STATE OF KANSAS

Office of the Attorney General

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CURT T. SCHNEIDER
Attorney General

March 27, 1975

Opinion No. 75- 138

Mr. Robert A. Arnold
Administrator
Kansas State Department of Credit Unions
234 Kansas Avenue
Topeka, Kansas 66603

Dear Mr. Arnold:

You have requested an opinion of this office whether a loan by the director of Nekan Bell Credit Union to themselves as the stockholders and the sole directors of the Nekan Bell Building Corporation violates the provisions of K.S.A. 17-2216, and the fiduciary trust bestowed upon them when they signed their oaths of office. The circumstances surrounding this loan are as follows:

1. The directors of the Nekan Bell Credit Union formed a corporation called the Nekan Bell Building Corporation.

2. The Nekan Bell Credit Union sold a building to the Nekan Bell Building Corporation, for $106,293 on January 2, 1974.

3. The Nekan Bell Credit Union then loaned a total of $383,553.13 to the Nekan Bell Building Corporation. The Nekan Bell Credit Union has a first mortgage on the building.

4. The note for the loan is "open end", and due on demand.

5. The interest rate is 8%, which is the only rate in the credit union at this rate.

6. The Nekan Bell Credit Union leases the first floor of the building for $18,474 per year. The remainder of the building is leased to other companies.

7. There is no financial statement of the corporation in the file, nor is there a title opinion or title insurance to guarantee that Nekan Bell Building Corporation has the clear title to the property. The credit union's interest is not properly protected.

You have further indicated to me in a subsequent personal conversation that in regard to #3 above, the amount of the loan to the directors of Nekan Bell Credit Union exceeds the amount authorized to be loaned to each as an individual director or to all cumulatively. The relevant portion of K.S.A. 17-2216 provides:

> "No director, employee or member of the credit or supervisory committee shall be allowed to borrow from the credit union or to become endorser for a borrower in excess of his holdings in the credit union in shares except that a credit union may make loans to its own directors, employees and to members of its own supervisory or credit committee, but all such loans shall be reported to the administrator at least annually, and such a loan may be made only if (a) the loan complies with all lawful requirements under the credit union law with respect to loans to other borrowers and is not on terms more favorable than those extended to other borrowers; (b) upon the making of the loan, the aggregate amount of loans outstanding to the borrower will not exceed by five thousand dollars ($5,000) the total amount of shareholdings in any credit union, not otherwise encumbered or pledged, which are pledged as security for loans to the borrower; (c) upon the making of the loan, the aggregate amount of loans outstanding under authority of this paragraph will not exeed ten (10) percentum of the unimpaired capital and surplus of the credit union; (d) the loan is approved by the credit committee and by the board of directors after the submission to them of a detailed current financial

> statement by the borrower; and (e) the borrower takes no part in the consideration of his application and does not attend any committee or board meeting while his application is under consideration.

A violation of the above is established by the absence of any one of those factors specified. The facts surrounding the loan to Nekan Bell Building Corporation clearly indicate violations of subsection (a) and (b). There may be a further violation of subsection (e) assuming that all the interested directors of the credit union took part in the meetings considering the loan application. Furthermore, the recited facts indicate the corporation has failed to report this loan to the administrator as mandated by K.S.A. 17-2216. The critical issue then becomes whether the directors of Nekan Bell Credit Union may circumvent the restrictions on their borrowing capacity under K.S.A. 17-2216 by establishing an independent corporation when the directorships of both corporations are composed entirely of the same individuals. Stated differently, the question to be resolved is whether in light of the recited facts it is proper to disregard the corporate entity and find that it is in actuality the alter ego or business conduit of the director-stockholders created primarily to enable them to conduct personal business and in order for them to obtain financial backing which would otherwise be prohibited by K.S.A. 17-2216.

In 18 Am. Jur. 2d, Corporations, and adopted by the Kansas Supreme Court in Kilpatrick Bros., Inc. v. Poynter, 205 Kan. 787, 473 P.2d 33 (1970), the following examination of the applicable law appears:

> "§ 14. Disregarding corporate entity, generally.
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> "The doctrine that a corporation is a legal entity existing separate and apart from the persons composing it is a legal theory introduced for the purposes of convenience and to subserve the ends of justice. The concept cannot, therefore, be extended to a point beyond its reason and policy, and when invoked in support of an end subversive of this policy, will be disregarded by the courts. Thus, in an appropriate case and in furtherance

> of the ends of justice, a corporation and the individual or individuals owning all its stock and assets will be treated as identical.
>
> "The principle of piercing the fiction of the corporate entity is, however, to be applied with great caution, and not precipitately. While corporate entities may be disregarded where they are made the implement for avoiding a clear legislative purpose, they will not be disregarded where those in control have deliberately adopted the corporate form in order to secure its advantages and where no violence to the legislative purpose is done by treating the corporate entity as a separate legal person. . . .
>
> "§ 15. Particular applications of principle of disregarding corporate entity.
>
> "Each case involving disregard of the corporate entity must rest upon its special facts. The corporate entity is generally disregarded where it is used as a cloak or cover for fraud or illegality, or to work an injustice, or where necessary to achieve equity. . . .
>
> ". . . Where the corporate fiction is merely an alter ego or business conduit of an individual, it may be disregarded in the interest of securing a just determination of an action." (pp.559-562.)

This latter rule provides that when the corporation is the mere alter ego, or business conduit of a person, it may be disregarded. The theory of alter ego has been adopted by the courts in those cases where the idea of the corporate entity has been used as a subterfuge and to observe it would otherwise work an injustice. To establish the alter ego doctrine, it must be shown that the stockholders' disregard of the corporate entity made it a mere instrumentality for the transaction of their own affairs; that there is such unity of interest and ownership that the separate personalities of the corporation and the owners no longer exist; and to adhere to the doctrine of corporate entity would promote injustice or protect fraud. Thus the doctrine of alter ego fastens liability on the individual who uses a corporation merely as an instrumentality to conduct his own personal business, such liability arising from fraud or injustice perpetrated not on the corporation but on third persons dealing with the corporation. Under it the

court merely disregards corporate entity and holds the individual responsible for his acts knowingly and intentionally done in the name of the corporation. Kilpatrick v. Poynter, infra.

As applied to this case, the facts indicate that the Nekan Bell Building Corporation was formed by the directors of the Nekan Bell Credit Union in order to circumvent restrictions which K.S.A. 17-2216 places on their ability to borrow from their own credit union. It is clear that both board of directors were, at the time of the loan, entirely composed of the same individuals. Further, it appears that only the stockholders of the building corporation were the directors of the credit union. The creation of this latter corporation enabled the directors in their credit union capacity to authorize and approve a loan to themselves through the guise of a loan to an independent corporation. Aside from the complete interlocking directorships, several other facts support the conclusion that the corporate status of Nekan Bell Building Corporation should be disregarded. First and foremost, the loan was made at an interest rate far more favorable than other similar loans. Furthermore, the total amount of the loan to Nekan Bell Building Corporation was far in excess of that amount each director singularly, or in unison, could have legitimately borrowed under K.S.A. 17-2216. Finally, the directors, in their credit union capacity, authorized sale of the credit union building to the second corporation who, in their latter capacity, leased floor space to the credit union and other commercial enterprises, thereby depriving the credit union and its stockholders from this additional source of revenue. The conjunction of these various facts leads to the conclusion that the corporate status of Nekan Bell Building Corporation should be disregarded and that the loan be considered as a loan to the directors and not the corporation.

Accordingly, it is the opinion of this office that under the facts as stated above, there is sufficient cause and reason to justify the conclusion that the directors of Nekan Bell Credit Union have violated in one or more particulars the provision of K.S.A. 17-2216, and thereby, the fiduciary trust imposed upon them when they took their oaths of office.

Yours very truly,

Curt Schneider

CURT T. SCHNEIDER
Attorney General

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