PIERCING THE CORPORATE VEIL

Is a shareholder always protected from corporate liabilities by the "corporate shell"?

A corporation and an LLC is a legal person or entity that exists separately from its shareholders. It may, therefore, contract or otherwise incur obligations apart from a shareholder. As a result, one desired aspect of a corporation is that shareholders (or in the case of an LLC, the members) are not individually liable for the debts or obligations of the entity. For purposes of our discussion, references herein to corporations will apply similarly to LLCs.

In some circumstances, however, courts will ignore the corporate identity and hold the individual shareholders liable for the debts and obligations of that corporation by applying a legal theory that is commonly referred to as the "alter ego doctrine." Under this theory, if a party whose interest has been injured due to the acts of a corporation can prove that the corporation entity is the "alter ego" of one or more individuals, the court may hold the individuals themselves personally responsible for the injurious conduct.

Typically, an alter ego allegation is made against a corporation and its shareholders when the corporation's assets or insurance are inadequate to respond to a claim or to pay a debt. A creditor who would otherwise go unpaid by the corporation will seek to hold its shareholders personally liable for the claim based on the theory that:

- The shareholder has not treated the corporation as an entity separate and apart from themselves so why should the Court,

- When maintaining the corporate veil would be inequitable.

Piercing the corporate veil has been granted in 40% of the cases where the issue was raised. Piercing initiated by the federal government is effective in almost 60% of the cases it has raised and more than 80% of the time when raised in a regulatory context or in environmental litigation and in fraud cases.[1]

The equitable remedy of piercing the corporate veil is applied in New Jersey in situations where the principal, i.e. owner, uses the corporation (or his LLC) as his "alter ego" and thus abuses the corporate form in order to advance his own personal interests. See Walensky v. Jonathan Royce International, Inc., 264 N.J. Super. 276 (App. Div. 1993). The two primary factors that weight in favor of an "alter ego" finding are the use of the business as a personal business conduit and a lack of a separate corporate identity. Judge Stripp distinctly summarized the criteria for piercing the corporate veil under New Jersey common laws as follows:

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[1] R. Thompson, "Piercing the Corporate Veil: An Empirical Study," 76 Cornell L. Rev. 1036, 1948-49 (1991).

1. A shareholder disregarded the corporate entity and made it into a mere instrumentality for their own affairs.

2. There was such a unity of interest and ownership that the owners and the corporation have no separate existence; and

3. Upholding the corporate veil would protect fraud or promote other injustice.

Piercing The Corporate Veil In Bankruptcy

In Bankruptcy proceedings, the court uses a concept called "substantive consolidation" to in effect pierce the veil. This doctrine permits the bankruptcy court to pool all of the debtor's assets as well as the assets of affiliated entities owned by the debtor, in order to satisfy claims against the debtor. Substantive consolidation will be allowed when:

° The creditor dealt with the entities as a whole, and not as separate entities, and

° The affairs of the debtor are so intertwined that the consolidation would benefit all of the creditors.

A fruitful discussion of piercing the corporate veil in a bankruptcy case in New Jersey can be found in Buildings by Jamie, Inc., United States Bankruptcy Court, District of New Jersey, Case No. 96-39381. In Buildings by Jamie, Inc., the creditors of the bankrupt debtor sought to recover monies loaned to the debtor. The debtor was a close corporation which constructed homes for sale to third parties. During a certain period of time preceding the bankruptcy, loans were made to the debtor for use exclusively in the construction of these homes. The debtor did not repay the loans. The creditors allege that the debtor transferred the net proceeds of sale of several homes to Jamie, Inc. (not the debtor) for no consideration, which in turn transferred $100,000 to the individual owners again for no consideration. The creditors further allege that the debtors transferred accounts receivables to a related corporation for no consideration. The creditors further argued that the individual debtors used the loan money from a guaranty for their personal benefit including construction of their personal residence and the purchase of real property and renovation of business property which was not owned by the debtor. Finally, the creditors alleged that in a series of transactions the debtor transferred all of its cash and several thousand dollars worth of assets to a related corporation for no consideration. During the period in question, the debtor ceased operations but the related corporations continued operations virtually indistinguishable from the debtor's business. These corporations were operated from the same location, by the same employees, shared the same offices and had the same shareholder.

The plaintiff sought to compel the debtor to repay the loan obligations and the transfers among debtor and non-debtor defendants. In doing so, they allege that the individual shareholders were liable for the debtor's debts based upon an "alter ego theory." The plaintiffs relied on lack of corporate formalities among the debtor and the non-debtor defendants as well as the free transferability of assets and share ownership, use of the same employees, same location and same line of business.

The plaintiffs sought to pierce the corporate veil based upon the complete disregard of corporate formalities, free transfer of assets among the corporations and the shareholders and the interchangeable use of corporations.

In reviewing New Jersey alter ego law, Judge Stripps sitting in the Bankruptcy Court reaffirmed the principal that it is well settled in New Jersey that the doctrine of piercing the corporate veil is employed when fraud or injustice has been perpetrated. The court stated that the principal (owner) could be held liable under theories of piercing the corporate veil and successor liability because the principal "was using the corporation as his "alter ego" and thus was abusing the corporate form in order to advance his own personal interest." Factors which weighed heavily included the principals treatment of the corporation as a personal business conduit and that the corporation was a mere instrument through which the shareholder conducted their own affairs and furthermore the principal failed to maintain an identity separate and apart from the corporation. The court also noted that in New Jersey courts generally pierce the corporate veil where such unity of ownership exists where the corporation operates as an instrument of the shareholders' personal business such that the failure to disregard the corporate entity would promote fraud. Finally, a court concluded that the bankruptcy trustee had the power to reach beyond the debtor corporation into the pockets of the corporation's shareholders.

HOW TO AVOID HAVING CORPORATE VEIL PIERCED

Shareholders are not liable for corporate debts or lawsuit liability if the corporation is properly established and maintained. To help insure that creditors cannot pierce the corporate veil and seek judgments against the shareholders, corporate formalities must be observed, the corporation must be treated as an entity separate and apart from its shareholders. Make sure the corporation has done the following:

- <u>Documentation and Formalities.</u> Create By-Laws, issue stock, maintain an up to date corporate minute book (do not wait for the night before an audit to create them), have separate books of account, file annual reports, have regular board meetings with all directors.

- <u>Avoid co-mingling.</u> Do not co-mingle corporate assets with those of shareholders, all corporate assets should be titled in the corporate name.

Corporations should have its own separate bank account. If you borrow from, or lend to the corporation, record an appropriate Resolution, sign a promissory note, charge fair market rate interest, make regular payments.

- Capitalization. Appropriately capitalize the corporation and purchase appropriate liability insurance.

- Employment Agreements. Enter into one between you and your corporation.

- Multiple Corporation. Avoid identical stock ownership of several corporations. Avoid having similar officers and directors. Use different business addresses, telephone numbers and employees.

In addition, the fact that a business is being operation as the corporation should be made evident. The words “inc.” or “incorporated” should be present on letterheads, business cards and corporate signs. Those who operate the entity should sign all contracts and documents in a corporate capacity indicating their corporate position.

In these uncertain times, the valuable advice you give your clients can pay dividends. An important part of estate planning and wealth preservation is the protection of assets. Keeping corporate liabilities separate from shareholders is an important part of the asset protection plan.

The attorneys at Scarinci Hollenbeck can assist you and your clients in implementing wealth presentation strategies. Please call Frank L. Brunetti or Joel R. Glucksman to schedule an appointment for you and your client.