By-Lined Article

DESPITE FAILURE OF TRUSTEE'S ARGUMENTS, DEBTOR'S PRINCIPAL PERSONALLY LIABLE

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In the case of *In re LMcD LLC*, the U.S. Bankruptcy Court for the Middle District of Pennsylvania found members of a closely held limited liability company liable for the LLC's debts. Although the trustee of the Chapter 7 bankruptcy estate argued liability based on multiple theories, including veil piercing, reverse veil piercing, single entity and quantum meruit, these theories were all dismissed by the court. Instead, the court imposed personal liability for certain debts of the debtor's estate because the member of the LLC had dealt with creditors personally and had not identified himself as an agent of the debtor.

The Facts

According to the Middle District's opinion, Kevin McDonald made his start from humble beginnings as a chef at Damenti's Restaurant, one of Luzerne County's better-known dining establishments. After working at Damenti's for several years, McDonald purchased the restaurant in 1977. Roughly a decade later, he incorporated the restaurant and split its ownership with his wife, Helen. A few years later, McDonald began displaying his ice carving art as a seasonal attraction on property adjacent to Damenti's. During the ensuing years, McDonald's carvings became more famous and drew more people to the site, the opinion says.

In 2004, McDonald formed LMcD LLC, a for-profit limited liability company, to showcase the works of various ice sculptors and gain publicity for his restaurant. Like Damenti's, LMcD was owned and controlled entirely by McDonald and his wife. On Oct. 25, 2004, LMcD applied for a fictitious name with the state of Pennsylvania and obtained the designation of "ICE 4 U 2 C." Under this trade name, LMcD promoted a 2005 ice festival. The ice festival was held from Jan. 21 to Feb. 21, 2005, at a new location 13 miles from Damenti's, according to the opinion.

While the festival collected admission fees and donations, these receipts were not nearly sufficient to offset the costs associated with the festival.

As a result of the losses suffered by LMcD at the ice festival, on July 28, 2005, LMcD filed a voluntary petition for bankruptcy protection under Chapter 7 of Title 11 of the U.S. Code. The petition listed unsecured claims with a value of $303,076.69 and assets totaling $5,110.59, according to the decision.

On June 26, 2006, William Schwab was appointed successor Chapter 7 trustee for LMcD. Schwab investigated the affairs of the debtor and, on Jan. 15, 2007, commenced adversary proceedings in which he sought to pierce the corporate veil against, among others, the McDonalds and Damenti's. In the complaint against the McDonalds, Schwab alleged that the debtor and another LLC owned by the McDonalds (which rented space to the debtor for the ice festival) were sham entities. Schwab alleged that the funds of Damenti's were intermingled with those of the debtor and noted in the complaint that confusion as to which entity was financially responsible for debts of the ice festival had led to more than six lawsuits with various combinations of the debtor, the McDonalds and Damenti's as defendants.

In the adversary proceedings, Schwab argued for piercing the corporate veil because the debtor and McDonald were "alter egos" and therefore jointly liable for the debts of the debtor; the McDonalds' interest in Damenti's could be reverse-pierced to hold Damenti's liable for the debts of the McDonalds as shareholders; the "single entity theory" required the LLCs to be treated as one; and equity required that Damenti's compensate the debtor for the significant promotional benefits it received from the festival at no real cost.

The court's analysis

The court initially determined that neither Damenti's nor LMcD had a credit card in its name. It found that, as a consequence, the McDonalds used their personal credit cards not only for themselves, but for their two companies. When their credit card bill came in, the McDonalds paid their personal charges and Damenti's paid the charges attributable to both the restaurant and to LMcD.

While recognizing that the equitable remedy of "piercing the corporate veil" is available in situations involving LLCs, the court also noted the strong presumption in Pennsylvania against such piercing. Factors considered in the court's analysis included whether the debtor was sufficiently capitalized, whether the parties adhered to corporate formalities, whether there was a substantial intermingling of corporate and personal affairs and whether the corporate form was used to perpetrate a fraud. In its analysis, the court noted that no one factor would normally be dispositive.

The court agreed that the debtor was undercapitalized. At trial, even the McDonalds' defense expert acknowledged that LMcD's initial capital should have been at least 10 percent of its debt. The court found evidence of a capital contribution of $25,000 by the McDonalds, while the schedule of debts filed by the debtor exceeded $300,000. Consequently, even the low threshold of 10 percent capitalization advanced by the McDonalds' expert led to the inescapable conclusion that the debtor was undercapitalized.

The court found in LMcD's favor on the corporate formality question. The court considered the certificate of organization, operating agreement, registration of fictitious name, commercial lease, bank account, license to operate, tax returns and application for employer identification number as evidence of the debtor's adherence to corporate formalities.

In connection with the question of intermingling, the court found that there were many instances in which the McDonalds or Damenti's paid for the credit card expenses of LMcD. However, this phenomenon actually benefited creditors of LMcD, because both the McDonalds and LMcD were liable for the same obligation. The court did find evidence that creditors and others doing business with the debtor could not distinguish between Damenti's, the McDonalds, or the debtor. It concluded, however, that there was no evidence of the commingling of assets: In fact, it noted that the trustee had not cited one example of LMcD funds being deposited into personal accounts of the McDonalds or Damenti's. Rather, it noted that LMcD's debts were often paid either by the McDonalds or by Damenti's.

On the issue of whether the corporate form was used to perpetrate a fraud, the court found in favor of the McDonalds. While noting that there may have been some confusion created by the McDonalds in the written advertising materials they circulated in preparation of the ice shows, the court could not conclude that this confusion was sufficient to constitute perpetration of a fraud and allow for a piercing of the LLC's veil.

Next, the court pointed out that Pennsylvania has not adopted the "single entity" theory, which is used to extend liability where "two or more corporations share common ownership and are, in reality, operating as a corporate combine." Nonetheless, it observed that the Pennsylvania Supreme Court would likely adopt the "single entity theory" in order to prevent injustice, and then performed the appropriate analysis. The court found most of the necessary elements present: unity of ownership, unified administrative control, and insolvency of the entity against which the claims lay. However, the court found that two important elements of the "single entity theory" to be absent: the "involuntary creditor" element and the "similar or supplementary business function" element.

First, the court found that LMcD's creditors were "voluntary creditors" in that they had the ability to inspect the debtor's financial affairs and discover potential risks before transacting business with the debtor, and nonetheless chose to extend credit to the debtor. Second, the court noted the possibility that Damenti's and the debtor could be viewed as having shared "similar or supplementary business functions" because the debtor took over the ice show that Damenti's had previously exclusively handled. However, the court ultimately found this element to be lacking because the location of the ice festival was physically too remote from the restaurant to provide a direct impact on patronage at the restaurant. As a result, the court concluded that the festival bestowed no supplementary economic benefit to the restaurant.

Having concluded that the last two elements of the single entity theory were lacking, the court held that even if the Pennsylvania Supreme Court adopted the single entity theory, the evidence before it did not justify its application in this case.

As to the argument for a remedy in quantum meruit against Damenti's, the court found that the trustee had proven the existence of elements of quantum meruit. Damenti's benefited at no cost from free publicity generated by the ice festival. Moreover, the court found it unjust for Damenti's to continue to accept the benefits from a failing company without the appropriate compensation. However, because the trustee had failed at trial to establish the reasonable value of the benefit bestowed upon Damenti's, the trustee could not recover under this theory.

Ultimately, the court held the McDonalds personally liable for certain contracts. Pennsylvania law provides for personal liability where an individual's signature to a contract does not clearly identify the signer as representative of another entity. As a result, to the extent that the McDonalds extended their own personal credit to buy goods for the debtor, they would be liable for those debts.

Final Thoughts

While the standard for piercing the corporate veil in Pennsylvania remains high, the elements that comprise the legal standard are important in themselves. In this case, the members of several closely held LLCs failed to clearly transact business in their capacity as representatives of their companies, and were consequently subject to personal liability for several transactions. While corporate formalities (including the need to identify individuals as corporate representatives) may be an added inconvenience for businesspeople, counsel are well-advised to stress the simple steps their clients should take in order to avoid exposure for their company debts.

Following corporate protocol is essential to managing risk, especially for new or unproven enterprises. And where effort is made and expense incurred to create such entities, protocol should be strictly followed and care should be taken to maintain the separateness of individual from corporate entity.

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