Corporations Beware Veil Piercing And Loss of Limited Liability Protection

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In two opinions rendered on February 23, 2012, the Kentucky Supreme Court highlighted the considerations that Kentucky courts are to apply in deciding whether to pierce the corporate veil of corporate defendants in order to permit their parent corporations or even their individual shareholders to be held liable for debts of or claims against the corporation.

The phrase “piercing the corporate veil” (also sometimes referred to as “lifting the corporate veil”) is a legal term for the equitable remedy plaintiffs sometimes seek against business entities that have corporate charters. Typically such cases involve smaller, closely held companies. The veil of liability protection normally afforded to a corporation’s owners, whether corporate or individual, may be pierced or lifted due to factors such as domination of the corporation by a parent or owner, noncompliance with legal requirements or corporate formalities, and/or gross unfairness to a third party from limitation of the liability of the corporation’s owners.

In *Inter-Tel Technologies v. Linn Station*, 360 S.W.3d 152 (Ky. 2012), http://opinions.kycourts.net/sc/2009-SC-000819-DG.pdf, the Court held that the three most critical factors to consider in determining whether to pierce the corporate veil of a subsidiary corporation and allow a parent corporation to be held liable for the subsidiary are: (1) grossly inadequate capitalization of the corporation; (2) egregious failure to observe legal formalities and disregard of distinctions between the parent and subsidiary; and (3) a high degree of control by the parent over the subsidiary's operations and decisions, particularly those of a day-to-day nature.

The Court listed numerous other factors to consider in making the determination whether the subsidiary’s domination by the parent justifies piercing the veil, which include failure to issue stock, nonpayment of dividends, insolvency of the corporation, nonfunctioning of the officers or directors, absence of corporate records, commingling of funds, diversion of corporate assets, failure to maintain an arm's-length relationships among related entities, and whether the corporation is a mere facade for the operation of the dominant shareholders.

The Court considered these factors and affirmed the decisions of lower courts permitting the veil to be pierced and holding a grandparent and parent corporation liable for a default judgment entered against a subsidiary.

The case of *Schultz v. General Electric Healthcare Financial Services Inc.*, 360 S.W.3d 171 (Ky. 2012), http://opinions.kycourts.net/sc/2010-SC-000183-DG.pdf, issued the same day as *Inter-Tel Technologies*, dealt with a trial court’s judgment on the

pleadings piercing the defendant's corporate veil and permitting its president and sole shareholder to be held personally liable for the corporation's debts. The main issues in the case were procedural – whether piercing the corporate veil is to be determined by the judge or by a jury (the Court noting the matter is equitable and thus to be determined by the judge), and whether the trial court's judgment on the pleadings to pierce the corporate veil was appropriate under the circumstances of the case (the Court concluding it was not). However, the opinion also discussed factors a court of equity should consider in making the determination whether to pierce the veil. Those factors include whether the corporate form was abused, whether the form was used to perpetrate a fraud, and whether enforcement of the defendant's corporate status would work an unfair hardship on a creditor or injured party.

Small, closely held corporations in particular should make sure they observe all legal requirements and formalities and otherwise meet the conditions for enforcement of their corporate status to avoid having their veils pierced and their owners exposed to unlimited liability.