

**COURT OF APPEALS
DECISION
DATED AND RELEASED**

April 17, 1996

A party may file with the Supreme Court a petition to review an adverse decision by the Court of Appeals. See § 808.10 and RULE 809.62, STATS.

NOTICE

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No. 94-3291

STATE OF WISCONSIN

**IN COURT OF APPEALS
DISTRICT II**

PEKIN INSURANCE COMPANY,

Plaintiff-Appellant,

v.

H. FULLER & SONS, INC.,

Defendant,

**KENNETH D. FULLER and
JUDITH FULLER,**

Defendants-Respondents.

APPEAL from a judgment of the circuit court for Waukesha County: ROBERT G. MAWDSLEY, Judge. *Affirmed.*

Before Brown, Nettesheim and Snyder, JJ.

PER CURIAM. Pekin Insurance Company appeals from a judgment dismissing its complaint against Kenneth and Judith Fuller after the circuit court determined that it would not disregard the H. Fuller & Sons, Inc. corporate entity to permit Pekin to collect unpaid insurance premiums directly

from the Fullers.¹ On appeal, Pekin argues: (1) that the circuit court should have granted Pekin a default judgment when the Fullers failed to comply with discovery demands and court orders relating to discovery; (2) that the circuit court should have required Kenneth to satisfy the debt to Pekin under a debt subordination theory; (3) that because the Fullers failed to follow corporate formalities, the corporate veil of H. Fuller & Sons (the corporation) should have been pierced to allow Pekin to recover the unpaid insurance premiums from the Fullers personally; and (4) that the circuit court should have found that the Fullers, as directors of the corporation, breached a contract entered into between the corporation and Pekin, thereby rendering them personally liable for the insurance premiums. We reject these arguments and affirm.

A default judgment is a remedy available to the circuit court when a party has failed to comply with the discovery statutes or court orders on discovery. See *Johnson v. Alice Chalmers Corp.*, 162 Wis.2d 261, 273-74, 470 N.W.2d 859, 863 (1991). Such a sanction is within the circuit court's discretion. *Id.* A circuit court's discretionary decision in addressing an alleged discovery violation will be sustained if the court examined the relevant facts, applied a proper legal standard and reached a conclusion that a reasonable judge could reach using a demonstrated rational process. *Id.* at 273, 470 N.W.2d at 863.

Our review of the record of the August 2, 1993, hearing on Pekin's motion to compel discovery reveals that the circuit court properly exercised its discretion in declining to grant Pekin a default judgment and requiring the Fullers and the corporation to comply with the discovery requests made of them.² We also conclude that Pekin's complaints about the manner in which the circuit court handled the hearing are not supported by the record.

¹ Pekin received a judgment against H. Fuller & Sons, Inc., but that corporation is insolvent.

² Pekin challenges the circuit court's decision. Accordingly, Pekin was required to include in its appendix to its appellant's brief the court's oral ruling in this matter. See RULE 809.19(2), STATS. In the future, counsel shall include such materials in the appendix as required by the rule. Failure to do so may result in the imposition of sanctions on counsel.

Pekin complains that the circuit court admitted at the hearing that it had not had an opportunity to review Pekin's motion and that it did not allow its counsel to make an argument before the Fullers' counsel responded to the motion. When Pekin's counsel was given an opportunity to address the court, the Fullers' counsel "interrupted repeatedly." Finally, the court did not listen to counsel's arguments.

It is true that the circuit court stated that it had not had a chance to review the motion. However, there is no indication from the transcript of the hearing that the court proceeded in a vacuum when ruling on Pekin's sanction motion. The court heard the argument of Pekin's counsel which mirrored the facts alleged in Pekin's motion. There is no indication in the record that the circuit court prohibited Pekin's counsel from addressing the court first. Rather, the Fullers' counsel first addressed the court to respond to the motion. Then Pekin's counsel addressed the court. The court then questioned counsel regarding the specifics of the discovery requested and the extent to which the Fullers had responded to it. After listening to counsel argue between themselves regarding the nature of the discovery request and the level of the Fullers' compliance, the court understandably stated that it had "stopped listening a couple of minutes ago."

The court found that the Fullers' responses to discovery were "long overdue" and assessed the status of each document requested to determine what efforts had been made or would be made to make them available to Pekin. Based upon counsels' representations, the court concluded that the documents were available and that efforts had to be made to give Pekin access to them. Considering fairness to both sides and the history of the case, the court concluded that granting a default judgment would not be the appropriate sanction.

We do not see any error in the court's discretionary decision not to grant Pekin a default judgment. The court listened to the arguments of counsel and determined that the best way to resolve the dispute was to clarify, item by item, which documents existed and how they would be produced.

Pekin complains on appeal that discovery problems continued after this hearing and that it was forced to seek an adjournment of the trial to

obtain and review records. However, Pekin's appellate briefs never identify which documents were not provided to it such that its trial preparation was hampered.³ In the absence of demonstrated prejudice, we are not inclined to conclude that the circuit court should have granted a pretrial default judgment to Pekin as a result of the difficulties in discovery.

At trial, the parties again addressed the discovery disputes and the court found that while some discovery responses were late, no remedy was required posttrial. The court noted that certain disputes arose because the discovery requests were not specific enough.⁴ The court found that the "discovery process more or less clunked along" and that neither party could agree as to how documents were to be produced or where they were located. The court was unable to determine which party was at fault in the discovery disputes, noting that each party insisted on conducting discovery in its own way, sacrificing expediency as a result. The court declined to grant a judgment to Pekin as a sanction for alleged discovery abuses and specifically found that "the court has not been given any indication of the fact that the problems in getting items and documents have caused any issue to go unearthed in terms of the equitable decision that the court has to make." We have reached the same determination with regard to presentation of the discovery disputes on appeal.

Pekin next argues that the circuit court should have pierced the corporate veil of the corporation to allow it to recover unpaid insurance premiums from the Fullers personally. Piercing the corporate veil is an equitable remedy which we review under an erroneous exercise of discretion standard. *Consumer's Co-op of Walworth County v. Olsen*, 142 Wis.2d 465, 472, 419 N.W.2d 211, 213 (1988). We review whether the circuit court relied upon the relevant facts, applied a proper legal standard and used a rational process to reach a reasonable decision. See *Johnson*, 162 Wis.2d at 273, 470 N.W.2d at 863. The trial court's findings of fact will be upheld unless they are clearly erroneous. See § 805.17(2), STATS.

³ Trial was ultimately adjourned from the fall of 1993 to September 1994.

⁴ For example, the court found that Pekin's interest in reviewing the corporation's canceled checks was not made clear in some of its discovery requests. The difficulty in reviewing those checks was due, in part, to that lack of specificity.

Piercing the corporate veil or disregarding the corporate fiction is an exception to the general principle of shareholder nonliability.⁵ *Consumer's Co-op*, 142 Wis.2d at 475, 419 N.W.2d at 214. However, the corporate veil can be pierced and shareholders held liable where "corporate affairs are organized, controlled and conducted so that the corporation has no separate existence of its own and is the mere instrumentality of the shareholder and the corporate form is used to evade an obligation, to gain an unjust advantage or to commit an injustice." *Wiebke v. Richardson & Sons, Inc.*, 83 Wis.2d 359, 363, 265 N.W.2d 571, 573 (1978). Absent such evidence, "the fundamental precept of limited liability must not give way wherever a close corporation fails to precisely observe corporate formalities." *Consumer's Co-op*, 142 Wis.2d at 476, 419 N.W.2d at 214.

Inadequate capitalization is also relevant to determining whether the corporate veil should be pierced to hold shareholders personally liable for corporate debts. See *id.* at 477, 419 N.W.2d at 215. However, "undercapitalization is not an independently sufficient ground to pierce the corporate veil." *Id.* at 482, 419 N.W.2d at 217.

With these principles in mind, we turn to the trial court's findings of fact. The court assessed the Fullers' credibility and financial facts involving the corporation, including its informal accounting system. The court found insufficient evidence (1) that the corporation was undercapitalized at the time it contracted with Pekin for insurance or (2) that the Fullers, the corporation's shareholders, disregarded the corporate form and treated the corporation's assets as their own or held themselves out as being personally liable for the corporation's debts. The court found that although there was a failure to observe corporate formalities in all instances, the shareholders still treated the corporation as a separate entity as evidenced by the filing of corporate tax returns and the ultimate sale of the corporation's assets at a public auction.

The court found that there was no evidence of "a draining off or siphoning of corporate funds." Judith's explanations regarding specific cash

⁵ "The general rule is that a corporation is treated as a legal entity distinct from its members" *Wiebke v. Richardson & Sons, Inc.*, 83 Wis.2d 359, 363, 265 N.W.2d 571, 573 (1978).

outlays from the corporation related to a business reason. While the court noted that the accounting for expenses left something to be desired, Judith's testimony regarding the expenses was hampered by the manner in which these expenses were investigated in discovery. The court accepted her testimony that had the expense documents been presented to the court in the manner in which they had been maintained, she would have been able to account for all of them. The court found that Kenneth made "a substantial commitment of personal funds" to keep the corporation going and pay its bills and Judith made loans to the corporation which were repaid.

Considering that the purpose of piercing the corporate veil is to avoid an injustice or fraud, the court stated that it could not find any intent to defraud Pekin of insurance premiums. The court found that the insurance premiums and other creditors' obligations went unpaid due to the corporation's general business reverses and not some specific intent to defraud Pekin or other creditors. The court considered that the corporation was a closely-held corporation and, after applying the principles set forth in *Consumer's Co-op*, concluded that the evidence at trial did not warrant piercing the corporate veil.

Pekin challenges these findings on appeal. The findings are based upon the trial court's assessment of the credibility of the Fullers and it was the ultimate arbiter of witness credibility. See *Village of Big Bend v. Anderson*, 103 Wis.2d 403, 410, 308 N.W.2d 887, 891 (Ct. App. 1981).

Pekin argues that the facts found by the trial court support another inference: that the corporation did not function independently of the Fullers. While this inference may be possible, we are bound to uphold the trial court's findings because it was the trial court's function to draw inferences from the evidence. The trial court's inferences and findings are not clearly erroneous. See *Leon's Frozen Custard, Inc. v. Leon Corp.*, 182 Wis.2d 236, 243, 513 N.W.2d 636, 640 (Ct. App. 1994). We conclude that the circuit court properly interpreted *Consumer's Co-op* and applied it to the facts and inferences found. The court did not misuse its discretion in declining to pierce the corporate veil to hold the Fullers personally liable for the corporation's insurance premium debt to Pekin.

Pekin also argues that the court erred in declining to hold Kenneth liable to Pekin on a debt subordination theory. The court declined to apply that

theory to this case after concluding that a leading case in this area, *Gelatt v. DeDakis*, 77 Wis.2d 578, 254 N.W.2d 171 (1977), was distinguishable. We agree with the circuit court that *Gelatt* does not apply to this case.

Gelatt involved an attempt to subordinate a shareholder's claim to that of other general creditors of an insolvent corporation. In *Consumer's Co-op*, the court noted that "[w]hile the doctrines of subordination and piercing the corporate veil are conceptually distinct, there are congruencies between the theory justifying subordination of a loan and piercing the corporate veil, to the extent that both concepts arise from the notion that there exists a minimal proprietary risk which should be borne by shareholders." *Consumer's Co-op*, 142 Wis.2d at 477, 419 N.W.2d at 215. Both remedies deny shareholders "the separate entity privilege" of a corporation. *Id.* at 478, 419 N.W.2d at 215 (quoted source omitted).

In *Gelatt*, a trade creditor of an allegedly insolvent retail clothing business sought the appointment of a receiver to administer assets pursuant to ch. 128, STATS. The receiver objected to a claim filed against the proceeds of a bulk transfer of the corporation's assets by shareholders who had made loans to the corporation. *Gelatt*, 77 Wis.2d at 582, 254 N.W.2d at 175. The circuit court subordinated the shareholders' claims to the claims of other general creditors because the shareholders' "loans" were more in the nature of capital contributions. *Id.* One shareholder appealed. *Id.*

On review, the supreme court noted that merely being an officer, director and/or shareholder who has lent money to a corporation is not sufficient to permit subordination of a claim. *Id.* at 602, 254 N.W.2d at 185. Subordination is intended to prevent the transfer to outside general creditors of risks properly borne by equity capital. *Id.* at 608, 254 N.W.2d at 188. This is particularly true where the corporation was undercapitalized. *Id.* at 607-08, 254 N.W.2d at 187-88. However, if a corporation has been adequately capitalized, "the shareholders have assumed an appropriate proprietary risk for the nature of the business involved, and the law has not required more." *Id.* at 608, 254 N.W.2d at 188. In *Gelatt*, the supreme court reversed the trial court's decision to subordinate the shareholder's loans on the ground that the corporation was adequately capitalized. *Id.* at 610, 254 N.W.2d at 189.

In this case, the trial court found that the corporation was adequately capitalized and that the financial reverses it suffered resulted from outside business losses, not from any improper conduct on behalf of the shareholders. Therefore, the factual basis for subordination is not present even if we were to conclude that *Gelatt* applies to this case. See *id.* at 611, 254 N.W.2d at 189.

Finally, Pekin argues that the Fullers should be personally liable as directors of the corporation for authorizing and participating in a breach of contract between the corporation and Pekin. A corporate officer can be held personally liable for procuring, causing or authorizing a breach of contract by the corporation. *Sprecher v. Weston's Bar, Inc.*, 78 Wis.2d 26, 39-40, 253 N.W.2d 493, 499 (1977). An improper motive on behalf of the corporate officer must be shown. *Id.* at 41, 253 N.W.2d at 500.

Pekin argues that the evidence shows that the Fullers did not have a proper motive when they declined to pay the premiums owed to Pekin. The trial court did not ascribe an improper motive to the Fullers. The inferences drawn by the trial court are not clearly erroneous.

By the Court.—Judgment affirmed.

This opinion will not be published. See RULE 809.23(1)(b)5, STATS.