"Piercing the Veil"

OF LIMITED LIABILITY ENTERPRISES

By Mark A. Turner CMA, CPA

In a stressed economy, creditors facing challenges collecting bad debts often want to reach into the deeper pockets of their customers' shareholders and owners. Collecting from people involved in limited liability companies can be frustrating because these entities limit the amount the owners and investors can lose; if the company hits hard times, the law protects these individuals from being held personally liable for their organization's debts and obligations. It essentially places a veil of protection over them.

On the flip side, debtors want to protect the private interests of that company's shareholders and owners. The question is: Do corporations, LLCs, and limited partnerships provide the bulletproof protection generally thought to defend against "veil piercing" challenges?

"Piercing the veil" is a metaphor for the judicial doctrine that permits a plaintiff to hold otherwise immune corporate shareholders personally liable for the debts owed by that corporation. The goal isn't to undermine protection from liability; piercing the veil requires that some injustice will occur if the formality of the veil isn't set aside.

In some states this level of injustice must amount to fraud, though most states don't hold to such a high threshold. Both state and federal courts have expressed reluctance to violate the sanctity of protective veils afforded by law.

Here are a few factors commonly used to decide whether to pierce the veil of an enterprise:

1. Capitalization is thin.
2. The dominant shareholder siphons off corporate assets.
3. Corporate formalities aren't observed. (This may include intermingling of business and personal assets, absence of corporate records, and nonfunctioning officers/directors.)
4. The corporation is a mere façade for the operations of the dominant shareholder.

(See Table 1 for a list of additional factors. All apply to both corporate-subsidiary and corporate-individual relationships.)

These factors are used collectively in forming an opinion as to whether the overall structure and operation of two otherwise separate entities is misleading. For example, simply having overlapping members of the board of directors or corporate officers between parent and subsidiary corporations falls short of the idea of pervasive control.

Table 1. Should the Veil Be Pierced?

Factors courts use in deciding whether to pierce the veil of an enterprise include:

- Thin capitalization
- Siphoning away of corporate assets by dominant shareholder
- Nonobservance of corporate formalities
- Confused intermingling of business activity/assets
- Absence of corporate records
- No payment of dividends
- Insolvency at time of litigated transaction
- Corporation a mere façade for the operations of the dominant shareholder
- Nonfunctioning officers/directors
- Same two individuals serving as shareholder/director and corporate officers
- Common ownership
- Pervasive control

Thin Capitalization

Notwithstanding the obvious concern over a customer's thin capitalization and the risk of being unable to collect/pay debts, thin capitalization can also be evidence of intent to leave a supplier or service provider in the lurch. Consider the 2003 case of two individuals in Virginia who entered into a business to renovate an abandoned residential structure and convert it to condominiums before selling it (*Thomas W. Dana et al. v. 313 Freemason, A Condominium Association, Inc.*). The men worked together on similar projects and had several in process at the time this project commenced. When a leaky roof proved difficult and costly to repair, the business owners sought the advice of an attorney who suggested they incorporate to reduce liability exposure. A corporation was then created, and this property became its asset. A note secured by the property wasn't transferred.

No separate checking account was established in the corporation's name, and the business continued to be conducted through an owner's personal checking account. As a result, the corporation never had any liquid assets. The trial court found that the corporation "suffered from nonexistent capitalization from its inception" and concluded that the corporation was formed to evade personal liability associated with the roof problems. There was a unity of interest and ownership such that the separate personalities of the corporation and individuals didn't exist. Accordingly, the corporate veil should be pierced and its shareholders held personally liable.

Generally, when two parties agree to do business, it's presumed that the party purchasing the goods or services is adequately capitalized and can fulfill its end of the bargain. In a Nebraska decision (*Anderson Excavating and Wrecking Company v. Argus Development Co. Inc.*), this wasn't the case. Here, a new corporation was created to buy and refurbish houses as part of a residential development. The corporation was formed with the minimum capital required, and a contract to acquire salvaged houses was signed. Upon gaining an initial commitment from a financial backer to finance acquisition of the homes, the corporation contracted to buy land on which to place the houses. But since the corporation lacked sufficient capital, the land purchase was never closed and the houses never paid for. The plaintiff then sought judgment against the corporation's sole shareholder under a "piercing the veil" claim. It argued that the corporate entity should be disregarded, partly because of inadequate capitalization.

The court decided that although the corporation had inadequate capital at the time of its incorporation, it had sufficient financing (based on commitments from financial backers) in place to initiate the project by the time the parties entered into the contract. The court also noted that inadequate capitalization is insufficient to prove fraud. Thus, the court declined to pierce the corporate veil.

So there's a question as to when capitalization must occur: whether prior to any business event occurring—i.e., at startup—or in anticipation of future events that hinge on the signing of contracts and the transfer of funds. States may differ on this issue. Practically speaking, thinly capitalized corporations are poor credit risks, but piercing the veil may require additional evidence, such as failure to observe formalities.

Siphoning Away Assets

Assets removed from the reach of creditors after a lawsuit is filed may be a fraudulent conveyance. In such a case, the court may seek to repossess the assets. Thus businesses should be cautious when transferring assets in times of financial distress. A regularly paid dividend may assuage arguments by creditors that a business has committed a fraudulent transfer, especially if the dividend was paid regardless of whether profits or losses were realized.

Keene Corporation (*Lippe et al. v. Bairnco Corporation et al.*) owned, among other things, an insulation business that once manufactured and sold asbestos-containing products. Over time the company transformed itself through a series of mergers, acquisitions, and sale of subsidiaries. The plaintiff in this case was a trust instituted to represent persons exposed to asbestos-containing products. The trust alleged that the corporation: "…sold its constituent businesses and paid dividends…as part of a scheme to divest itself of assets that otherwise would have been available to…asbestos-victim creditors. Plaintiffs contended that all of the corporate defendants were liable to these creditors under theories of actual fraudulent conveyance."

The Second Circuit U.S. Court of Appeals concluded that a reasonable jury would be unable to decide that the creditor's claims were shielded because of the corporation's merger-and-acquisition activity. No evidence supported a finding that valuations of asset sales and exchanges were based on anything other than an arm's-length value. Furthermore, dividend rates were based on an outside financial advisor's recommendation made in comparison to prevailing dividend rates of comparable businesses. Therefore, veil piercing wasn't warranted.

Plaintiffs have difficulty proving that a company intentionally siphoned off resources in order to avoid financial responsibility. Evidence of regular dividends—independent of profits—and arm's-length exchanges between a corporation and other parties runs counter to the notion that assets are being siphoned off.

Corporate Formalities

For a company to maintain its corporate existence, proper corporate formalities should be observed. Among those formalities are:

- Meaningful shareholder and director meetings;
- Maintenance of corporate records, such as accounting, bookkeeping, bank, employee, stock, and tax records, as well as contracts and correspondence; and
- State and federal annual filings.

When corporations are small and informal, it becomes easy to bypass required annual shareholder meetings or keeping shareholder minutes. Inactive boards of directors and poorly informed directors can be signs of trouble. Evidence of engagement by board members is provided when management acts on board recommendations.

In a case that highlights what not to do (*Joseph L. Fontana and Angela D. Fontana v. TLD Builders, Inc.*), an Illinois court considered whether to hold an individual personally responsible for a $1.2 million judgment by piercing the corporate veil of a small construction company. The corporation failed to fulfill its contractual commitment in building a single-family residence for the plaintiff. During an investigation, the following information was discovered:

- The wife of the individual being sued was unaware that she was the corporation's president and not merely a director (i.e., nonfunctioning corporate officer).
- She was the corporation's sole shareholder—even though her husband dealt with all financial matters.
- There was a general failure to observe corporate formalities.
- No dividends were ever paid.
- She didn't know where any of the corporate assets were, and there were few business records of receipts and payments.

- Amounts received from sale of properties weren't deposited to corporate accounts.
- Corporate funds were commingled with personal funds.

In short, nothing that's supposed to be done in operating a corporation was done. The president's husband was the dominant force behind the corporation, which was little more than a shell established to shield him from liability. The fact that he wasn't a shareholder didn't prevent him from being regarded as the equitable owner of the corporation. The court concluded the corporate veil must be pierced to avoid a clear injustice.

Could the plaintiff have averted the entire fiasco by more carefully investigating their contractor's business practices? In relationships with smaller businesses—even between agreeable parties—some hard-nosed questions aren't unreasonable. Is it offensive to ask questions such as: Who are your corporate officers, where does your corporation bank, do you pay dividends, how do you keep records, how do you separate business from personal finances? Certainly a personal performance bond would have provided some protection for the plaintiff.

A Mere Façade

A school district found that obtaining judgment from a service provider's parent corporation wasn't forthcoming when the provider became insolvent. In this 2004 federal case, New York's Rondout Valley Central School District asked the U.S. District Court to pierce a business's corporate veil and hold the parent, a large utility, accountable. The school district believed that their business with the subsidiary was, in part, secured by its affiliation with the parent. These kinds of ties occur regularly in business and lend credibility to the supplier—whether or not deserved.

But the facts of the case didn't support the charge of pervasive control. That is, the subsidiary wasn't a mere façade of the parent because the parent wasn't a dominant shareholder. The parent didn't dictate to subsidiary officers what future actions should be taken with respect to the subsidiary. Neither did the parent exert control over the sub's daily operations—though it was apparent that regular reports were produced and provided to its parent corporation. Furthermore, a management services agreement merely explained—it didn't mandate—that the sub accept parent services. These separate entities weren't in reality a single entity, so, in the view of this district court, the corporate veil shouldn't be pierced.

When choosing to do business with a lesser-known subsidiary of a well-established company, there's no guarantee that the parent will "stand in the gap" should the subsidiary fail. And in today's business climate, where ownership interests are discarded like cards at the poker table, affiliation guarantees must be carefully scrutinized. There likely are no deep pockets to access if there's no formal agreement between a customer and a supplier's parent. Therefore, when relying on a corporate affiliation to support a subsidiary's commitments, you should clearly understand how far the parent will go to back its subsidiary.

Reluctantly Piercing the Veil

For most states, in order to state a claim for piercing the corporate veil, plaintiffs must show that: (1) one corporation is organized and operated as to make it a mere instrumentality of another corporation, and (2) the dominant corporation is using the subservient corporation to perpetuate fraud, to accomplish injustice, or to circumvent the law.

In the case of *Thomas Pearson et al. v. Component Technology Corporation*, the Third Circuit U.S. Court of Appeals noted that, in general:

"The courts have refused to pierce the veil when subsidiary corporations use the trade name of the parent, accept administrative support from the parent, and have a significant economic relationship with the parent. Thus, in order to succeed…plaintiffs must essentially demonstrate that in all aspects of the business, the two corporations actually functioned as a single entity and should be treated as such."

In 1998, Liberty Mutual Insurance Corporation brought suit against a customer—Illinois-based M&O Springfield Company—for failure to pay overdue premiums. The premiums were for workers' compensation insurance that the customer was required to carry in order to conduct business that included installing and repairing insulation, removing asbestos, and erecting scaffolding for construction projects. As a result of low profits and the loss of its workers' compensation coverage, M&O Springfield shut down, leaving an insurance bill unpaid. The company was dissolved. Liberty Mutual then sought payment from Springfield's sole shareholder, a director and officer, and four other companies controlled by the shareholder on the basis that they were all interrelated and thus should be held accountable for the unpaid debts. The following factors were offered in support of that conclusion:

1. All corporations shared the same address.
2. All corporations performed similar work.

3. The corporations shared employees.
4. All of Springfield's work was for the other companies, and it had no other customers.
5. The same two individuals served as shareholders, directors, and officers of the companies.
6. Springfield didn't pay any salary, wages, or dividends to its officers, shareholders, or directors during the relevant period.
7. All of the corporations except one were capitalized at the statutory minimum of $1,000.

Liberty Mutual further argued that "Springfield was merely being used as a conduit for its sister corporations and that the increased revenue that Springfield would have accrued (if it had been paid the market rate for its work) was passed through to the other defendants by charging them less for its services."

The Seventh Circuit U.S. Court of Appeals found in favor of the defendant. Piercing the corporate veil should be exercised reluctantly and cautiously. The court reasoned that: At a minimum, a plaintiff must demonstrate the existence of "something more than the prospect of an unsatisfied judgment." It must show something like "an intentional scheme to squirrel assets into a liability-free corporation while heaping liabilities upon an asset-free corporation…"

Therefore, while the evidence may have supported a finding of a unity of interest and ownership sufficient to ignore the corporate formalities, there wasn't sufficient evidence that a separate existence would sanction a fraud or promote injustice.

A reading of court decisions across various states shows that veils are rarely pierced when one party is simply trying to collect unpaid debt, and they are rarely, if ever, pierced to hold an officer or chief executive accountable for the unlawful acts of the entity. It's also noteworthy that a number of state courts have sanctioned piercing the veil of LLCs using the same reasoning applied to corporations. The takeaway: Know the state laws where business is conducted.

Reverse and Successor Piercing

In a classic piercing case, shareholders are deemed responsible for the obligations of the corporation. In a reverse piercing, assets of the corporate entity are used to satisfy the debts of a corporate insider. In either case, the corporate entity and shareholder are considered one and the same.

Successor liability, while similar to corporate veil piercing and relying on similar factors, involves the relationship between an entity that existed for one period of time and an arguably different entity that existed for a subsequent period. Successor liability turns not on the connection between entity and current owners, but on the connection between an entity and its predecessor. The predecessor may be a sole proprietor who then incorporates, one corporation that undergoes reorganization, or two or more entities that merge. Generally, successor liability is a matter of state law. This includes a decision as to which state law applies, as in the case of liability transfers between entities organized in different states.

In a 2005 Delaware case, *Mason v. Network of Wilmington*, an individual sought to hold a successor liable for an employment discrimination claim against a predecessor corporation. The individual claimed her former employer was undercapitalized, failed to follow corporate formalities, and was the owner's mere alter ego. In this case, however, the business accused of discriminating was sold in an apparent arm's-length transaction, and there was no evidence the sale occurred to escape actual or potential creditors. Furthermore, the successor corporation was only liable for the liabilities it expressly assumed.

Take the Right Action

During these extraordinarily difficult economic times, businesses should be careful to manage their affairs to safeguard the limited liability protection afforded them as corporations, LLCs, or limited partnerships. To steer clear of veil-piercing claims, they need to avoid thin capitalization, prevent siphoning away of assets by dominant shareholders, attend to corporate formalities, and establish a clear dividend policy, among other measures.

Businesses should also recognize that actions they take or fail to take to protect their own veils are also actions that identify risky customers. That is, customers who are thinly capitalized, fail to observe corporate formalities, have no dividend policy, are poor corporate record keepers, and have nonfunctioning directors are likely bad credit risks. The fact that these businesses fail to meet criteria, however, is no assurance that their veils will be pierced and owners held accountable for corporate debts. Accountants and financial professionals in business should make sure their companies are protected and that they have correct procedures in place. **SF**

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