DuPage County Bar Assn Business Law Section

Piercing the Corporate Veil: How to Do It and How to Avoid It

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Corporate Veil-Piercing

Road Map for Today's Talk:

- **Overview and definitions**
- **Litigator to discuss Illinois cases in which Corporate Veil has been pierced and how to pierce. Analysis of veil-piercing factors in Illinois case** ***Fontana vs. TLD Builders, Inc. (2001)*** 362 Ill. App. 3d 491(2005*);* and the later cases ***Steiner Electric Co vs Maniscalco (2016)*** IL App 1st 132023, ***Buckley v Abuzir (2014)*.** 2012 IL App 1st 112246-U 130469 Ill. App. 2014.
- **Liability types resulting from Corporate Veil-piercing by an adversary, creditor, litigant or regulator, who looks through, and grabs any available asset to satisfy the liability**
  - **Business-to-Personal liability and**
  - **Business-to-Business cross-contamination liability,**
- **LLCs can be pierced too** ***Maghsoui Enterprises v Tufenkian. 2009*** US Dist. Lex 107266 (11/16/2009)
- **Corporate lawyer to discuss:**
  - **Corporate Formalities used to protect corporate veil, and**
  - **Business formalities and behavior to avoid corporate veil-piercing**
- **Highlight Statutory provisions that affect corporate formalities (handout)**

What is a “Corporate Veil” ?

The “Corporate Veil” is created by forming a Corporation or LLC around a business, or an activity, or around an ownership of property

- The “Corporate Veil” around the business insulates the business owners’ assets from personal liability that the business may incur, in a business-to-personal claim.

- Corporate Veil of one entity insulates its business assets from cross-liability claims against a group of its affiliated business entities (in a business-to-business claim against one of the group of entities.)

What is Piercing the Corporate Veil: And What is the Result

- "Piercing the Corporate Veil" is a common-law equitable remedy and doctrine
  - Intended to prevent persons or entities to get by with committing fraud, misconduct, torts, liability shifting……without responsibility or accountability by hiding behind the "corporate veil" . The 'corporate veil" can be used as sham to shield what is really personal activity, or activity of other related entities.
  - The remedy allows a litigant, creditor or regulator to pierce through the Corporate Veil protection, and seize or lien personal assets of business owner, to satisfy the liability. Or seize or lien assets of its affiliated business to satisfy the liability.
- Liability for debts, loss of assets, contract performance or breach, taxes, fraud, misstatements, breach of Fiduciary Duty and others…….all can be imposed after the Corporate Veil has been pierced. (Professional Liability inures personally, either way)
- Unintended or accidental risk to personal assets, and related business assets, if the business being sued has been lax in its operation as a business entity. Business owners strive to avoid "piercing the corporate veil" to avoid adversary's look-through and asset-grab of business owner's personal assets.

The Elements of Piercing the Corporate Veil

1) a unity of interest and ownership such that the separate personalities of the corporation and defendant do not exist (i.e. alter ego) ; and

2) The adherence to the fiction of a separate corporate existence would promote an injustice or inequitable consequences.

1. Unity of Interest & Ownership

- (1) inadequate capitalization;
- (2) failure to issue stock;
- (3) failure to observe corporate formalities;
- (4) nonpayment of dividends;
- (5) insolvency of the debtor corporation;
- (6) nonfunctioning of the other officers or directors;
- (7) absence of corporate records;
- (8) commingling of funds;
- (9) diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors;
- (10) failure to maintain arm's-length relationships among related entities; and
- (11) whether, in fact, the corporation is a mere facade for the operation of the dominant stockholders

2. Fraud, Injustice Or Inequitable

- circumstances must exist such that adherence to the fiction of a separate corporate existence would sanction a fraud, promote injustice, or promote inequitable consequences.

- "[s]ome element of unfairness, something akin to fraud or deception, or the existence of a compelling public interest."

Case Law - Alter Ego

The "alter ego" theory.

- **Is the Corporation merely an "alter ego" of an individual owner? Setting up "flimsy organizations" just to escape personal liability?**
  - Consider whether: (1) such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) circumstances such that an adherence to the fiction of a separate corporate existence would promote injustice or inequitable consequences. Fiumetto vs Carrett Enterprises, Inc Case 321 Ill.App.3d 946, 749N.E.2d 992, 255 Ill. Dec. 510) 2001

- **Is a group of corps or LLCs all operating as one entity?**

- **Is an affiliated entity, or a parent or sub, in reality the operating and responsible party (rather than the person being sued)?**

Litigation typically occurs over fraud or misdeeds of the person behind the business.

Veil-Piercing Case: Fontana Factors Analysis

- **Veil-Piercing Factors in “Fontana”: (*Fontana vs TLD Builders, Inc. 263 Ill.App. 3d 491, 840 NE2d 767(2d D 2005*) in which the shareholder was held personally liable for $ 1 million debt of the corporation:**
  - **Undercapitalization or “inadequate capitalization”**
  - **Failure to issue stock**
  - **Absence of Corporate Records or inadequate records**
  - **Failure to Observe Corporate Formalities**
  - **Comingling of funds or assets**
  - **Diversion of Assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors**
  - **Failure to maintain arm’s-length relationships among related entities’ owners and principals.**
  - **Insolvency of the Corporation or LLC**
  - **Nonfunctioning of other officers and directors**
  - **Nonpayment of Dividends or Distributions to Shareholders or**
  - **Corporation acting as a façade for operation of the shareholder**
- **Case Law 2014 and 2016 Updates: *Steiner* and *Buckley***

Veil-Piercing Case: Fontana Case

Key Findings in Unity of Interest Analysis in Fontana:

1) Defendant was President of the Corp;
2) The Corp did not have any employees;
3) It had no initial capital contribution
4) The Corp did not have any written contracts with subcontractors
5) The Corp did not have any financial records of payments it made;
6) Absence of Corp. Resolution authorization repayment for loans;
7) Wife director was non-functioning and not active director;
8) Wife directors had no knowledge of loans of $500,000 owed to her;

Key Findings in Fraud, Inequitable Analysis in Fontana:

1) Defendant placed wife in nominal role to shield himself from liability;
2) After lawsuit was filed, Defendant began selling off assets to the detriment of potential creditors & created new corp. without any explanation;
3) Corp had $1.8 m assets, yet made profit in only 2 of 5 years, with no employees;

Veil-Piercing Case: Weight of Factors

Courts Examine Multiple Factors, the totality of the circumstance, whether any "bad acts" occurred, whether there is another remedy for the plaintiff:

***Fontana*'s "veil-piercing" factors are given differing weights by the courts, and Weight depends on the facts and circumstances**

- Generally, the decision to disregard the corporate entity will not rest upon a single factor regarding unity of interest between a corporation and an individual. Piercing the corporate veil is an equitable remedy.

- In order to pierce the corporate veil, a plaintiff must demonstrate:
- (1) such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and
- (2) circumstances such that an adherence to the fiction of a separate corporate existence would promote injustice or inequitable consequences.
- Oran Cart believes there is a trend now with the Courts that values certain factors over others, as a sort of equitable weighing. This way, a person is not unfairly harmed on a mere technicality.

Veil-Piercing: Buckley v. Abuzir (1st Dist – 2014)

Key Findings in Unity of Interest Analysis in Buckley:

1) **Grant of Motion to Dismiss reversed;**
2) **Judgment against Silver Fox Pastries;**
3) **Subsequent suit against Defendant ; Defendant had no formal role Co.**
4) **Sister and brother-in-law were owners/officer/agent;**
5) **SFP never filed any annual reports;**
6) **SFP never had any directors;**
7) **SFP did not have any stock records / or any annual meetings**
8) **Court concluded after survey of jurisdictions, a non-SH or D can be held personally liable under PCV equitable theory;**

Key Findings in Fraud, Inequitable Analysis in Buckley:

1) **Defendant operated SFP initially as a supplier to Plaintiff;**
2) **Defendant made all business decisions ; hired Plaintiff's head baker;**
3) **Through the baker and supply chain, D had access to Plaintiff's recipes and customer lists;**
4) **D's supplier customers were also customers of Plaintiff**

Veil-Piercing of LLCs

LLCs can be pierced too ***Maghsoui Enterprises v Tufenkian. 2009*** US Dist. Lex 107266 (11/16/2009) PA case

In Illinois veil-piercing of an LLC is allowed if similar veil-piercing factors of a corporation would allow it. But in general members and managers not labile for debts of the LLC. IL LLC Act Section 10-10. However, a Member or Manager may incur personal liability based on their own personal actions of fraud, misconduct etc.

Illinois LLC Act: Section 10-10 language: (a-5) removes effect of Dass and Carollo cases. LLC Act mentions "wrongful acts or omissions" . It seems piercing is allowed in IL for wrongful acts. Some litigators have argued that some language in 10-10 would prevent piercing.

- Illinois LLC Act Sec. 10-10. Liability of members and managers.
- (a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.
- (a-5) Nothing in subsection (a) or subsection (d) limits the personal liability of a member or manager imposed under law other than this Act, including, but not limited to, agency, contract, and tort law. The purpose of this subsection (a-5) is to overrule the interpretation of subsections (a) and (d) set forth in Dass v. Yale, 2013 IL App (1st) 122520, and Carollo v. Irwin, 2011 IL App (1st) 102765, and clarify that under existing law a member or manager of a limited liability company may be liable under law other than this Act for its own wrongful acts or omissions, even when acting or purporting to act on behalf of a limited liability company. …..

(c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.

Wyoming corporate veil piercing case of a Single Member LLC, in Wyoming. Fraud by single member owner. They Wyoming statue reversed that. See notes after last slide.

Corporate Formalities to Avoid Veil Piercing (1)

- **Form an Entity (Corp or LLC)**
  - Don't use GP, Sole Prop (and maybe not LP)
  - Don't operate a joint venture without forming an LLC around it
  - LLC: Form as "Manager-Managed" not "Member-Managed" LLC (State in Articles)

- **File Secretary of State Annual Reports for Corp or LLC.**
  - Inquirers Check online
  - File online, create Outlook recurring calendar reminder

- **Don't Let it Go Dissolved**
- If annual report is 6 months late, state will dissolve administratively.
- If dissolved Sec. 12.45 eliminates gap period personal liability when owner reinstates

- **Avoid Thin Capitalization.** "Thinly capitalized" means not enough money to run the company without putting it at risk. Leads to insolvency. Avoid Thin Capitalization both at startup and during ongoing operations. (See handout)
- Start With, and Continue to Keep in Corp or LLC, enough Cash to Operate the Business
- On formation, corp. is "capitalized" with at least enough in company for the share purchase amount to pay for formation of company
- Other money can be put into corporation or LLC in loan, not as share buy, from owner
- Later in operation, keep corporation capitalized with enough cash to run the company
- *Fiumetto vs Carrett Enterprises, Inc* Case 321 Ill.App.3d 946, 749N.E.2d 992, 255 Ill. Dec. 510) 2001 A veil piercing and capitalization case

Shares - Corporate Formalities to Avoid Piercing

Shares Issued & Ownership Documented

- **Create a Stock Ledge or LLC Ledger. Document Shares LLC Interests Issued. Ledger is bible for share issuances. Especially key if issuing "uncertificated shares", not issuing paper certificates**
- **Document payment for shares by each SH or LLC member to meet requirement of "fully paid, validly issued and non-assessible"**
- **Share records Required by Statute. Sec 7.75(a) of BCA**
- **Do Share Certificates (electronic /paperless is fine)."Uncertificated Shares" go paperless if preferred. (No need to deal with lost certificates, or collecting paper Certificates when redeeming shares**
- **Report Share Changes to Secretary of State (required) BCA 14.30**
- **Do Corporate Resolutions: Authorized Shares , Issued Shares, Voting Rights, Shares redeemed or cancelled or transferred, investors in or out, (also Signers, Officers, Spending, Contracts, Property Purchase, Transactions;) Sign Resolutions or Shares not Validly issued**
- **Don't Issue More Shares Than Authorized in Articles of Incorporation**
- **File to Increase "Authorized Shares" if shares have all been issued**
- **Don't use $0 par or tiny par value .001 or .01.**

***More Corporate Formalities to Avoid Veil Piercing** (2)*

- **Corporate Authority: Resolutions, LLC Operating Docs Signed:**
  - Elect Directors & Officers (or Managers), Authorize Bank Signers & Contract singers; Spending Limits, Property Purchases, Transactions, Corporate Actions, Loans, Material Contracts; Authorize Share Transactions, Voting Percentages.
  - Resolutions by written consent, not req. by meeting, electronic 7.05, 7.10
  - Resolutions must be signed to be valid. Get electronic signatures or copy pasted sigs into word docs, they are legal.
  - Shares only validly issued & entity actions only Valid if approved by Resolutions (or LLC Operating Agreement Provisions)
  - IL BCA 7.75 Requires that "each corporation shall keep correct and complete books and records of account and shall also keep minutes of the proceedings of its shareholders and board of directors…record of its shareholders

- **Operating Docs.** Helpful, but not Required, if Resolutions or Minutes are documented
- **Material Transactions Approved by Resolution.** Changing Directors or officers, issuing more shares or redeeming, borrowing money, buying property, buying a business, selling the business, or material corporate action. Must be signed to be valid. Fontana, state that "Companies must be diligent in documenting and approving all material transactions of a corporation, especially those between the corporation and a SH…", or the corp. and other entities.

- **Meetings in Person Not Required.** Corp action may be effected by Resolution and Written Consent instead of meeting. (But doing NO Meeting or Resolutions supports Veil Piercing). Statute: "Failure to hold meetings does not work a forfeiture or dissolution of the corp. or affect validity of corporate action…" Sec 7.05 LLC's don't need to meet corporate formalities of holding annual

***More Corporate Formalities to Avoid Piercing** (3)*

- **Sign documents & contracts in business name, with officer or manager title. Not in personal name. Separate personal guarantee**
- **Maintain Separate Actions, Identity, Contracts**
- **Maintain Separate Corporate Assets, Property, Liabilities and Transactions**
- **Only Authorized Officers Allowed to sign contracts, Purchase Orders**
  - **watch titles in email signatures and on business cards**
- **Keep Corporate Records Straight. Document everything, Contracts,Transactions**
- **If Operating Two businesses, Form two business entities. Corporate Veil can be pierced business to personal, or business to business . Cost of forming multiple entities is less than cost of defending a veil-piercing case.**
- **If LegalZoom Used,** Double Check Work with real a Lawyer. LZ incorporates with no Corporate Resolutions or Operating Documents included in the low-cost flat formation fee

Financial Formalities to Avoid Piercing

- **Maintain Separate Accounting Records and Keep diligently; No "Comingling" of Funds or Assets Between Businesses or Business and Personal.**
  - **No Check writing from one business account to pay for an expense of another.**
  - **Don't pay personal expenses from business checking**
    - **Instead, issue a paycheck, book a loan payment or shareholder dividend**
  - **Separate finances business & personal; (No vacation condo or college tuition to business)**
  - **Keep assets and labilities separate.   Details on Page 4 of Handout**
  - **Separate finances & tax returns**
  - **Be careful about sharing officers and directors, office space, vendor accounts, management company**
  - **Use QuickBooks or hire bookkeeping help.**

- **File Tax Returns:** Income Tax Return. If applicable, Payroll tax, Sales & Use Tax Reporting. If not filed, could be evidence of no formalities?

Business Steps to Avoid Piercing

- **Maintain Insurance**
- **Limit Liability in Written Contracts & Indemnification**
- **Operate Like a business, Not willy-nilly, not like a Hobby or like personal checkbook, not loose flimsy operation;**
  - **Use documentation, processes, professional operations**
- **High standards of integrity and performance, to avoid suits.**
- **Don’t breach contracts**
- **Don’t commit fraud**
- **Conduct Due Diligence on** Parties before partnering with them (Avoid less than ideal people, co-owners, partners, transactions, vendors, lenders, investors, board members
- **Keep your own Due Diligence in order**
  - **Keep at Hand: Articles, FEIN Tax ID, IL Tax ID, Business License, Records**
- **Put up a Website; File Local Business License; Hire Employees:** Evidence of real business. Litigators, look for signs of not real business
- **Avoid Using Personal Name as the Business Name** and on Social Media, so that the identity is of the business, not the person.

Illinois Statutes on Records, Formalities, Director and Owner Personal Liabilities

- **Illinois statutory provisions that may affect corporate records, formalities, and personal liabilities of directors**

- ***A. Corporation Statutes***
- **Illinois Business Corporation Act § 7.75 Corporate Records and Shareholder Examination**. Statute requires maintaining share ownership records, records of corporate actions.
- **Illinois Business Corporation Act § 7.05 and 7.10 Shareholder Meetings and Actions**. Can be by unanimous written consent
- **Illinois Business Corporation Act §§ 8.60 to 8.85 Directors Liabilities, Indemnification, Conflicts**
- **Illinois Business Corporation Act § 12.45 Reinstatement of Administratively Dissolved** Corp. (Litigators: If defending a veil-piercing suit, have defendant file a reinstatement to mitigate this factor. Reinstatement is no small task if requires filing all the late annual reports, plus late fees, plus reinstatement fees. File it through a filing service and use expedite)

- ***B. LLC Statutes***
- **Illinois LLC Act Sec. 10-10 Liability of Members and Managers** (Failure to maintain corporate formalities is not grounds for imposing personal liability on members or managers. But committing fraud or other wrongful acts or omissions can trigger liability to members or managers.)

Fiduciary Duty & Conflicts - Multiple Businesses or Multiple Owner Business

- **Multiple Businesses:** Fiduciary Duty to owners of each business, and to all businesses of which you are officer, director, manager. Balance conflict among other entities owned or managed. Business Partner's Conflicts Can Become Your Conflicts
- **Director Conflicts & Liability** IL BCA Section 8.60
- **Disclose Conflicts** to those who would be affected by them, would scrutinize them, or would later object to them when disclosed. Some conflicts addressed by disclosure and agreement; some not.
- **Conflicts in other Business** Relationships – Referral Fees and profit sharing, must be disclosed
- **Liability:** Legally liable for breach of fiduciary duty, pay back profits +Common law and IL Sections 8.60 to 8.85
- **Business Judgement Rule** – Defense to breach of duty Section 8.85 of IL BCA

Fiduciary Duty & Conflicts of Interest – Duty By Whom, To Whom & What

- **<u>Who</u> is Bound by Fiduciary Duty: Officer, Director, Managing Member, Member of a member-managed LLC, "Control Person"**
- **<u>Duty To Whom</u>: Shareholders, partners, the business itself**
- **<u>What</u> is Fiduciary Duty? "Highest legal and ethical duty of one party to another". In Corporate Sense:**
  - **Duty of care, good faith, loyalty; honesty, ethics; Reasonable care of assets; act in shareholders' best interest (not to director's benefit); Acting as trustee for shareholders**
- **<u>Duties:</u> No conflicts of interest between director and shareholders or company (or fully disclose them).**
- **Do not work in competing business, or own one.**
- **Earn no profit, advantage, or leverage from fiduciary position.**
- **Minority Shareholder freeze out: Fiduciary must deal in good faith.**
- **Board views all possible options & chooses best for company & its owners, in current and future business.**

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Notes on Capitalization

- Capitalization of a corporation is a major factor in assessing whether a legitimate separate corporate entity existed, for purposes of piercing the corporate veil.
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- If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability.
-
- To determine whether a corporation is adequately capitalized, for purposes of determining whether to pierce the corporate veil, one must compare the amount of capital to the amount of business to be conducted and obligations to be fulfilled.
-
- When a party enters into a contractual relationship with a corporation, a relevant consideration in determining whether to pierce the corporate veil is whether the party is misled into believing a shareholder or director is also a party; however, tort victims do not choose to become victims of particular tortfeasors or rely upon the tortfeasor's ability to compensate them.
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- Fiumetto vs Carrett Enterprises, Inc Case 321 Ill.App.3d 946, 749N.E.2d 992, 255 Ill. Dec. 510) 2001

Notes on Wyoming Case

- **In the aftermath of the Green Hunter Energy case, Wyoming legislature recently added two new subsections to its LLC Act that will make "piercing the veil" of a Wyoming LLC more difficult. The law has been amended to address the limited liability of Wyoming LLC Members, which was weakened by the Green Hunter decision:**
- ***(c) for purposes of imposing liability on any member or manager of a limited liability company for the debts, obligations or other liabilities of the company, a court shall consider only the following factors no one (1) of which, except fraud, is sufficient to impose liability:***
- ***(i) Fraud;***
- ***(ii) Inadequate capitalization;***
- ***(iii) Failure to observe company formalities as required by law; and***
- ***(iv) Intermingling of assets, business operations and finances of the company and the members to such an extent that there is no distinction between them.***
- ***(d) In any analysis conducted under subsection (c) of this section, a court shall not consider factors intrinsic to the character and operation of a limited liability company, whether a single or multiple member limited liability company. Factors intrinsic to the character and operation of a limited liability company include but are not limited to:***
- ***(i) The ability to elect treatment as a disregarded or pass-through entity for tax purposes;***
- ***(ii) Flexible operation or organization including the failure to observe any particular formality relating to the exercise of the company's powers or management of its activities;***
- ***(iii) The exercise of ownership, influence and governance by a member or manager;***
- ***(iv) The protection of members' and managers' personal assets from the obligations and acts of the limited liability company.***
- **It is important to note that subsection (d) essentially states that Wyoming courts cannot pierce the LLC veil because of "factors intrinsic to the character and operation of a limited liability company". This patches up the swiss cheese hole created in the Green Hunter decision, which the Wyoming Supreme Court created when it said that the company being a single-member LLC, and a disregarded entity for tax purposes, was a factor it considered in its decision to pierce the veil.**