

Don't Let Them Pierce YOUR Corporate Veil!

You have set up your corporation to shield your personal assets from liability. But a creditor may believe your company has no assets in it so he hires an attorney who specializes in piercing the corporate veil. The attorney knows where to look to get through the corporate shield into your personal assets if you have not taken all the steps to keep your business protected.

You may be operating your business as a limited liability company, so you don't have to worry about anyone piercing your corporate veil, right? Well, the terminology may be different, but many of the same concepts apply to a limited liability company.

The first part of this article addresses the issues with a corporation. The following list is a compilation of the mistakes that can be made by corporations that can result in personal liability to the stockholders. Here they are:

1. Failure to have regular board of directors' meetings.
2. Failure to have annual shareholders' meetings.
3. Failure to issue the corporate stock or maintain the stockholders' ledger.
4. Failure to maintain up-to-date corporate records.
5. Failure to have the required initial organization meeting.
6. Failure to adopt corporate by-laws.
7. Failure to maintain proper accounting records.
8. Failure to advertise and serve notice that the business is operating as a corporation.
9. Failure to transfer assets into the corporation.
10. Failure to get the proper state and local business licenses in the name of the corporation.
11. Failure to file annual state and federal report forms. Failure to file an annual franchise tax return in the State which will result in suspension of the Corporation by the State Tax Commission.
12. The principal stockholder(s) use corporate funds for personal purposes (paying grocery bills, home mortgage, or otherwise treating company funds as personal funds) - commingling of funds between the corporation and the principal stockholder(s) or other entities controlled by the stockholder(s).
13. Non-functioning of corporate officers and directors (who were elected to be placeholders by a primary stockholder but were not intended to do anything, or have no power to act in their titled roles.)
14. Undercapitalization—not enough of an investment to enable the corporation to function.
15. Any attempt to defraud customers or creditors.

Several Oklahoma cases include the following language: "Oklahoma permits the court to disregard the corporate entity if used, (1) to defeat public convenience, (2) justify wrong, (3) to perpetrate fraud whether actual or implied, or (4) to defend crime." *Robertson v. Roy L. Morgan, Production Company*, 411 F.2d 1041, 1043 (10th Cir. 1969) (Citations omitted). If the legal entity is used to accomplish these purposes, the law may treat the corporation as an association of persons.

Id. The goal in piercing the corporate veil is to impute liability for the acts of the corporation to the responsible persons.” (Matter of Estate of Rahill, 1991 OK CIV APP 83, 827 P.2d 896)

In the Federal Courts regarding an Oklahoma case, (*N.L.R.B. v. Reliable Electric Construction Co., Inc.*, 2001 10CIR 669), the court used the following test language: “In order to determine whether the corporate veil should be pierced, this court must ask:

“(I) was there such unity of interest and lack of respect given to the separate identity of the corporation by its shareholders that the personalities and assets of the corporation and the individual are indistinct, and (ii) would adherence to the corporate fiction sanction a fraud, promote injustice, or lead to an evasion of legal obligations.”

So how do you protect yourself from personal liability when something goes wrong with your corporation’s liability? Correct any of the mistakes from the list above. When you record your corporate minutes, include reference to the following matters:

- Compensation of officers
- Authorization of important contracts
- Acquisition of property
- Loans and guarantees
- Designation of banks
- Engagements of lawyers, accountants, and other professionals
- Declaration of dividends
- Approval of mergers
- Issuance of shares
- Sale of assets
- Authorization to sign checks, deposit funds, and make withdrawals
- Approval of financial statements and audit reports
- Compliance with governmental regulations
- Adoption of employee benefit plans

What about your limited liability company? Many of the same principles apply. In an article on the subject entitled "Piercing the Corporate Veil" of a Limited Liability Company by John C. Murray, there was reference to the Connecticut case *Stone v. Frederick Hobby Associates II, LLC*, 2001 Conn. Super. LEXIS 1853, Superior Court, judicial district of Stamford-Norwalk, at Stamford, Docket No. CV000181620S (July 10, 2001). The court allowed the plaintiffs to preattach assets of the owners of the limited liability company where the owners had insufficient assets to complete a contract for the construction of a home and had failed to perform the work and complete the contract and had no assets of its own. Quoting from the article: “According to the court, the instrumentality rule requires proof of three elements: 1. complete domination and control of both the entity's policy and business practices; 2. use of such control to commit fraud or wrong, breach of a legal duty, or a dishonest or unjust act (such as using such control to avoid personal liability previously assumed by an individual); and 3. that the aforesaid control and breach of duty must proximately cause the injury or loss.” The essence of the case is that the court concluded that the

entity was being used to commit a fraud or wrong and the owners were using the entity as a tool to shield them from the responsibility of fulfilling the contract.

The major significant difference between a corporation and a limited liability company is the statutory requirement of holding meetings for stockholders and directors. The minutes of a corporation must be kept in a minute book as evidence of its operating separately from its stockholders. Although there is no statutory requirement of minutes for a limited liability company and it does not need to issue certificates of ownership, the keeping of minutes of business actions and holding periodic meetings of members of the limited liability company which are recorded in the minute book can be a good way to establish that a limited liability company is being operated as a business and not as a front for unfair activity. I suggest that the best way to protect a limited liability company from being pierced is to 1) provide adequate capitalization for it to do its job, 2) operate it as a legitimate business, not as a personal alter-ego, or in a way to take unfair advantage of creditors and 3) keep proper records, file tax returns and reports, hold periodic meetings and/or minutes of company actions.

Limited liability companies have not been around long enough for there to be many cases, and there are few now, but many of the same principles apply to them as apply to the concept of piercing the corporate veil.

In summary, don't use your business entity to commit fraud and don't use it as your personal alter-ego--keep it on the up and up and operate it as a business, not as a personal expense account and keep adequate records and filings. Its not complicated to do it and the rewards far outweigh the time it takes to do it. Really!

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