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PIERCING THE CORPORATE VEIL

HOW LIMITED IS THE LIABILITY OF DOING BUSINESS AS A CORPORATION?

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"One of the main reasons for the popularity of corporations is that stockholders are not personally liable for the debts of the corporation. The corporation, and it alone, is liable. A stockholder stands to lose what he has dedicated to the corporate enterprise and nothing more." So goes the general rule. The corporate veil, the corporate shield –phrases used to describe the legal fact that a corporation is an entity separate and distinct from its officers and shareholders – protects shareholders, directors and officers from liability for corporate debts. As with many rules of law, there are exceptions; there are circumstances under which the corporate veil will be lifted by a court and the owners or officers of the corporation will be held personally liable.

The willingness of a court to disregard the corporate veil depends to a large extent on the purpose for piercing the corporate veil. Is someone seeking to pierce the veil to get more money for child support or merely because they lost money doing business with a corporation? If they lost money in a business transaction, was dishonesty or fraud involved?

In the family setting, in particular in divorces where child support obligations are at issue, the corporate shield offers little real protection. For example, in a divorce, the courts are charged to determine the total monthly income of the divorcing parties from all sources. In such circumstances, the court will ignore the corporate veil in order to determine the actual earning potential of a shareholder: How much are corporate benefits worth? Does the corporate salary reflect real income potential? Are corporate funds being used for other purposes which are less important than child support? As one court stated: "The support of one's children is a fundamental obligation which takes precedence over almost everything else."

The courts are also willing to pierce the corporate veil with little, if any, hesitation where the corporation has been used to defraud third parties. A person who lies, or misrepresents an important fact, to another person in order to get that person to do business with the corporation will be liable to that person. Where the corporation itself commits fraud, Nebraska courts will disregard the corporate fiction and hold those people in the corporation who are responsible for that fraud liable in their individual capacities. Responsibility for corporate fraud may be based not only on active personal involvement in the fraud, but on the actions of agents or on approval or ratification of the fraud.

In trying to determine whether or not to pierce a corporate veil in order to prevent fraud or injustice, a court will look at the following factors, which are not acts of fraud in themselves but which may be seen as evidence of fraud:

- **Grossly Inadequate Capitalization**: Were the assets put into the corporation very small in relation to the nature of the business of the corporation and the risks of that business. Capitalization is generally determined as of the time of incorporation; however, in some circumstances courts have allowed subsequent loans to the corporation to cure an initial lack of adequate capital.

- **Insolvency**: Was the corporation insolvent when a debt or contractual obligation was incurred? A corporation is insolvent if it is unable to pay debts as they come due in the ordinary course of business. It may also be insolvent if it has considerably more liabilities than assets.

- **Diversion of Funds**: Have shareholders taken corporate funds and used them for personal purposes? Reimbursement of expenses to shareholders, officers or directors on behalf of the corporation does not constitute diversion.

- **Disregard of Corporate Formalities**: It is important to observe corporate formalities – to conduct business as an officer of the corporation, to deal with third parties through the corporation, to hold annual meetings, to keep corporate records, etc. However, failure to observe corporate formalities alone will not typically support an effort to pierce the corporate veil. It may be used as evidence, however, of a lack of difference between the owner and the corporation.

- **Disregard of the Corporate Entity**: The corporate veil may be pierced where the owner of a corporation and the corporation itself cannot be distinguished. Is the corporation merely a shell, an alter ego ("other self") of the owner? Did the corporation operate solely based on cash infusions from the owner? Does it serve no business purpose separate from the owner? Was it insolvent when the debts to owners were taken into account? Are the corporation's interests one-in-the-same with the owner? Was the corporation used merely to serve the interests of the owner to the detriment of the corporation's creditors?

Courts typically will not pierce the corporate veil of closely held corporations simply because a business has failed and people are left holding unpaid claims. Piercing the veil for a mere commercial reason flies in the face of the purpose of limited liability – it seeks to hold the owners, directors or officers liable to third parties for their damages for doing business with the corporation.

In general, in order to pierce the veil, a court must find in analyzing the five factors that creditors have been defrauded, or that the corporation has been used to commit an injustice against the creditors. As previously stated, the ease or difficulty of piercing the corporate veil depends on the purpose for which the piercing is sought. The person who seeks to pierce the corporate veil has the burden of proving that there is a justification for doing so, and the mere fact that the corporation has not paid its debt is not enough to meet that burden.

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SOURCES

The following legal resources have been used in preparing this material:

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