

# Piercing the Corporate Veil

By Michael A Thomason, Attorney

A fundamental principal of corporate law is that a corporation is regarded as a legal entity separate from its shareholders. Shareholders, therefore, generally enjoy the protection of limited liability for the acts and debts of the corporate entity.

This protection plays an important role in encouraging investment by limiting the risk involved in corporate ownership. As the Supreme Court has noted, it is often on the assumption of corporate separateness and limited liability that “large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted.”<sup>1</sup>

Under certain circumstances, however, a court may “pierce the corporate veil” and treat a corporation’s acts as if done by those actually controlling the corporation. Under this exception to the general rule of limited liability, a court may disregard the corporate entity and hold a corporation’s shareholders personally liable for the acts and debts of the corporation.

The doctrine of piercing the corporate veil is an equitable remedy governed by state law. Although there are a number of formulations of the doctrine, courts generally pierce the corporate veil only in narrow circumstances in which the corporation is so controlled as to be the “alter ego” or mere “instrumentality” of its owners.<sup>2</sup> Because the doctrine is an equitable remedy, it is generally only available where maintaining the corporate form would

work an injustice upon an innocent party.<sup>3</sup>

Many states have developed a two-part test to determine whether a court should pierce the corporate veil. The test places the burden on the claimant to show that, 1) there is such a unity of interest and ownership that the separate personalities of the corporation and its corporate shareholder no longer exist and, 2) if the acts are treated as those of the corporation alone, then an inequitable result will follow.<sup>4</sup>

## Unity of Interest & Ownership

Courts generally refer to a common set of factors when examining the unity of interest and ownership element of the test. These cases often arise in the context of a parent-subsidary relationship where a plaintiff claims that a parent entity should be liable for the debts and actions of its subsidiary. Among the factors generally considered in this analyses are whether:

- The parent and the subsidiary have common stock ownership
- The parent and the subsidiary have common directors or officers
- The parent and the subsidiary have common business departments
- The parent and the subsidiary file consolidated financial statements and tax returns
- The parent finances the subsidiary
- The parent caused the incorporation of

the subsidiary

- The subsidiary operates with grossly inadequate capital
- The parent pays the salaries and other expenses of the subsidiary
- The subsidiary receives no business except that given to it by the parent
- The parent uses the subsidiary’s property as its own
- The daily operations of the two corporations are not kept separate
- The subsidiary does not observe the basic corporate formalities, such as keeping separate books and records as well as holding shareholder and board meetings<sup>5</sup>

Courts typically reason that no single factor is outcome determinative. Instead, they analyze the factors under the totality of the circumstances.<sup>6</sup> The standards are not identical in each state, but courts generally require substantial control by the parent entity over the finances, policies and practices of the subsidiary to such a degree that the parent entity operates the controlled corporation merely as its business conduit or agent.<sup>7</sup>

In addition to applying the doctrine in the parent-subsidary context, a court may pierce the veil in other circumstances, including to hold an individual shareholder liable for the acts and debts of a corporation,<sup>8</sup> or to hold members of a limited liability company liable for the acts and debts of the company.<sup>9</sup> Certain courts have

“reverse pierced” the corporate veil to hold a corporation accountable for the debts and liabilities of its owners in cases where a corporation was treated as an alter ego of its owners.<sup>10</sup>

## Inequitable Result

Because the doctrine is applied to prevent injustice and achieve an equitable result, courts have generally required that a plaintiff show fraud or similar abuse of the corporate form in order to pierce the corporate veil.<sup>11</sup> Courts have often held that something akin to fraud, deception or bad faith, or the presence of a compelling public interest must be present in order to disregard the corporate form.<sup>12</sup> Courts have cautioned plaintiffs against relying on inadequate capitalization alone and have reasoned that difficulty in enforcing a judgment or collecting a debt generally does not, by itself, satisfy the second element of the test.<sup>13</sup>

## Recommendations

Although not an exhaustive list, the following is sound advice for strengthening a business entity’s veil:

**No commingling of funds**—Funds between an owner and the company should not be treated as interchangeable. Fund transfers should be documented.

**Employee and reporting relationships**—Individuals working for a company should be employees of that company and report to their superiors at that company as opposed to a company’s parent entity.

**Independent board of directors and officers**—Avoid having several interlocking director and officer positions between a subsidiary and its parent entity.

**Intercompany agreements**—Prepare intercompany agreements to memorialize the services provided by and transactions entered into between a company and its affiliates. To the extent possible, charge arm’s-length fees for such services and transactions.

**Capitalization**—Do not undercapitalize the company. Undercapitalization is one

of the most common claims by plaintiffs to pierce the corporate veil.

**Corporate formalities**—Maintain separate corporate records, accounts, meetings and other formalities.

**External communications**—The company should operate and execute contracts under its company name and hold itself out as a separate entity in its communications and dealings with third parties.

## Conclusion

Although the default rule is that a corporation maintains an existence separate from its owners, courts may pierce the corporate veil under certain circumstances and hold owners liable for the acts and debts of the corporation. Owners of corporations and other limited liability entities should, at a minimum, maintain separate corporate formalities for their business entities and avoid operating companies as “alter egos” or mere “instrumentalities” of their owners or affiliated companies.

<sup>1</sup> *Anderson v. Abbott*, 321 U.S.349, 362 (1944)

<sup>2</sup> *Webber v. Inland Empire Invs., Inc.*, 88 Cal. Rptr. 2d 594, 603-04 (Cal. Ct. App. 1999)

<sup>3</sup> *Taylor Steel, Inc. v. Keeton*, 417 F.3d 598,606 (6th Cir. 2005)

<sup>4</sup> *Ted Harrison Oil Co. v. Dokka*, 617 N.E.2d 898, 901 (Ill. App. Ct. 1993)

<sup>5</sup> *United States v. Jon-T Chemicals, Inc.*, 768 F.2d 686, 691-92 (5th Cir. 1985)

<sup>6</sup> *Kinney Shoe Corp. v. Polan*, 939 F.Supp. 209, 210 (4th Cir. 1991)

<sup>7</sup> *Jon-T Chemicals, Inc.*, 768 F.2d at 691

<sup>8</sup> See, eg: *Pepsi-Cola Metro Bottling Co. v. Checkers, Inc.*, 754 F.2d 10, 16 (1st Cir. 1985) (“[S]hareholders may be held liable where they control the operation of the corporation and run it for their personal benefit, and where justice requires that the separate existence of the corporation be ignored.”)

<sup>9</sup> See, eg: *Kaycee Land and Livestock v. Flahive*, 46 P.3d 323, 327 (Wyo. 2002) (“We can discern no reason, in either law or policy, to treat LLCs differently than we treat corporations. If the members and officers of an LLC fail to treat it as a separate entity as contemplated by statute, they should not enjoy immunity from individual liability for the LLC’s acts that cause damage to third parties.”)

<sup>10</sup> See, eg: *LFC Mktg. Group, Inc. v. Loomis*, 8

P.3d 841, 904 (Nev. 2000) (“[We conclude that reverse piercing is appropriate in those limited instances where the particular facts and equities show the existence of an alter ego relationship and require that the corporate fiction be ignored so that justice may be promoted.”)

<sup>11</sup> See, eg: *Shelton v. Clements*, 834 So.2d 775, 781 (Ala. Civ. App. 2002) (“[A] party seeking to pierce the corporate veil must show fraud in asserting the corporate existence or must show that recognition of the corporate existence will result in injustice or inequitable consequences.”)

<sup>12</sup> *Sea-Land Services, Inc. v. Pepper Source*, 941 F.2d 519, 523 (7th Cir. 1991)

<sup>13</sup> See, eg: *Id.* at 524 (“Generalizing from these cases, we see that the courts that properly have pierced corporate veils to avoid ‘promoting injustice’ have found that, unless it did so, some ‘wrong’ beyond a creditor’s inability to collect would result: the common sense rules of adverse possession would be undermined; former partners would be permitted to skirt the legal rules concerning monetary obligations; a party would be unjustly enriched; a parent corporation that caused a sub’s liabilities and its inability to pay for them would escape those liabilities; or an intentional scheme to squirrel assets into a liability-free corporation while heaping liabilities upon an asset-free corporation would be successful.”)

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