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Piercing The Corporate Veil

(Law of Corporation)

The phrase "piercing the corporate veil" is a metaphor to describe the cases in which a court refuses to recognize separate existence of a corporation despite compliance with all the formalities for the creation of a de jure corporation. The phrase "piercing the corporate veil" is abbreviated to "PVC' in the balance of this part".

A. TRADITIONAL TESTS

The traditional test for PVC ("piercing the corporate veil") is to "prevent fraud" or to "achieve equity". Many courts add the goals of "preventing oppression" or "avoiding illegality". These tests are all result-oriented are give little indication of the circumstances in which a court will refuse to recognize the separate existence of a corporation.

In deciding whether to PVC, courts have developed concepts (or doctrines) of "shareholder domination"; alter ago; "mere instrumentality"; or "identity". These concepts are also result oriented.

1. DEFINITIONS OF ALTER EGO AND INSTRUMENTALITY

"Alter ego" literally means "second self". Courts hold that PVC is proper under the alter ego doctrine where (a) such unity of ownership and

interest exist between corporation and shareholder that the corporation has ceased to have separate existence, and (b) recognition of the separate existence of the corporation sanctions fraud or leads to an inequitable result. A corporation becomes the' instrumentality' of a shareholder where there has been an excessive exercise of control by the shareholder that leads to wrongful or inequitable conduct that in turn causes the plaintiff a loss.

a. It is unclear whether "alter ego" and "instrumentality" are subdivisions of PCV or whether they are grounds for holding shareholders liable independent of the general tests of "preventing fraud" or "achieving equity".

b. Many courts and commentators view these various doctrines as Interchangeable with and essentially the same as the general concept of PVC.

c. These various tests are particularly unrealistic in a one-person

Corporation, since, in a sense, a sole shareholder always "dominates" his or her corporation. Similarly, that corporation in the same sense is always an "instrumentality" of the shareholder, as well as the "alter ego" of the shareholder, since there is no one else with an ownership interest in the corporation.

2. JUDICIAL ATTITUDES TOWERD SEPARATE IDENTITY OF CORPARATION

Many courts state that the "general" or "cardinal" rule is that the corporation is separate and independent from its shareholder and that is separate existence should be recognized.

3. PUBLICLY AND CLOSELY HELD CORPORATIONS

PVC is exclusively a doctrine applicable to closely held corporations. There are no modern examples in which that doctrine has been applied to publicly held corporation. Caveat: PVC may be applied to subsidiary corporations owned by a publicly held parent corporation. However, in these cases the separate existence of the subsidiary and not the parent is being ignored.

4. ONE OR TWO PERSON CORPORATIONS

One or two corporations are treated no differently than other corporations in PVC cases. While PVC is probably more likely to in small corporations' with one or two shareholders than in corporations with more shareholders, essentially the same tests are applied, and in appropriate cases the separate existence of one two person corporations will be recognized.

5. MOTIVE FOR INCORPORATION

Motive is unimportant in the sense that the separate corporate existence may be recognize even though the corporation was formed solely for the purpose of avoiding unlimited liability. Example, X is the sole owner of a retail drug business which includes home deliveries. X decides to incorporate solely because she fears potential liability for (1) accidents by her delivery trucks and (2) adverse drug reactions from the products she sells. If the corporation is formed and operated consistently with the principles set forth below, its separate corporate existence should be recognized despite the liability-avoiding motive of the sole shareholder.

6. BROTHER-SISTER CORPORATION

PVC cases are not limited to the liability of individual or corporate

shareholder for corporate obligations. In appropriate cases, the separate existence of related corporations, i.e., corporations with common shareholders may be ignored so that the two corporations are treated as a single entity. This may occur even though the common shareholders are not found to be personally liable for corporate obligations under a PCV theory.

7. INACTIVE SHAREHOLDERS

PCV is not an all-or-nothing principle. In appropriate cases, active shareholders may be held liable for corporate debts on a PCV theory but inactive shareholders may be found not to be personally liable on such obligations.

8. ESTOPPEL AGAINST SHAREHOLDERS

PVC is basically an equitable doctrine available to creditors of the corporation whose separate existence is being questioned. It generally is not available to the corporation itself or its shareholders who now regret having formed the corporation; it also may not be available to the bankruptcy trustee of the corporation whose separate existence is being questioned, though individual creditors may be able to assert a claim under the PCV doctrine.

B. INDIVIDUAL SHAREHOLDERS LIABILITY CORPORATE DEBTS

Many PCV cases involve attempts to hold shareholders who are individual liable for corporate obligations (The rules relating to corporate shareholders are somewhat different and are discussed in the following subsection).

1. CONSENSUAL TRANSACTIONS

In most cases where a third person has dealt voluntarily with the corporation (usually contract claims) the third person should not be able to PCV and hold the shareholders personally liable. Absent unusual circumstances he has "assumed the risk" that the corporation will be unable to meet its obligations when he dealt voluntarily with the corporation and did not demand a personal guarantee from the shareholder. Many but not all cases accept this approach.

a. "Unusual circumstances" in which shareholder liability for contract claims might be imposed include:

- I. The shareholders conduct business in such a way as to cause confusion between individual and corporate finances. Example: For convince, X pays all bills of his corporation by his personal checks and reimburses himself at the end of each week by a single corporate check. X should be personally liable on corporate obligations to persons who are aware that bills in the past have been paid from X's personal funds. Caveat: In both of these examples, the plaintiff was personally familiar with the intermingled transactions and may have relied on them. A creditor who was not directly aware of them may also be able to hold the shareholder liable under PCV principles in many states, though such a claim is more difficult to maintain or justify in the absence of detrimental reliance.
- II. The third party is in some way misled or tricked into dealing with the corporation.
- III. The corporation is operated in an unusual way so that:
  a. It can never make a profit;
  b. Available funds are siphoned off to the shareholder without regard to the needs of the operation; or
  c. It is operated so that it is always insolvent.
- IV. The capitalization of the corporation is in some away misrepresented. Of course, an affirmative misrepresentation by the shareholder of the capitalization of the corporation might constitute

actionable fraud independent of the PCV doctrine.

- V. The shareholder orally promises unconditionally to be personally responsible for the corporate obligations under circumstances where it is inequitable to permit the shareholder to rely on the statute of frauds.

b. Inadequate or nominal capitalization should normally not be a factor in contract cases. Indeed, the formation of a nominally capitalized corporation may be an integral part of a carefully devised plan by the parties to allocate the risk of loss; courts should not change allocations of risks that are worked out by the parties in the absence of fraud or other abuse of the contact process.

c. Many cases involving voluntary dealings rely on the failure of the Corporation and the shareholder to follow corporate formalities as a basic for PCV.

2. NONCONSENSUAL TRANSACTIONS

Incises involving non-consensual transactions there is usually no element of voluntary dealing. As a result, one cannot usually argue that the third person “assumed the risk” by dealing with a nominally capitalized corporation.

a. To recognize the separate corporate existence of a nominally capitalized corporation engaged in a hazardous activity in effect shifts the risk of loss or injury to some random members of the general public who happen to be injured by the activity.

b. Lack of adequate capitalization should be considered a major factor in PCV in tort cases. While important, most cases that find shareholders liable involve, in addition to inadequate capitalization, some additional justification to PCV.

- I. If the capital was originally reasonable adequate in light of the probable risks, a PCV argument is likely to be rejected if unavailable business reverses have reduced the amount of capital so that tort creditor cannot be fully compensated.
- II. A PCV argument is likely to be accepted where the original is nominal or small in light of contemplated business risks.
- III. A PCV argument is likely to be adopted where the corporation is formed with minimal capital specifically to engage in ultra-hazardous activities which causes injury to property.Example: A corporation is formed to do blasting pursuant to a contract. As a result of the blasting operations damage occurs to adjoining property. The shareholders are indirectly involved in decision as to the conduct of the business; the corporation is nominally capitalized with the bulk of the assets loaned to the corporation by the shareholders. The shareholders are personally liable for the damages caused by the blasting operations.
- IV. Liability insurance should be viewed as the equivalent of free capital for purposes of PCV in torts cases. This is because such insurance provide readily available funds to tort victims.

c. It is widely believed that courts are more willing to accept PCV cases, however, found no evidence to support this belief. Caveat: Most litigated cases involve only the saliency of a complaint to withstand a motion to dismiss rather than review of a judgment on the merits.

Caveat: The study referred to considered only the results of reported appellate cases. Settlement statistics may reflect that PCV tort cases are settled more often than contract cases.

d. Shareholders may be personally liable for corporate torts on theories other than PCV. The individual tort reason who actually caused the injury is personally liable whether or not he was acting as an agent corporation. If he was acting as a corporate agent, the corporation is also liable for the tort under the theory of respondent superior. If the tort reason and it is

unnecessary r-to argue PCV.

- I. If the corporation may be viewed as the agent of a shareholder, the shareholder becomes liable for corporate torts on a respondent superior theory.
- II In a typical case, however, the tort faros is a judgment proof employee, the corporation is also unable to satisfy the claim, and attempts are made to hold shareholders personally liable on a PCV theory.
- III. In some cases, actual dominant and control of a subsidiary's affairs may be sufficient to PCV and hold the parent liable.

d. Commentators have suggested that on the basis of economic analysis shareholders should be personally liable for al tort claims not involving voluntary transactions. The proposal is for liability proportional to shareholders interests, not joint and several liabilities. This proposal has never received serious consideration.

3. FAILURE TO FOLLOW CORPORATE FORMALITIES

In PCV cases, a factor that is often significant if not decisive is the to follow corporate formalities.

a. A PCV argument is much likely to be accepted if the plaintiff can show (in addition to abuse of the corporate form in a contracts case or inadequate capital or liability insurance in a torts case) a failure to follow formalities, such as: a failure to complete the formation of the corporation; a failure-to contribute capital or to issue shares; a failure to hold elections, meetings and to follow the other trappings of corporation formality; a pattern of decision-making in which shareholders make business decisions much as though they were partners; a failure to designate clearly the capacity of person who are acting on behalf of the

corporation; and a pattern involving the mixing of personal and corporate activities, such as informal loans, use of corporate funds for personal loans, or vice versa.

b. While a failure to follow corporate formalities may lead to confusion or deception in some cases, liability does not appear to be dependent on a showing that third persons were misled or confused. Reliance on failure to follow formalities to establish PCV may be justified on at two least two different grounds:

- I. The failure to follow formalities may indicate that the shareholders that the corporation as an' alter ego' or' instrumentality' by not maintaining the separate existence of the corporation; or
- II. PCV may be viewed as a sanction to assure that corporate formalities are in fact followed as contemplated by statute.

4. ARTIFICIAL DIVISION OF A SINGLE BUSINESS ENTITY:

In all PCV cases, an important factor is whether a single business is artificially divided into several different corporations to reduce exposure of assets to liabilities. "Professor Berle" referred to this phenomenon as the theory of "enterprise entity".

a. The normal response to an artificial division of a single business entity is holding the entire entity responsible for the debts of the business rather than to hold the shareholders personally liable for such debts.

b. Two or more corporations owned by a single shareholder or owned approximately proportionally by several shareholders are often referred to as "brother-sister corporations". Such corporations may also be analyzed as a type of' parent-subsidiary' relationship discussed below.

C. PARENT CORPORATIN’S LIABILITY FOR OBLIGATIONS OF SUBSIDIARY CORPORATION

Many PCV cases involve shareholders who themselves are corporations. In other words, the issue involves the responsibility of a parent corporation for the actions of a subsidiary. Practically every publicly held corporation has numerous subsidiaries engaged in a variety of related or different businesses. Subsidiaries are usually wholly owned by the parent corporation but they may also be partially owned. It is often stated that courts are more likely to PCV when the shareholders is itself a corporation than when the share holders is an individual, but there is little empirical evidence supporting this assertion.

1. TYPES OF ISSUES THAT MAY ARISE

PCV in parent – subsidiary context may arise in several ways in addition to the question whether the parent corporation is liable for the debts of a subsidiary:

a. The issue may be whether transactions between two subsidiaries must be recognized by third persons who are affected by the transaction.

b. The issue bay be whether a parent may be conspire with its subsidiary, or weather two subsidiaries may conspire together, to violate law or the rights of third parties.

c. The issue may involve a question of statutory construction: e.g, do statues that refer generally to “corporation” or “operator” apply to both parent corporations and affiliated or subsidiary corporations.

2. CONFUSION OF AFFAIRS

A parent corporation may be held liable for its subsidiary’s obligations if it

fails to maintain a clear separation between parent and subsidiary affairs. A failure to maintain a clear separation between affairs of different subsidiary corporations may result in the separate existence of those corporations being ignored as well. Conduct that may lead to parental liability includes:

a. Referring to the subsidiary as a “department” or “division” of the parent;

b. Mixing business affairs, such as using parental stationery to respond to inquiries addressed to the subsidiary;

c. Having common officers who do not clearly delineate the capacity in which they are acting, i.e., a failure to identify “which hat he (or she) is wearing”;

d. Mixing assets, such as having the subsidiary sign a pledge of assets to secure parental indebtedness, transferring funds informally from one entity to other without the formalities normally involved in a loan, or having a common bank account.

3. PERMISSSIBLE ACTIVITIES

If practices similar to those described in paragraph 2 are avoided, a PCV argument should be rejected even though:

a. One corporation owns all the shares of the corporation;

b. The corporations have common officers or directors;

c. The corporations file a consolidated tax return their earnings to their shareholders on a consolidated basis;

d. The parent corporation maintain a cash management function by which

all cash accounts are centralized to obtain the most favourable interest rates and minimize borrowing costs, so long as records are carefully kept and each subsidiary has immediate access to its funds as needed for its operations;

e. The parent corporation provides centralized accounting and legal services for all subsidiaries, charging for such services on an even-handed and reasonable basis;

f. The parent and subsidiary have a common office or share common office space so long as the terms of the arrangement are reasonable and the separate identities are maintained by appropriate signs, telephone listings, and the like; and

g. The board of directors of the subsidiary consists of the parent, actions by employees of the parent, actions by employees of the subsidiary are reviewed by the employees o the parent, and the organizational chart of the parent includes the parent includes the subsidiary.

Caveat: Parent and subsidiary corporations have common economic interest and some degree of interaction and oversight is permitted. However, if the separate existence of the subsidiary is to be recognized it is essential that the subsidiary have some independence and discretion with respect to business matters.

4. FRAUD OR INJUSTICE

Some cases have concluded that in a contract case apparent is liable for its subsidiary’s liabilities only upon a showing of “fraud or injustice”.

5. CONCLUSION

Most courts appear to apply the same PCV principles to parent-subsidiary

relationships as are applied to shareholders who are individuals. With the continued growth of corporate groups in the future, and the increased number of regulatory and environmental laws, it is possible that a unique set of principles for PCV in corporate groups will evolve.

D. USE OF THE SEPARATE CORPORATE ECINTENCE TO DEFEAT PUBLIC POLICY

The flexibility of the corporate fiction often permits it to be used in away arguably tends to defeat or undercut statutory policies.

1. GENERAL PRINCIPLE

The issues generally revolve more around the strength and purposes of the state public policy than the degree or extent of formation of method of operation of the corporation.

Example: A statute prohibits bank directors from borrowing from their bank. A corporation that is wholly owned by a bank director seeks to obtain a loan farm the bank. The argument that the corporate barrower has a separate identity from the shareholder and the therefore the loan may be validly made would defeat a clearly defined public policy expressed in the statute; the loan should therefore be held to violate the statute. This result might be rationalized on the ground that the corporation is the "alter ego" of its shareholder and that a loan to the "corporation" is the therefore a loan to the "shareholder". However, the real justification for the result is that recognition of the separate corporate existence would tend to defeat public policy.

2. QUALIFICATION OF SHAREHOLDER FOR EMPLOYEE BENEFITS

A corporation may also be used to qualify a person for public benefits

available to employees who she would not be entitled to if she conducted business in her own name. The validity of this practice also depends on an evaluation of the policies underlying the grant of benefits.

3. OTHER POLICY ISSUES

A PCV analysis may also be used whether a parent corporation is bound by a subsidiary’s union contract.

E. CHOICE OF LAW IN PIERCING THE CORPORATE VEIL

Some states are more liberal than others in permitting PCV. A question may arise in the case of a foreign corporation whether the law of the state of incorporation or the law of the state in which the transactions occurred should apply in determining whether the court should PCV.

1. HISTORICAL DEVELOPMENT

Until about1980 no attention was paid to the choice of law issue since there did not seem to be significant variations in the law of PCV from state to state. The few cases in which the choice of law issue was raised generally concluded that the law in each possible state was the same and it was unnecessary to determine which law was applicable. In most cases arising during this period, the court simply applied the case law of the forum state without discussing the choice of law issue at all.

2. GENERAL PRINCIPLES

The rule generally followed in the few cases that have addressed the issue is that the liability of a shareholder for the debts of the corporation is a matter of the internal affairs of a corporation, to be governed by the law of the state of incorporation.

a. This rule is likely to be followed where the corporation has significant economic ties to the state of incorporation, particularly if the shareholders are themselves residents of the state of incorporation.

b. A Texas statute mandates the application of the internal affairs rule to PCV in the case of foreign corporations authorized to business in Texas.

Caveat: Under general conflict of laws principles applicable to torts, a court sitting in the state where the accident or event occurred may determine to apply local law to the. PCV issue if the contacts of the Corporation with the state of incorporation are minimal and all significant contacts are with the forum state.

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