Piercing the Corporation Veil

I. In some circumstances, even though a corporation has been validly formed, the courts will hold the shareholders, officers, or directors personally liable for corporate obligations because the corporation is abusing the legislative privilege of conducting business in the corporate form.
    A. The law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability. But, the courts will disregard the corporate form, or pierce the corporate veil whenever necessary to prevent fraud or to achieve equity. (*Walkovoszky v. Carlton*)

II. In determining whether liability should be extended to reach assets beyond those belonging to the corporation, we are guided by the general rules of agency. (*Walkovoszky v. Carlton*)

III. Piercing the corporate veil is an equitable remedy, and the burden rests on the party asserting the claim. A totality of the circumstances test is used in determining whether to pierce the corporate veil and each case must be decided on its own facts. (*Kinney Shoe Corp. v. Polan*)

IV. As a general rule, a de jure corporation will be treated as a legal entity until sufficient reason to the contrary appears. Each case is different, but there are three recurring situations in which the veil is often pierced.
    A. When corporate formalities are ignored;
    B. When the corporation is inadequately capitalized at the outset; and
    C. To prevent fraud.

V. If a corporation is the "alter ego," "agent," or "instrumentality" of a sole proprietor or of another corporation, its separate identity may be disregarded.
    A. Individual shareholders. If the shareholders treat the assets of the corporation as their own, use corporate funds to pay their private debts, fail to keep separate corporate books, and fail to observe corporate formalities, courts often find that the corporate entity is a mere alter ego of the shareholders.
        1. Sloppy administration alone may not be sufficient to warrant piercing the corporate veil. The operation of the corporation must result in

some basic injustice so that equity would require that the individual shareholders respond to the damage they have caused.

B. Parent-subsidiary corporations. A subsidiary corporation or affiliated corporation entity if the formalities of separate corporate procedures for each corporation are not observed.
    1. For example, both corporations must be held out to the public as separate entities; separate meetings of directors and officers should be held; identical or substantially overlapping directors and officers should be avoided; and corporate policies should be significantly different.

C. Affiliated corporations. It is generally accepted that shareholders will be personally liable for their corporation's obligations if at incorporation they fail to provide adequate capitalization.
    1. The shareholders must put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. Undercapitalization cannot be proved merely by showing that the corporation is now insolvent.
    2. However, if insolvency occurs soon after incorporation, it may be a primary indicator of undercapitalization.

VI. Inadequate capitalization- shareholders will be personally liable for their corporation's obligations if at incorporation they fail to provide adequate capitalization. The shareholders must put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. Undercapitalization cannot be proved merely by showing that the corporation is now insolvent. However, if insolvency occurs soon after incorporation, it may be a primary indicator of undercapitalization.

A. One-Person or Close Corporation
    1. No absolute test for adequate capitalization has been formed. In any case, the corporation should have enough capital to pay debts when they come due. The scope of the contemplated operations of the

corporation, and the potential liability foreseeable from the operations, are factors to consider.

B. Parent-Subsidiary Corporations

1. A parent corporation's inadequate capitalization of a subsidiary corporation may constitute constructive fraud on all persons who deal with that subsidiary. One additional test should be applied in the parent-subsidiary situation: whether the subsidiary may reasonably expect to achieve independent financial stability from its operation.

VII. Avoidance of existing obligations, fraud, or evasion of statutory provisions

A. The corporate entity will be disregarded any time it is necessary to prevent fraud or to prevent an individual shareholder from using the corporate entity to avoid his existing personal obligations.

B. Avoiding liability. There mere fact that an individual chooses to adopt the corporate form of business to avoid personal liability is not, of itself, a reason to pierce the corporate veil.

C. Fraud. The corporate veil will be pierced whenever the avoidance of personal liability through the formation of a corporation operates as a fraud on creditors or other outsiders.

VIII. Who Is Liable?

A. When the corporate entity is ignored and the shield of limited liability is pierced, the persons composing the corporate entity may be held personally liable.

B. Normally, only the persons who were active in the management or operation of the business will be held personally liable. Passive investors who acted in good faith will not be held liable for corporate obligations.

C. Theories of liability

1. Joint and several liability. When shareholders are held liable, they will be held liable for the entire amount of the claim (even if it exceeds the amount that would have been considered adequate capitalization). Liability for obligations of the corporation is extended to the shareholders as joint and several liability.

2. Property cases. If a corporation has conveyed its assets to a shareholder in fraud of creditors, upon piercing the corporate veil the assets may be reached on principles of fraudulent conveyance.

IX. Who May Pierce?

A. Creditors- the creditors of a corporation are the most likely to pierce the corporate veil, and the cases involving disregard of corporateness primarily involve creditors.

B. Shareholders- those who choose to conduct business in the corporate form may not disregard the corporate entity at their will to serve their own purposes. Courts virtually never pierce the corporate veil at the request of the shareholder.

X. Example: *Sea-Land Services v. Pepper Source* (211)

A. A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met:

1. There must be such unity of interest and ownership that the separate personalities of the corporation and the individual (or other corporation) no longer exists.

a) The failure to maintain adequate corporate records or to comply with corporate formalities.

(1) Marchese did not remember any of his corporations ever passing articles of incorporation, bylaws, or other agreements.

b) The commingling of funds or assets.

(1) Marchese runs all of these corporations out of the same, single office, with the same phone line, the same expense accounts, and the like. Marchese borrows substantial sums of money from these corporations interest free.

c) Under capitalization

(1) The corporations borrow money from each other when need be, which left at least PS completely out of capital when the Sea-Land bill came due.

d) One corporation treating the assets of another corporation as its own.

(1) Marchese has used the bank accounts of these corporations to pay all kinds of personal expenses.