Piercing the corporate veil

How the protection of the corporate form may not be the shield you expected

It is widely understood that organizing a business as a corporation or a limited liability company insulates its owners from personal liability for the debts of the company. What is less well appreciated is that, under certain circumstances, such protection can be lost.

"When a creditor of a corporation or limited liability company is unable to collect from the company itself, it is not unusual for it to try to circumvent the corporate shield and recover the amount owed from the individual, or parent company, which owns the debtor entity," says Michael A. Weinberg, a partner with the business litigation specialty firm Novack and Macey LLP. "Such attempts to 'pierce the corporate veil' face steep legal hurdles, but nonetheless can, under certain circumstances, pose real threats to owners of corporations and LLCs. Accordingly, it is imperative not only that owners understand why such piercing attempts sometimes succeed and how they can avoid such a fate, but that creditors understand when pursuit of a veil-piercing remedy is warranted."

Smart Business spoke with Weinberg about the factors that Illinois courts consider when determining whether corporate veils should be pierced in debtor-creditor disputes, how business owners can minimize the risk of exposure to personal liability for company debt and when creditors should think about seeking a veil-piercing remedy.

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What is veil-piercing, and when might it come into play as a means of collection?

As a general rule, corporations are entities distinct from their shareholders and LLCs are entities distinct from their members. Accordingly, those owners are not liable for the entities' debts. The doctrine of veil-piercing recognizes that situations may arise when the legal separation between entity and ownership should be stripped away. In those instances, corporate shareholders or LLC members can be held personally liable for company debts and liabilities. Piercing the veil is an extraordinary remedy and creditors should not view it as a routine tactic whenever a corporation or LLC defaults on a debt or obligation. The purpose of veil-piercing is to prevent fraud or grave injustice, and where such conditions are absent, piercing efforts are likely to fail.

In cases arising out of commercial relationships, and not torts where different considerations may apply, Illinois courts frequently apply a two-part test to decide whether veil-piercing is appropriate. Part one is whether the corporation or LLC is operating as a mere 'alter ego' for the owner, and part two is whether adherence to the fiction of separate corporate existence facilitates fraud or inequitable consequences. That a business fails, and cannot meet its obligations, does not ordinarily implicate fraud or injustice, and indeed, that is seldom the case. However, occasionally, the way in which a corporation or LLC is run demonstrates that it was operated as a mere instrumentality of its owner, so that it would be unfair to allow the owner to escape personal liability for the company's obligations. In those circumstances, a creditor may appropriately consider pursuit of a veil-piercing remedy.

What factors do courts consider when deciding if veil-piercing is justified?

Courts have identified a number of factors that help determine if and when a veil should be pierced in cases arising out of commercial transactions. Those factors include, among other things, inadequate capitalization; failure to issue stock; non-observance of corporate formalities, such as maintaining corporate record books, holding directors or shareholders meetings, etc.; failure to pay dividends or make distributions; insolvency; no real role or duties performed by non-owner officers; absence of corporate records; commingling of funds; diversion of company funds by or to a shareholder or other recipient to the detriment of creditors; lack of arms-length relationships among related entities; and whether the corporation is merely a façade for the operations of the dominant shareholders. No 'magic number' of factors need be present for veil-piercing to be justified, but it is equally clear that fewer than all of the factors can be sufficient to support application of the remedy.

What should business owners do to minimize the risk of veil-piercing?

It's simple: Avoid any of the 11 things I just mentioned. Too many business owners assume that, once they have organized their enterprise as a corporation or LLC, their worries are over. That leads to sloppy practices and opens the door to veil-piercing. Maintaining proper records and paperwork, holding required meetings, providing reasonable start-up capital, segregating assets from those of related entities and not taking company resources for personal benefit when business circumstances do not justify such transfers will go a long way toward preserving the limited liability protection that the corporate or LLC forms of an organization were intended to provide.

From a creditor's perspective, when should veil-piercing be considered as a possible remedy?

Start by asking whether a fraud or injustice occurred. There has to be something fundamentally unfair about how and why a creditor did not get paid if piercing is to come into play. Just because a business goes belly-up does not mean it was being operated as an alter ego of its owners. Millions of companies fail, but only a tiny fraction of those businesses will have functioned in such a way as to justify a veil-piercing claim. If a creditor feels something about the debtor's operation does not pass the smell test, or better yet, if some of the 11 factors referred to earlier are known to be present, then further inquiry as to whether veil-piercing should be pursued is warranted. Where the minimum required support for a veil-piercing claim can be mustered in support of a complaint, discovery will often turn up further facts, which strengthen the claim. However, Illinois courts do not favor veil-piercing, so the odds of success are remote. <<

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