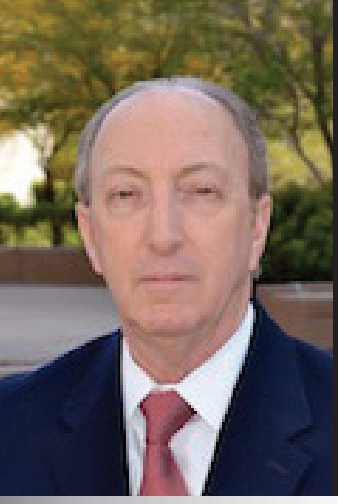

Piercing The Corporate Veil

When Does a Business Owner Have Personal Liability?

By Jack Barone

In the modern business world, corporations and limited liability companies are the preferred form of business entities over sole proprietorships. While there are a variety of reasons for this preference, the seminal advantage of the corporate form is the limited liability it offers its shareholders or owners. The basic premise is that creditors of the corporation or LLC are not permitted to satisfy corporate debts by suing or otherwise pursuing the shareholders. To the contrary, sole proprietors and general partners have unlimited personal liability in all obligations of the business. However, the liability protection afforded by the corporate form is not unlimited. Even if an ordinary corporation or LLC has been properly formed, it may be operated in such a manner as to lose the advantages of limited liability. The term "piercing the corporate veil" is the legal process of imposing liability for corporate activity, in disregard of the corporate entity, on a person or entity other than the offending corporation itself. In general, the courts will ignore the corporate entity and strip the organizers and managers of the limited liability they normally enjoy when, for example, the purpose of the entity formation was accomplished to perpetrate a fraud.

Aside from initial formation for a fraudulent purpose, there are a number of circumstances post-formation that can lead to a creditor seeking to pierce the corporate veil. When the entity has been thinly capitalized, i.e., underfinanced, a creditor or creditors may seek to sue the corporate shareholders (or members of an LLC) directly, if it appears that the business was organized and operated without adequate capital to meet the obligations that could reasonably be expected to arise. In such instances, the amount of capital so required is a question of fact based on the needs of the business. Another scenario in which shareholders or members may be held personally liable is where they have treated the corporation not as a separate entity, but as an alter ego of themselves, as is often the case with closely held corporations and LLCs. Typically, this arises when the shareholders fail to distinguish between the corporation's affairs and the assets of the owners (comingling of assets) or when the corporate formalities have not been observed e.g., failure to hold corporate meetings or failure to keep separate books. It should be noted that in this situation, the actions need not rise to the level of fraud but mere misfeasance by the shareholders or members may be sufficient. Additionally, courts may seek to ignore the corporate form if they determine that corporate form has been used to evade a statutory or contractual obligation.

Jack Barone is a co-founder of the law firm of Rai & Barone, P.C. His firm represents clients in the practice areas of construction defect litigation, specializing in subcontractor defense, general liability, business transactions, commercial litigation, and insurance defense of all types. The firm has extensive arbitration, mediation and trial experience. Rai & Barone's goal is to provide expeditious, affordable, and effective representation to its clients. Jack can be reached at (602) 476-7100 or via e-mail at jack.barone@raibarone.com.

Another less commonly seen situation, which may lead to the imposition of liability on the managers or directors of a corporation, is what is known as a derivative action or suit. Such an action is based on a primary right of the corporation, but is asserted on its behalf by a shareholder(s) of the corporation. Derivative actions typically arise from a breach of fiduciary duty by those entrusted with the management or direction of the corporation to minority shareholders or members.

Although cases involving piercing the corporate veil are relatively rare, some general guidelines for corporations and LLCs, especially small or closely held entities, to observe are:

1. The corporation should be adequately capitalized to meet its obligations;
2. The shareholders or members should not treat company property as if it were their personal property;
3. The separate corporate form should be observed on a daily basis, such as separate business accounts, corporate stationary and forms, and no misrepresentations about the nature of the corporate entity, or shareholder relationships; and
4. The formalities of corporate procedure should be maintained e.g., keeping minutes of corporate meetings, holding annual meetings and complying with state procedural requirements.

One final circumstance that merits brief mention – particularly in today's world where bankruptcy filings are commonplace – concerns the liability of shareholders or members when the corporation becomes insolvent. In general, liability for corporate debts in bankruptcy does not extend to those individuals, unless some other independent basis to pierce the corporate veil exists, as discussed above. However, if a corporation becomes insolvent, debts owed by the corporation or LLC to the shareholders or members may be subordinated to claims of other creditors, so that shareholder or member claims will not be paid until all other creditors have been paid. This process, known as Deep Rock doctrine, applies even when shareholders or members claims are fully secured. Typically, such a situation arises when there has been corporate mismanagement, under capitalization or bad faith. In such cases, the bankruptcy courts have the power of equitable subordination of shareholder's loans to outside creditors.

In summary, business owners, whether as corporate shareholders or LLC members, should be aware that while there are many protections from liability afforded to the corporate form, they are not without limit, and owners' actions could subject them to personal exposure, if the corporate veil is successfully pierced.