Pierce the Veil

Uphold your personal liability protection in the face of a corporate downturn.

By Markus May

A word of advice: Operate businesses as separate entities, or else risk losing everything...literally.

A corporation is a separate entity, distinct from its shareholders, officers and directors. Similarly, an LLC is separate from its members. By setting up your business as a corporation or other limited liability entity, you avoid personal liability—and therefore the risk of losing your personal assets should business turn sour.

That said, the courts have held that, when a business operates as an individual's or another entity's "alterego" or business conduit, then the protective veil is pierced. In order for this to happen, a two-part test has to be met: (1) There is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) The "fiction" of a separate corporate entity allows a fraud or promotes injustice or inequitable consequences.

To determine whether a corporation is merely an alter-ego of another entity, Illinois courts look at the following 11 factors, none of which is determinative on its own:

1. Inadequate capitalization. Courts consider it inequitable to allow shareholders to set up flimsy organizations just to escape personal liability. You need to compare the amount of capital to the amount of business to be conducted and the obligations to be fulfilled. You can then determine whether a corporation is adequately capitalized.

There is some uncertainty, however, regarding what constitutes company capitalization. Some courts recognize inventory, equipment and lines of credit as part of the capitalization structure. Some look closely at the *nature* of the business to determine whether it is undercapitalized and whether the company *intended* to minimize its assets to the detriment of its creditors. What's more, courts have held that a company's ability to function on its own for many years is evidence that it is not undercapitalized.

In actual business practice, many small-business owners provide an initial capitalization of a minimal amount such as $1,000. Some courts likely would find this inadequate capitalization in defending against a piercing claim. Others may look more closely at the way the business was run before determining it was undercapitalized. In any event, as a preventative step, accountants should advise clients about the potential danger of undercapitalization so they can make an informed decision about how much capital to contribute to an entity.

2. Failure to issue stock. If stock isn't issued, it will bear some weight in determining whether a company is a separate entity from the individual alleged to be the alter-ego. However, this factor isn't heavily relied upon. Wise practitioners ensure the company is set up properly. For instance, too many clients use form documents and "DIY" services, and neglect to issue stock and create a stock ledger. Accountants and attorneys should work together to determine who does what *in the formation stage* toprevent anything from slipping through the cracks. ▸▸

3. Failure to observe corporate formalities. These formalities—which are essential if the business is to be seen as a separate entity—include keeping the company registered with the Secretary of State, holding annual meetings, maintaining annual minutes, and signing corporate documents with the individual's title.

A recent Illinois court opinion found that a company failed to observe the corporate formalities by not attaching legal descriptions of properties sold to the corporate resolutions approving the property sale, and not adopting corporate resolutions authorizing payments on loans to shareholders. Ratifying corporate actions after the fact is not improper, per se, but could be considered an indication of neglect. The best policy is for corporate boards to approve corporate actions before or at the time they occur. For LLCs, Illinois law provides that the corporate formalities need not be followed. That said, LLC managers or members may opt to approve all LLC actions in writing, since the case law in this area is not yet developed.

4. Absence of company records. Does the client file proper tax returns that reflect the proper entity? Are bank accounts listed in the entity's—not the individual's—name? Are contracts, bids, work schedules, etc. in writing? Are there financial records that show the flow of money into and out of the organization, as well as proper balance sheets and income statements? Are all personal loans to owners and other individuals documented not only with a promissory note, but also in the corporate tax returns?

The absence of these and any other company records that could be deemed necessary to transacting business as a separate entity is an important factor that courts consider in determining whether to pierce the corporate veil.

5. Nonpayment of dividends. If they're not paid, this could indicate that a corporation is the shareholders' alter-ego. However, this factor is not determinative where other countervailing facts exist. The point is, when an accountant advises a client on monetary distributions out of the company, he or she should advise them to create the appropriate documentation and keep it in the company books.

6. Insolvency of the debtor company. If the company was solvent, it presumably would pay its debts and the plaintiff would proceed directly against the company without piercing the corporate veil. It therefore follows that this factor is often construed in favor of piercing liability protection. When the company is insolvent solely due to the underlying claim, however, this factor should not be construed against the shareholders.

7. Division of assets from the corporation by or to a stockholder, other person or entity to the creditors' detriment. If payments are made to an owner, and creditors are harmed as a result, this will have a strong bearing on the court's decision.

8. Nonfunctioning of the other officers or directors. Companies should not appoint board members or officers who are not actively engaged in making company decisions. Advisors need to be especially wary of this issue when a client wants to obtain a minority or woman-owned business designation, and no such person is active in the company's management.

9. Commingling of funds. This occurs when company funds are transferred into a personal bank account or into another business's bank account, or when personal funds are placed in a business account. If company records don't indicate that money was paid to an owner as compensation or dividends, and money shows up

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in the owner's bank account, courts may find that there has been an improper commingling of funds.

Companies need to clearly document the payment of any funds to shareholders or other controlling individuals—preferably in the form of corporate resolutions. Inform clients of the need to maintain separate bank accounts and to avoid paying personal expenses from the business account. If business expenses are paid from a personal account, there should be documentation supporting the expense and any later expense reimbursement to the individual.

10. Failure to maintain arm's-length relationships. Failing to maintain arm's-length relationships among related entities may indicate some form of sharp dealing or preferential treatment. This has a strong bearing on a court's decision to pierce liability protection. However, merely operating several businesses out of the same location or the use of one company's trademark by another is not enough to determine that this factor has been met. Generally speaking, a company should not receive a benefit that it could not obtain on the market. For example, charging below market rent under a real property lease may be seen as self-dealing and a failure to maintain an arm's-length relationship.

11. The corporation is a façade for the dominant stockholders. This catch-all factor allows a court to find that a company is the alter-ego of another entity when, even though some of the above factors are not met, it is believed that the corporate veil should be pierced.

The second prong of the "piercing" analysis involves showing that, by allowing the separate corporate entity, fraud, injustice or inequitable consequences occur. Generally speaking, if the 11 major factors are met and there is any type of self-dealing, then this second prong will be met.

For example, in a recent case, a home builder sold assets worth $1.8 million and paid off various creditors. One of those creditors was a shareholder who was paid $91,783 on an undocumented shareholder loan. Other creditors were not paid in full. The shareholder also created a new business which began building homes after the lawsuit was filed. Based primarily on these facts, and after an analysis of the 11 factors, the court removed liability protection based on its determination that the company's assets were reduced to the creditors' detriment.

The practice pointer here is to advise clients to avoid any type of self-dealing that could be perceived as promoting an inequitable result, injustice or fraud. This includes repaying individual shareholder loans after a potential lawsuit has been filed. Clients should continue operating the business without payments to owners outside the normal course of business when the business is not doing well.

For the professional advising an ongoing business, the importance of documenting business transactions, especially those between a company and its owners or other individuals exercising control over company actions, cannot be emphasized enough. Accountants need to reiterate the importance of maintaining corporate formalities and documenting material transactions. If a company is failing, the company's owners should avoid any form of self-dealing or else risk losing their personal as well as their business assets. □

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