearance in the cases and the strong likelihood of multicollinearity with  $D_{\text{belief}}$  in the cases where it arose.

### B. Simple Regression

I performed a multiple-regression analysis similar to McChesney's with these modern cases. As in McChesney's analysis, the output parameter  $LL_{\text{decision}}$  was set to a value of one where the court granted limited liability (that is, found for the individual defendant) and was set to zero where the court held the individual defendant personally liable.

Because the parameters  $D_{\text{active}}$ ,  $D_{\text{disperse}}$ ,  $D_{\text{belief}}$ , and  $P_{\text{belief}}$  are binary, there could be nothing gained by including a second parameter to represent the inverse situation (for example,  $!D_{\text{active}}$ ,  $!P_{\text{belief}}$ ).  $D_{\text{active}}$  was set to a value of one if the individual defendant was active in the management of the defective corporation and zero if not active in management.  $D_{\text{belief}}$  was set to a value of one if the individual defendant believed the business was validly incorporated and was set to zero where there is no such belief.  $P_{\text{belief}}$  was set to a value of one if the plaintiff dealt with the business as a corporation and was set to zero where the plaintiff did not.

Unlike in McChesney's analysis, where all cases were appellate, thirty-four (39.5%) of the eighty-six decisions in this Study are trial-court opinions where there was no lower-court opinion. Therefore,  $LL_{\text{below}}$  is not a binary parameter; it has three possible states (where lower courts grant limited liability, where lower courts impose personal liability, and where there is no lower-court opinion). Therefore, an inverse parameter  $!LL_{\text{below}}$  is created to represent the

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601–02 (N.D. Ill. 1985); *J.M. Lynne Co. v. Geraghty*, 528 A.2d 786, 789 (Conn. 1987); *Harry Rich Corp. v. Feinberg*, 518 So. 2d 377, 378, 382 (Fla. Dist. Ct. App. 1987); *Pinson v. Hartsfield Int'l Commerce Ctr., Ltd.*, 382 S.E.2d 136, 138 (Ga. Ct. App. 1989); *Almac, Inc. v. JRH Dev., Inc.*, 391 N.W.2d 919, 924 (Minn. Ct. App. 1986); *Guilford Builders Supply Co. v. Reynolds*, 249 N.C. 612, 616, 107 S.E.2d 80, 83 (1959); *Cranwood Dev. Co.*, 1989 WL 139575, at \*4; *Cooper v. Stetler*, No. 42885, 1981 WL 10353, at \*4 (Ohio Ct. App. June 18, 1981); *Co. Stores Dev. Corp. v. Pottery Warehouse, Inc.*, 733 S.W.2d 886, 888 (Tenn. Ct. App. 1987); *Guest Servs. Co. of Va. v. Della Ratta*, No. 101281, 1992 WL 884625, at \*8–9 (Va. Cir. Ct. Apr. 8, 1992).

181. *But see Cohen*, 68 A.2d at 424–25 (holding that complaint sufficiently alleged fraud where the defendants were accused of acting fraudulently because they knew they had no authority to act on behalf of the corporation, despite the fact that defendants were not shareholders, officers, or directors of the corporation, and therefore did not know corporation was in receivership).

case where the lower court did not grant limited liability.  $LL_{\text{below}}$  was set to one if the lower court granted limited liability and  $!LL_{\text{below}}$  was set to one if the lower court imposed personal liability. Where there was no lower-court decision, both parameters equal zero.

TABLE 4. SIMPLE REGRESSION ANALYSIS OF THE 1945–2008 DEFECTIVE-INCORPORATION CASES. (ABSOLUTE *T*-STATISTICS IN PARENTHESES.)

Iteration	1	2	3	4	5
Intercept	-0.473 (0.40)	-0.463 (0.40)	-0.412 (0.36)	-0.476 (0.42)	-0.531 (0.47)
$D_{\text{comply}}$	0.036 (0.39)	0.035 (0.39)			
$P_{\text{belief}}$	-0.009 (0.09)				
$D_{\text{belief}}$	0.441 (4.70)	0.441 (4.74)	0.440 (4.75)	0.435 (4.75)	0.426 (4.71)
$D_{\text{active}}$	-0.399 (2.64)	-0.396 (2.69)	-0.399 (2.73)	-0.388 (2.70)	-0.399 (2.80)
$D_{\text{cured}}$	0.073 (0.80)	0.074 (0.81)	0.067 (0.76)	0.062 (0.71)	
$LL_{\text{below}}$	0.062 (0.53)	0.061 (0.53)	0.058 (0.51)		
$!LL_{\text{below}}$	-0.170 (1.47)	-0.172 (1.52)	-0.177 (1.58)	-0.207 (2.15)	-0.204 (2.14)
TF	2.863 (0.93)	2.826 (0.93)	2.790 (0.93)	3.071 (1.04)	3.322 (1.14)
TF <sup>2</sup>	-1.898 (1.00)	-1.877 (1.00)	-1.866 (1.00)	-2.073 (1.14)	-2.225 (1.24)
Prediction Success	65 / 86 (75.6%)	65 / 86 (75.6%)	66 / 86 (76.7%)	66 / 86 (76.7%)	68 / 86 (79.1%)

Time factor TF from Equation 2 was included in the regression, both as a linear parameter and a second-order (TF<sup>2</sup>) parameter. Because this database covers such a large range of time, looking at second-order time effects permitted a determination of more complex changes in judicial application of the doctrine over time.

The results are shown in Table 4. Parameters that proved to be insignificant in the analysis were removed iteratively. The final iteration is shown in Column 5. Interestingly enough, three parameters prove insignificant in this analysis: (1) whether the plaintiff dealt with the entity as a corporation ( $P_{\text{belief}}$ ), (2) whether the articles of incorporation were filed with the state ( $D_{\text{comply}}$ ), and (3) whether the defect was corrected after the fact ( $D_{\text{cured}}$ ).<sup>182</sup> At first

182. Courts are split on whether a retroactive attempt to correct the incorporation defect constitutes attempted compliance with the corporation statute. See, e.g., *Reiman v. Int'l Hospitality Group, Ltd.*, 614 A.2d 925, 932 (D.C. 1992) (holding that limited liability cannot flow from curing the defect

glance, this would appear to indicate that the doctrine of defective incorporation is, in fact, muddled. Whether or not the plaintiff dealt with the business as a corporation is the sole element of corporation by estoppel, yet in this analysis it was not a statistically significant indicator of limited liability. Likewise, whether or not there was an attempt to file paperwork with the state has been treated by commentators as the sole requirement for de facto corporation, yet in this analysis it was not a statistically significant indicator of limited liability. Eliminating those insignificant parameters from the regression analysis, we end up with the following equation for predicting limited liability:

## EQUATION 5

$$LL_{decision} = -0.531 + 0.426 \times D_{belief} - 0.399 \times D_{active} - 0.204 \times (!LL_{below}) + 3.322 \times TF - 2.225 \times TF^2$$

The regression indicates that the most significant parameter (t=4.71) is whether or not the individual defendant actually believed that the corporation was valid ( $D_{belief}$ ). Also, the magnitude of the coefficient (0.426) is rather large considering the fact that the outcome of the correlation ranges from zero (for individual liability) to one (for limited liability). The fact that the defendant believed the corporation is valid could therefore combine with other factors to lean heavily toward limited liability.

The second most significant parameter (t=2.80) is whether or not the individual defendant was active in management ( $D_{active}$ ). The magnitude of this coefficient (0.399) is also large relative to the range of the output parameter. The sign is negative, indicating that a defendant who was active in management is very likely to have personal liability imposed. While activity in management is not a stated element of either de facto corporation or corporation by estoppel, the cases strongly suggest that these concepts apply only to active defendants.<sup>183</sup> This does not mean that inactive defendants are more likely to be held personally liable. Where the defendant was not active in management, he will typically not have been aware that the corporation was defective and will benefit from the court's favorable treatment of those who believed the corporation is valid.<sup>184</sup>

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retroactively); *Barker-Chadsey Co. v. W.C. Fuller Co.*, 448 N.E.2d 1283, 1287 (Mass. App. Ct. 1983) (making reinstatement an express requirement of limited liability).

183. See, e.g., *Bean v. McDonald's Corp.*, No. 8640, 1990 WL 751365, at \*2 (Va. Cir. Ct. Nov. 27, 1990) ("It is a strong public policy in Virginia that shields officers and directors from individual liability for a corporate obligation.")

184. See, e.g., *U.S. Fid. & Guar. Corp. v. Putzy*, 613 F. Supp. 594, 601 (N.D.

Another statistically significant parameter is whether the lower court imposed personal liability ( $LL_{\text{below}}$ ). Because one-third of the cases were trial-court opinions, this parameter has no influence in those cases. In the appellate decisions, the parameter is not as influential as whether the individual defendant was active in management or believed the corporation was valid. However, the sign on the coefficient is positive for  $LL_{\text{below}}$  and negative for  $!LL_{\text{below}}$ , indicating that the appellate court has a tendency to follow the lower court.

Application of Equation 5 does not shine much light on the defective-incorporation doctrine. In the year 2010 ( $TF = 1.10$ ), in a typical trial-court case ( $!LL_{\text{below}}=0$ ) where the defendant was active in management ( $D_{\text{active}}=1$ ), and the defendant believed that the corporation was valid ( $D_{\text{belief}}=1$ ), the equation reduces to:

#### EQUATION 6

$$LL_{\text{decision}} = -0.531 + 0.426 \times 1 - 0.399 \times 1 + 3.322 \times 1.1 - 2.225 \times (1.1)^2 = 0.458$$

The result (0.458) is almost exactly the average of one (limited liability) and zero (personal liability). In other words, it is a coin toss whether that factual setting today would result in limited liability. The multiple-linear-regression analysis did not clarify the defective-incorporation doctrine, so a modified approach is attempted next.

#### C. Modified Regression

The linear-regression analysis recommended by McChesney and used heretofore in this Study would appear to be a very useful tool for analyzing judicial doctrines where courts have announced a “balancing test.” Where a number of independent parameters are evaluated to arrive at a judicial conclusion, this analytical method would clearly demonstrate the relative weight courts attach to each factor. However, for a case like de facto corporation, where the judicial test is composed of a number of mandatory elements, I hypothesize that some modification to the analysis is necessary. For example, if there has been no exercise of corporate authority, there is no need to consider whether there has been a colorable attempt to comply—the entity cannot be a de facto corporation because one element has not been met.

To address this issue, I modified the regression analysis somewhat. To evaluate whether there has been a good-faith attempt to incorporate, I created a new variable to represent the

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Ill. 1985) (holding that personal liability did not extend to passive investor who in good faith believed the corporation was valid).

situation where the defendant both attempted to comply with the state incorporation statute and believed that the attempt was successful. This variable can be represented as ( $D_{\text{belief}} \times D_{\text{comply}}$ )—only if both  $D_{\text{belief}}$  and  $D_{\text{comply}}$  are “true,” or non-zero, can the multiple also be true. Likewise, to measure the incremental benefit of curing the defect after becoming aware that the entity was defectively incorporated, I created a variable to represent the multiple ( $D_{\text{belief}} \times D_{\text{cured}}$ ).

The results are shown in Table 5. Parameters that proved to be insignificant in the analysis were removed iteratively. The final iteration is shown in Column 4. This regression can be represented as the following equation:

## EQUATION 7

$$\begin{aligned}
 LL_{\text{decision}} = & -0.512 - 0.367 \times D_{\text{active}} - 0.154 \times (!LL_{\text{below}}) \\
 & + P_{\text{belief}} \times [0.347 \times D_{\text{belief}} - 0.204 \times (!D_{\text{belief}})] \\
 & + 3.317 \times TF - 2.112 \times TF^2
 \end{aligned}$$

TABLE 5. MODIFIED REGRESSION ANALYSIS OF THE 1945–2008 DEFECTIVE-INCORPORATION CASES. (ABSOLUTE *T*-STATISTICS IN PARENTHESES.)

Iteration	1	2	3	4
Intercept	-0.388 (0.34)	-0.478 (0.32)	-0.527 (0.47)	-0.512 (0.46)
$D_{\text{active}}$	-0.369 (2.50)	-0.373 (2.54)	-0.359 (2.51)	-0.367 (2.57)
$D_{\text{belief}}$ $\times P_{\text{belief}}$	0.294 (2.28)	0.301 (2.36)	0.304 (2.40)	0.347 (3.02)
$! D_{\text{belief}}$ $\times P_{\text{belief}}$	-0.182 (1.58)	-0.197 (1.77)	-0.187 (1.72)	-0.204 (1.90)
$D_{\text{belief}}$ $\times D_{\text{comply}}$	0.096 (0.77)	0.099 (0.80)	0.101 (0.82)	
$D_{\text{belief}}$ $\times D_{\text{cured}}$	0.059 (0.48)			
$LL_{\text{below}}$	0.056 (0.50)	0.056 (0.49)		
$! LL_{\text{below}}$	-0.125 (1.10)	-0.122 (1.07)	-0.151 (1.57)	-0.154 (1.61)
TF	2.826 (0.94)	3.077 (1.05)	3.293 (1.14)	3.317 (1.15)
TF <sup>2</sup>	-1.784 (0.96)	-1.929 (1.05)	-2.098 (1.17)	-2.112 (1.18)
Prediction Success	69 / 86 (81.0%)	69 / 86 (81.0%)	69 / 86 (81.0%)	70 / 86 (81.4%)

What is most interesting is the influence of whether the plaintiff dealt with the entity on a corporate basis ( $P_{\text{belief}}$ ). If the defendant acted with a good-faith belief that the corporation was valid, then  $P_{\text{belief}}$  has a significant positive influence on a judicial determination of limited liability. This closely reflects the classic de facto–corporation situation:  $D_{\text{belief}}$  is a strong indicator of a good-faith, colorable attempt to comply, and  $P_{\text{belief}}$  (dealing on a corporate basis) is a strong indicator that the entity exercised corporate power. Conversely, where the defendant did not act with a good-faith belief that the corporation was valid, then  $P_{\text{belief}}$  has a negative influence on limited liability. This is the classic fraud exception to corporation by estoppel: where the plaintiff dealt with the entity on a corporate basis ( $P_{\text{belief}}$ ), it will be estopped from holding the defendant personally liable, unless the defendant did not act in good faith ( $!D_{\text{belief}}$ ).<sup>185</sup>

This helps explain why the simple regressions shown above have tended to indicate that  $P_{\text{belief}}$  does not have a significant impact on limited liability. The parameter cannot be considered independently because it could either indicate a willingness by the plaintiff to agree to limited liability, in which case limited liability should be granted, or it could indicate fraud on the part of the defendant, in which case individual liability should be imposed.

Application of Equation 7 provides a more satisfactory result. In the year 2010 ( $TF = 1.10$ ), in a typical trial-court case ( $!LL_{\text{below}}=0$ ) where the defendant was active in management ( $D_{\text{active}}=1$ ), and the plaintiff dealt with the entity as a corporation ( $P_{\text{belief}}=1$ ), the equation reduces to:

#### EQUATION 8

$$\begin{aligned} LL_{\text{decision}} &= -0.512 - 0.367 \times 1 + \left[ 0.347 \times D_{\text{belief}} - 0.204 \times (!D_{\text{belief}}) \right] \\ &\quad + 3.317 \times 1.1 - 2.112 \times (1.1)^2 \\ &= 0.214 + \left[ 0.347 \times D_{\text{belief}} - 0.204 \times (!D_{\text{belief}}) \right] \end{aligned}$$

Where the defendant believed that the corporation was valid, the result (0.561) tends toward limited liability. Where the defendant did not believe that the corporation was valid, the result (0.010) indicates that personal liability will almost certainly be imposed.

The time factor has a statistically significant impact on the prediction (both the first-order and second-order effects). Taking the

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185. On the other hand, if the plaintiff is aware that it is contracting with a defective corporation, the individual defendant is likely to escape personal liability. See, e.g., *Sherwood & Roberts-Or., Inc. v. Alexander*, 525 P.2d 135, 138–39 (Or. 1974); *Co. Stores Dev. Corp.*, 733 S.W.2d at 888.



first derivative of Equation 7 with respect to time, we can determine the “optimal” date for limited liability:

## EQUATION 9

$$\frac{d}{d(TF)} (LL_{decision}) = 3.317 - 2(2.112 \times TF) = 0$$

$$TF = \frac{3.317}{2(2.112)} = 0.79$$

$$Date = 1900 + 100 \times TF = 1979$$

This result indicates that courts were most likely to grant limited liability in 1979—ten years after the 1969 Revised MBCA purported to prohibit limited liability for defective corporations and shortly before the 1984 Revised MBCA appeared to relax strict adherence to incorporation requirements.<sup>186</sup> This provides additional support for the observation that the courts strongly retaliated against attempts to eliminate the concept of de facto corporation in the 1970s<sup>187</sup> and then moderated their stance after the Code was revised to give courts more flexibility.

## CONCLUSION

A modified regression analysis has shown that judicial application of the defective-incorporation doctrine is both predictable and rational. The doctrine applied by the courts can be stated: *Where the defendant is active in the management of a business entity that is not validly incorporated, he will not be held personally liable for his actions on behalf of the corporation so long as he believed the corporation was valid at the time of the actions.*

This is entirely consistent with the concept of de facto corporation. The defendant believed that the corporation was valid where he made a colorable attempt to comply with the corporation statute, and if he took action on behalf of the corporation, then he attempted to exercise corporate authority. This is also entirely consistent with the concept of corporation by estoppel: if the plaintiff believed that the corporation existed, or dealt with the entity as a corporation, it was because the defendant held itself out to the plaintiff as a corporation. However, if the defendant did so without actually believing that the corporation was valid, then it committed

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186. Courts in this time frame found creative ways to grant limited liability in the face of statutes that purported to eliminate it. *See, e.g.,* Pinson v. Hartsfield Int'l Commerce Ctr., Ltd., 382 S.E.2d 136, 137 (Ga. Ct. App. 1989) (“Although the concept of de facto corporations has been eliminated in this state . . . the doctrine of corporation by estoppel is still alive and well.”).

187. *See supra* notes 27–28, 155 and accompanying text.

a fraud on the plaintiff, and the exception to corporation by estoppel applies.

Commentators who have suggested that the doctrine of de facto incorporation is jumbled have actually been incorrectly evaluating the element “colorable attempt to comply.” Previous commentators have measured this element by determining whether the state had some notice that the business was behaving as a corporation.<sup>188</sup> The courts, on the other hand, appear to measure whether there was a “colorable attempt to comply” by evaluating whether the defendant in fact believed a corporation existed.

The latter approach is really the most logical. Where a defendant filed some paperwork with the state but knew that incorporation had failed, it would be inequitable to protect his subsequent actions on behalf of the defective corporation with limited liability. Likewise, where a defendant incorrectly believed that he was acting on behalf of a valid corporation in transactions with the plaintiff, it would generally be inequitable to treat the defendant’s obligations under the transaction differently based on whether the state received paperwork. In general, if the defendant believed that the corporation was valid, it is unfair to distinguish between degrees of insufficient compliance, because in all cases where the defendant believed the corporation was valid, he was unaware that further steps needed to be taken.

Other commentators have come to the conclusion that the doctrines of de facto corporation and corporation by estoppel are inconclusive on their own and that the common law actually merges the doctrines. I would suggest that, for the case where the plaintiff is attempting to hold an individual liable for the actions of a defective corporation, corporation by estoppel is actually a subset of de facto corporation.

A business is a de facto corporation where there was a colorable attempt to comply with the state’s corporation statutes (as measured by whether the individual defendant believed that the corporation was valid) combined with an attempt to exercise corporate authority (that is, holding oneself out as a corporation). The definition lends itself to an entire course of conduct, so that the entity will be a de facto corporation for the duration that it believes it is a corporation with respect to the plaintiffs to whom it has held itself out as a corporation. With respect to those individual plaintiffs, the entity is also a corporation by estoppel: the plaintiff either deals with the defendant as a corporation, or believes it is a corporation, precisely because the defendant has held itself out as a corporation. And the fraud exception to corporation by estoppel does not apply precisely because the individual defendant himself

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188. See Frey, *supra* note 4, at 1165; McChesney, *supra* note 10, at 501; Bradley, *supra* note 13, at 527–28.

believes that the corporation is valid and thus has no intent to defraud.

At least in the limited-liability situation, the court rarely has to determine whether the entity is a *de facto* corporation. That would require it to make the difficult factual finding of the time period in which the defendant was in colorable compliance. (The defendant will almost never be a *de facto* corporation at the time of trial, because by then it will have notice of some defect in its status and can no longer be said to be in attempted compliance.) Also, the court will rarely have evidence of whether the defendant held itself out as a corporation to anyone except the plaintiff. A finding that the entity is a *de facto* corporation over some period of time would effectively be a declaratory judgment that the individuals could not be held liable for any actions they took on behalf of the entity during that time with respect to any entity in or out of court or, as some courts have put it, “only subject to liability against the state.”<sup>189</sup> The courts will almost always take the more conservative approach and only evaluate the corporation’s validity with respect to the transaction at issue in the case, that is, determine whether it was a corporation by estoppel.

The doctrine of defective incorporation, mischaracterized and misunderstood, has been largely protected by the courts despite attempts by legislatures and the drafters of the Model Business Corporation Act to eliminate it.<sup>190</sup> Over time, courts have gradually increased application of the doctrine in order to find limited liability where there is no valid corporation. The 1974 MBCA purported to eliminate the doctrine, and states adopted the revision in defense of strict adherence to their incorporation statutes. However, the legislative action appeared to strengthen judicial resolve to entrench the doctrine. By finding limited liability where the parties in good faith intended their dealings to be a corporate transaction, courts affirmed that corporate dealings are essentially contracts between the parties, not involving the state.

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189. See, e.g., *Cranson v. Int’l Bus. Machs. Corp.*, 200 A.2d 33, 38 (Md. 1964) (“Where there is . . . application of the *de facto* corporation doctrine, there exists an entity which is a corporation *de jure* against all persons but the state. On the other hand, the estoppel theory is applied only to the facts of each particular case and may be invoked even where there is no corporation *de facto*.”).

190. See Frey, *supra* note 4, at 1179–80; McChesney, *supra* note 10, at 494; Bradley, *supra* note 13, at 523–24.

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