Piercing the Corporate Veil: Minimizing Alter Ego Liability for Subsidiaries, Affiliates and Related Entities

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VEIL PIERCING

- Cases are arising more frequently in which a creditor of a member or partner attempts to reach the debtor’s membership or partnership interest. A related issue for LLCs, LLPs, and LPs is the protection of members, managers, and partners from liability to creditors of the entity.

- Veil piercing is an equitable remedy that applies to hold an owner (and, occasionally, non-owners) liable for a debt of the entity.

- Although LLCs, LLPs, and LPs are often described as limited liability entities, even if the applicable statutes did not contain the liability limitations discussed in this presentation, debts of the entity ordinarily would not be considered those of the entity’s owners because the entity is a separate legal entity. Bayless Manning, A CONCISE TEXTBOOK ON LEGAL CAPITAL 6 (2nd Ed. 1981).
Commentators have summarized the rule this way:

The most common veil-piercing test requires a plaintiff to demonstrate that a corporation was an ‘alter ego’ or ‘mere instrumentality,’ as evidenced by complete control and domination, of a shareholder used to perpetuate a fraud, wrong, or injustice that has proximately caused unjust loss or injury to the plaintiff. Oh, Veil-Piercing, 89 Tex. L. Rev. 81, 84 (2010).

Some commentators have asserted that veil piercing “seems to happen freakishly. Like lighting, it is rare, severe, and unprincipled.” Frank H. Easterbrook and David R. Fischel, “Limited Liability and the Corporation,” 52 U. Chi. L. Rev. 89 (1985). This author believes that case analysis shows that although veil piercing may be rare and severe, there are principles that are, or should be, applied by courts in these cases.
VEIL PIERCING

- Veil piercing should be rare because limited liability and the separateness of entities and their owners are intended purposes of the LLC Act and the statutory provisions allowing for LLPs and LLLPs. An observation by an early corporate commentator is equally applicable to LLCs, LLPs, and LLLPs today:

- The policy of our law to-day sanctions incorporation with the consequent immunity from individual liability. It follows that no fraud is committed in incorporating for the precise purpose of avoiding and escaping personal responsibility. Indeed, that is exactly why most people incorporate, and those dealing with corporations know, or at least are presumed to know, the law in this regard.

- I. Maurice Wormser, *Disregard of the Corporate Fiction and Allied Corporate Problems* 18 (Baker Voorhis & Co. 1927).
VEIL PIERCING

- As discussed above and in the analysis of cases below, veil-piercing claims succeed when the entity is nothing more than the alter ego of the owner and has been wrongfully used to the detriment of third parties. A person who establishes an entity and respects its existence may properly use the entity to accomplish a purpose that the person could not achieve individually. For example, in many cases, licenses and franchises may be issued only to certain types of entities. Several federal tax benefits are available to corporations but not to other entities. For example, only C corporations may have tax-favored medical reimbursement plans (I.R.C. § 105) or provide tax-free group life insurance (I.R.C § 79). Only corporations (C and S) may engage in tax-free reorganizations under I.R.C. §368.

- Wormser described an interesting 1908 case, *People's Pleasure Park v. Rohlede*, 109 Va. 47, 61 S.E. 794 (1908), in which a creative attorney used a corporation to avoid racially motivated deed restrictions:
VEIL PIERCING

In *People’s Pleasure Park Co. v. Rohlede*, a large tract of land was divided up into a number of lots, each deed of a lot containing a covenant providing that title to the real estate should never pass into a person or persons of African descent or into a colored person or persons. Thereafter, a corporation was organized “composed exclusively of negroes.” It took title to a number of the lots and proposed to establish an elaborate amusement park for colored people. The corporation knew, when it purchased the land, of the title restriction. Suit was brought in equity by an owner of other [adjoining] lots to have the deed to the corporation cancelled and set aside. The court rendered judgment for the corporation, holding that though all its members were negroes, yet the corporation was a legal personality entirely separate, apart and distinct from its stockholders, and that therefore the covenant was not breached. The court said, in effect, that the corporation was not colored, because it “is a person which exists in contemplation of law only, and not physically.”
The Delaware Court of Chancery explained the Delaware approach to piercing the corporate veil as follows:

This Court will disregard the corporate form only in the “exceptional case.” Determining whether to do so requires a fact intensive inquiry, which may consider the following factors, none of which are dominant: (1) whether the company was adequately capitalized for the undertaking; (2) whether the company was solvent; (3) whether corporate formalities were observed; (4) whether the controlling shareholder siphoned company funds; or (5) whether, in general, the company simply functioned as a façade for the controlling shareholder. Delaware courts also must find an element of fraud to pierce the corporate veil [citing *Mason v. Network of Wilm., Inc.*, 2005 WL 16539954, at *3 (Del. Ch. 2005)] (other citations omitted). *Winner Acceptance Corp. v. Return on Capital Corp.*, 2008 WL 5352063 at *3 (Del. Ch. 2008).
VEIL PIERCING

- Texas cases hold that, in addition to establishing alter-ego, the plaintiff must show that the defendant perpetrated an actual fraud for the defendant’s personal benefit. *Fin and Feather Club v. Leander*, 415 S.W. 3d 548 (Tex. App. 2013); *DDH Aviation, L.L.C. v. Holly*, 2005 WL 770595 (N.D. Tex. March 31, 2005).

- A New York court has stated that a member must have “engaged in acts amounting to an abuse or perversion of the LLC form to perpetuate a wrong or injustice” to justify piercing the veil of an LLC. *Grammas v. Lockwood Associates, LLC*, 944 N.Y.S. 2d 623 (App. Div. 2nd Dept. 2012).
VEIL PIERCING

- A California court has held that “actual fraud is not required to invoke the alter ego doctrine” but that the doctrine will be applied to prevent an unjust and inequitable result. *Stinky Love, Inc. v. Lacy*, 2004 WL 1803273 (Cal. App. Aug. 13, 2004). The court of appeals upheld the trial court’s judgment piercing an LLC’s veil and holding Lacy, the LLC’s founder and CEO, personally liable on a judgment against the LLC. The LLC contracted with Stinky Love, Inc. (“Stinky”) to distribute Stinky’s movie “Love Stinks.” Various representatives of the LLC represented to Stinky on more than one occasion that Lacy had committed $30 million in capital to the LLC. Lacy tried to raise $30 million but was unsuccessful and instead capitalized the LLC with $1,000,000 of his own money and $150,000 from another company he controlled. Lacy and his family controlled 100% of the LLC, and Lacy closely managed the details of the LLC’s business and its expenditures. The distribution agreement between Stinky and the LLC required the LLC to spend $8,000,000 on prints and advertising and to pay $4.3 million, plus a portion of the gross receipts, for the distribution rights to the movie. The movie fared poorly, and Stinky never received any of the purchase price. Stinky obtained an arbitration award against the LLC for breach of contract in the amount of $4.3 million, and the award was confirmed by a judgment. Lacy filed bankruptcy, but the stay was lifted to allow Stinky to pursue Lacy. Following a bench trial, the court found Lacy was the alter ego of the LLC and amended the arbitration judgment to add Lacy as a debtor.
VEIL PIERCING

The court of appeals noted that the alter ego doctrine applies to members of an LLC and stated that two conditions must be met to invoke the doctrine: (1) there is such unity of interest between the corporation and its equitable owner that the separate personalities of the corporation and its shareholder do not really exist; and (2) it would be inequitable to treat the acts in question as those of the corporation alone. The court listed various factors that are considered in applying the alter ego doctrine and concluded the evidence was sufficient to support the trial court’s finding of alter ego. The court pointed to evidence of unity of interest and ownership based on the Lacy’s family’s control of the LLC and use of its assets for their own benefit (including paying off personal credit cards and other debts and maintaining family-owned realty). Stinky’s accountant identified 750 related party disbursements totaling millions of dollars. The court found ample evidence of inadequate capitalization based on the minimal amount of capital committed to the LLC relative to its obligations under the distributorship agreement. Finally, the court found it unjust and inequitable that the LLC convinced Stinky to enter the distribution agreement based on repeated assurances of adequate capitalization and resources. The court stated that actual fraud is not required to invoke the alter ego doctrine and that the doctrine is not limited to tort cases.
VEIL PIERCING

- Another California court held that alter ego liability could apply even where the individuals did not directly own an interest in the LLC but were members of the sole member of the LLC and even though the individuals’ indirect interest was only 18%. “The ownership of even a single share in the corporate entity is sufficient to qualify one for alter ego liability.” *Triple “R” Service v. Watson*, 2005 WL 1023236 (Cal. App. 4 Dist. May 3, 2005).
VEIL PIERCING IF ISSUE IS PERSONAL JURISDICTION

Note that courts may apply a lesser standard to veil piercing and alter ego if the issue is personal jurisdiction: See Oliver v. Boston University, No. 16570, 2000 WL 1038197 (Del. Ch. July 18, 2000), holding that LLC was alter ego of Boston University for purposes of personal jurisdiction, assuming truth of allegations that LLC was formed by Boston University solely to serve its interest and was completely dominated by the University. See also Boston Scientific Corporation v. Wall Cardiovascular Technologies, LLC, 647 F. Supp. 2d 358 (D. Del. 2009) (rejecting argument that Texas LLC was subject to personal jurisdiction in Delaware as alter ego of Delaware LLC because record did not show sufficient level of control, absence of corporate formalities, or fraud, injustice, or inequity in use of corporate form; recognizing separate legal existence of LLC and its members under Texas law and rejecting argument that personal jurisdiction over LLC is proper in any forum in which LLC’s members are subject to jurisdiction) and Gonzalez v. Lehtinen, 2008 WL 668600 (Tex. App. 2008). The court in Gonzalez concluded that there was sufficient evidence for the trial court to make an implied finding that a Texas LLC was the alter ego of Cardenas, a prominent Mexican citizen, and that Cardenas was therefore subject to the Texas long-arm statute as someone who “did business” in Texas. In a jurisdictional veil-piercing case, the court stated that it does not assess certain issues such as fraud and undercapitalization. Instead, the focus was on whether Cardenas controlled the internal business operations of the LLC to a degree “greater than that normally associated with common ownership and directorship.” In Wolf v. Summers-Wood, L.P., 214 S.W. 3d 783 (Tex. App. 2007), the court held that the fiduciary shield doctrine barred jurisdiction over non-resident officers of LLC where contacts were in representative capacity and were not systematic or continuous and the officers did not operate in a manner indistinguishable from their personal affairs or in a manner calculated to mislead.
In the corporate context, the veil may be pierced where a subsidiary corporation is merely an alter ego or agent of the corporate parent, where the corporation is merely the alter ego of the shareholder, or where the corporate shield is being used to defraud creditors. See Fish v. East, 114 F.2d 177 (10th Cir. 1940).

Frederick Powell, in PARENT AND SUBSIDIARY CORPORATIONS, LIABILITY OF A PARENT CORPORATION FOR THE OBLIGATIONS OF ITS SUBSIDIARY, articulated a three-part test as to when the veil should be pierced. Initially, it needed to be demonstrated that the entity to be pierced was the “alter ego” or “mere instrumentality” of the parent corporation such that the subsidiary was completely under its control and domination. Second, there was a requirement of “fraud or wrong” pursuant to which the utilization of the subsidiary had been unjust, fraudulent or wrongful towards the injured plaintiff. Third and last, there was a requirement that the plaintiff had suffered some wrong consequent to the conduct of the corporate parent.

See PRESSER, PIERCING THE CORPORATE VEIL § 1:6 at p. 41.
Veil Piercing in Subsidiary Situations

- In furtherance of determining whether the subsidiary was an alter ego or a mere instrumentality, Powell listed eleven factors that should be assessed, namely:
  - a) Does the parent own all or most of stock of the subsidiary?
  - b) Do the parent and subsidiary corporations have common directors or officers?
  - c) Does the parent corporation finance the subsidiary?
  - d) Did the parent corporation subscribe to all of the capital stock of the subsidiary or otherwise cause its incorporation?
  - e) Does the subsidiary have grossly inadequate capital?
  - f) Does the parent pay the salaries and other expenses or losses of the subsidiary?
  - g) Does the subsidiary do no business except with the parent or does the subsidiary have no assets except those conveyed to it by the parent?
  - h) Is the subsidiary described by the parent (in papers of statements) as a department or division of the parent or is the business or financial responsibility of the subsidiary referred to as the parent corporation's own?
  - i) Does the parent use the property of the subsidiary as its own?
  - j) Do the directors or executives fail to act independently in the interest of the subsidiary, and do they instead take orders from the parent, and act in the parent's interest?
  - k) Are the formal legal requirements of the subsidiary not observed?
Piercing The Corporate Veil Webinar

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The Alter Ego Theory

- From agency principles to instrumentality rule
- Business entity is so dominated by the individual business owner that it conducts the owner’s personal business. 
  *Rohmer Assoc. v. Rohmer, 36 A.D.3d 990, 830 N.Y.S.2d 356 (3d Dept. 2007)*
- Issue – is the entity being used for purely personal rather than corporate purposes
- If the business (corporation or LLC) is being dominated and abused by the owner for personal purposes, each will be deemed the alter ego of the other
The Alter Ego Theory (cont.)

- If abuse of the corporate or LLC form is used to commit a wrong against a third party, the corporate form will be disregarded – i.e., corporate veil will be pierced
- Business owner will be held personally liable for corporate obligations
- Not an independent cause of action
Required Proof/Factors

- Heavy burden of proof
- Difficult to convince Court to use equitable power to pierce corporate veil
- Factors relied upon (between corporation and owner – New York):
  - shuttling funds in and out of personal and business bank accounts
  - using corporate funds and property for personal purposes and obligations
Required Proof/Factors (cont.)

- corporation or LLC is under-capitalized
- lack of corporate formalities (i.e., issuance of stock, election of directors, keeping corporate records, etc.)
- common office space and telephone numbers used by corporation (LLC) and individual business owner
- overlap in ownership, officers, directors and personnel
- business owner using corporation as “personal ATM”
- no one factor is dispositive
Fraud Not Required (New York)

- Not necessary to prove fraud in New York – in other words, it is not necessary to prove intent to abuse corporate form to perpetrate a fraud or harm a third party
- It is sufficient if a consistent pattern of domination and abuse – excessive control – exists and it causes harm to a third party
- Error (in New York) for Court to instruct jury that fraud is required to pierce corporate veil Passalacqua Builders, Inc. v. Resnick Developers South, Inc., et al., 933 F.2d 131 (2d Cir. 1991)
Classic Indicia of Fraud (New York)

- While proof of fraud not required, it is highly relevant and strengthens showing
- In New York, transfer by business owner of corporate/LLC funds to a family member of owner without consideration is “classic indicia of fraud” *Federal Deposit Insurance Corporation v. Conte*, 204 A.D.2d 845, 612 N.Y.S. 2d 261, 263 (3d Dept. 1994)
- Transfer to family member reflects fraudulent intent to evade corporate creditors and for owner to enrich himself at the expense of corporate creditors
Harm to Third Party

- In New York, for Court to use equitable power to pierce corporate veil, abuse of corporate form must cause harm to a third party *Morris v. New York State Dept. of Taxation*, 82 N.Y.2d 135, 623 N.E.2d 1157 (1993)

- Typical harm is inability of judgment creditor of corporation/LLC to satisfy judgment against corporation/LLC with funds diverted from corporation/LLC to the business owner
Piercing the Veil Between Corporations (Parent and Subsidiary)

- Factors relied upon (New York)
  - The absence of corporate formalities such as issuance of stock, election of directors, etc.
  - Inadequate capitalization
  - Whether funds are put in and taken out of the corporation for personal rather than corporate purposes
  - Overlap in ownership, officers, directors and personnel
Piercing the Veil Between Corporations (Parent and Subsidiary) (cont.)

- Common office space, address and telephone number for the corporate entities
- The amount of business discretion displayed by the allegedly dominated corporation
- Whether the related corporations deal with the dominated corporation at arms-length
- Whether the corporations are treated as independent profit centers
The payment or guarantee of debts of the dominated corporation by other corporations in the corporate group

Whether the dominating corporation in question uses property owned by the dominated corporation as if it were its own

No other factor is dispositive
Reverse Piercing Doctrine (New York)

- Creditors usually ask the Court to pierce the corporate veil to hold business owner personally liable for corporate debts
- Once it is shown that the business entity and the business owner are alter egos, they are deemed to be a single personality
- They are merely two sides of the same financial coin
Reverse Piercing Doctrine (New York) (cont.)

- Once the alter ego finding is made, the piercing of the corporate veil flows in both directions – the business owner is treated as the alter ego of the business entity, and vice versa. *Sweeney, Cohn, Stahl & Vaccaro v. Kane, et al.*, 6 A.D.3d 72, 75, 773 N.Y.S.2d 420, 423 (2d Dept. 2004)

- Under the Reverse Piercing Doctrine, the corporation will be held liable for the debts of the business owner, and corporate assets may be used to satisfy a creditor’s judgment against the individual business owner.
Reverse Piercing Doctrine (New York) (cont.)

- Reverse Piercing Doctrine has been applied to hold a subsidiary liable for debts of its parent Securities Investor Protection Corporation v. Stratton Oakmont, Inc., 234, B.R. 293, 320 (S.D N.Y. 1999)
Courts Will Not Place Form Over Substance

- Accounting treatment of transactions is not dispositive; Courts will not permit accounting mechanisms to be improperly used to shield assets from creditors
- The focus is not on accounting treatment of a transaction, but the reality of the actual conduct of the business owner and whether such conduct harmed third parties, such as judgment creditors

*Wajilam Exports v. ATL Shipping, 475 F.Supp.2d 275 (S.D.N.Y. 2006)*
Courts Will Not Place Form Over Substance (cont.)

- An example: The judgment debtor is the business owner; the owner uses corporate funds for personal purposes and transfers corporate funds to his wife for no consideration; the funds at issue are never in possession of the business owner (never deposited in owner’s bank account) – the funds are transferred directly from the corporate bank account to the owner’s personal creditors and his wife.
Courts Will Not Place Form Over Substance (cont.)

- Example continued: In attempting to oppose an alter ego finding, the business owner relies on financial statements and tax returns showing the above transactions as income to him; it is claimed that the use of corporate funds for personal purposes and the transfer of corporate funds to his wife are proper distributions to him of corporate earnings.
Courts Will Not Place Form Over Substance (cont.)

- Focusing on the reality that the business owner never took personal possession of the alleged distributions of income which enabled him to evade his personal judgment creditor, the Court rejected the owner’s defense and ruled that the corporation and its owner were alter egos.

- Applying the Reverse Piercing Doctrine, the Court further held that the corporation was liable for the debts of the business owner and that the corporation’s assets could be used to satisfy a judgment against the business owner.
Limited Liability Companies

- In New York, the alter ego theory applies to Limited Liability Companies in the same manner as traditional corporations *Colonial Surety Company v. Lakeview Advisors, LLC*, 93 A.D.3d 1253, 941 N.Y.S.2d 371 (4th Dept. 2012)

- In New York, other than focusing on the conduct and transactions of the controlling member(s) of the LLC in place of the controlling shareholder(s) of the traditional corporation, the above-described criteria for piercing the corporate veil is the same
Equitable Considerations

- Equity is a means to avoid a harsh result from a strict application of the law.
- In the context of corporations (or limited liability companies), a strict application of the law will uphold the fiction of separateness between the corporation and its owner, and between a parent and subsidiary corporation.
Veil piercing rules allow a court to fashion a remedy when the corporate form is abused at the expense of a third party.

Equitable principles are applied to strike a proper balance between the policy behind the legal fiction of corporate separateness and the need to protect those who transact business with a corporation.
POTENTIAL LIABILITY OF NON-OWNER

In McCallum Family LLC v. Winger, 221 P.3d 691 (Colo. App. 2009), the court held a non-shareholder liable in a corporate veil-piercing case where the non-shareholder dominated the corporation and caused its assets to be used for his benefit and the benefit of his family (which included the shareholders). The court applied an apparently new theory—“equitable ownership.”
VEIL PIERCING IN LLCs

As will be discussed below, limited liability company statutes generally provide liability shields similar to those provided for corporations. Accordingly, case law illustrates that situations that result in LLC piercing resemble those that result in piercing the corporate veil. *Netjets Aviation, Inc. v. LAC Commc’ns., LLC*, 537 F.3d 168, 176 (2d Cir. 2008). The Delaware Chancery Court has indicated that the circumstances justifying piercing the LLC veil must be pervasive—not just stemming from a single transaction. *EBG Holdings LLC v. Vredezicht’s Gravenhage 109 B.V.*, Civil Action No. 3184-VCP, 2008 WL 4057745 (Del. Ch. 2008). In this case, a Delaware LLC sued one of its members, a Dutch LLC (“VG 109”), and the member’s parent corporation (“NIBC”), seeking a declaration that VG 109 was NIBC’s alter ego, as well as specific performance of provisions of the LLC agreement, among other things. The court found that there was not a sufficient showing of fraud or other inequity to disregard the NIBC corporate form. The court pointed out that the fraud or injustice must stem from an inequitable use of the corporate form itself, not merely from the underlying cause of action for breach of contract. The court found that a conclusory statement in the complaint that NIBC knowingly used VG 109 as an instrument to shield itself from liability for tax obligations related to ownership in the LLC was insufficient to support a reasonable inference that NIBC’s use of VG 109’s limited liability status was fraudulent or inequitable. There also was no showing that VG 109’s capitalization was so minimal as to prove it was a sham entity.
Accordingly, case law illustrates that situations that result in LLC piercing resemble those that result in piercing the corporate veil. *Netjets Aviation, Inc. v. LAC Commc’ns., LLC*, 537 F.3d 168, 176 (2d Cir. 2008). As noted above, the Delaware Chancery Court has indicated that the circumstances justifying piercing the LLC veil must be pervasive—not just stemming from a single transaction. *EBG Holdings LLC v. Vredezicht’s Gravenhage 109 B.V.*
VEIL PIERCING IN LLCS

The Colorado LLC statute states that the failure of an LLC “to observe the formalities or requirements relating to the management of its business and affairs is not in and of itself a ground” for piercing through the LLC to the members. There must be more. In *In Re Phillips*, the Colorado Supreme Court answered a question certified to it by the Federal District Court for Colorado and held that, to determine whether piercing the corporate veil is appropriate, the court must:

1. Inquire into whether the corporate entity is the alter ego of the shareholder;
2. Inquire whether justice requires recognizing the substance of the relationship between the shareholder and corporation over the form because the corporate fiction was used to perpetrate a fraud or defeat a rightful claim; and
3. Evaluate whether an equitable result will be achieved by disregarding the corporate form and holding the shareholder personally liable for the acts of the business entity.
Among the factors described in the cases that should be considered for piercing a corporate veil that would be applicable in an LLC context are:

- The LLC’s capital is grossly inadequate for its anticipated business operations; and
- Where there is commingling of funds between entities or between the LLC and its members or managers.

*In re Phillips*, 139 P.3d 639 at 644 (Colo. 2006). See, also, the ten factor test established by the Tenth Circuit Court of Appeals interpreting Colorado law in *Skidmore, Owings & Merrill v. Canada Life Assurance Co.* 907 F.2d 1026, 1027 (10th Cir. 1990) and the classic test for piercing the corporate veil to hold a shareholder liable for corporate obligations in *Fish v. East*, 114 F.2d 177 (10th Cir. 1940) (also interpreting Colorado law).
VEIL PIERCING IN LLCs

But see Larry E. Ribstein and Robert R. Keatinge, *Ribstein and Keatinge on Limited Liability Companies* (Thompson/West, 2d Ed., 2006 Supp., St. Paul, Mn) at § 12.3, advising that veil piercing for inadequate capitalization is less likely for LLCs than for corporations because there exists express statutory authority in LLC Acts for withdrawal of funds from failing firms – and consequently creditors are able to assess risk and accordingly adjust credit terms for undercapitalized LLCs.

A Weird LLC Case

In 2009, the Colorado Court of Appeals held a non-member manager (Trowbridge) potentially liable to a creditor, remanding to the trial court to determine “Whether it is equitable to hold Trowbridge personally liable for the LLC’s improper actions by piercing the corporate [sic] veil.” Sheffield Services Company, et al. v. Trowbridge and Mason, 211 P.3d 639 (Colo. Ct. App. 2009). For a criticism of the Sheffield case, see Lidstone, “Piercing the Veil of an LLC or a Corporation,” 39 The Colorado Lawyer, no 8 at 71 (August 2010). According to the Court of Appeals, among the findings that the trial court will have to make are “whether, under the common law, (1) Colfax [the LLC] is Trowbridge’s alter ego, (2) justice requires recognizing the substance of Trowbridge’s relationship with Colfax because he used Colfax to perpetuate a fraud or defeat a rightful claim, and (3) disregarding the relationship’s form and holding Trowbridge personally liable would lead to an equitable result.” In connection with another claim (but arguably related to “justice” and “an equitable result”) the Court of Appeals directed the trial court also to determine: “Whether the LLCs were or became insolvent when Trowbridge distributed LLC assets to the non-party members and, if so, whether Trowbridge breached the common law duty of an LLC manager to avoid favoring personal interests over the LLC’s creditors’ claims.” In reaching its conclusions, the Colorado Court of appeals ignored C. R. S. §7-80-705, which provides that “[m]embers and managers of limited liability companies are not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.”
Weird LLC Case Overruled

In 2013, the Colorado Supreme Court overruled Sheffield. *Weinstein v. Colborne Foodbotics, LLC*, 302 P.3rd 263, 269 (Colo. 2013). Weinstein holds that a creditor of a Colorado LLC may not enforce an obligation of a member to return an unlawful distribution and that the managers of an insolvent Colorado LLC do not owe a fiduciary duty to the LLC’s creditors.
VEIL PIERCING IN LLCs

The federal district court for the District of Oregon stated that it would allow the piercing of the limited liability veil of an LLC where:

- the defendant controlled the debtor;
- the defendant engaged in improper conduct; and
- as a result of the improper conduct, the plaintiff either entered into a transaction that it otherwise would not have entered into, or the plaintiff was not able to collect a debt against an insolvent entity.

In this case, the court found that the defendant, who was the sole manager and member, clearly controlled the LLC. The court also found “improper conduct” where there was “commingling assets and a general disregard of [the LLC’s] form and status as a separate legal entity.” The trial court could not determine the third factor on motions and left it for determination at trial.

Statutory Provisions re Veil Piercing

Corporations.
A basic tenant of modern corporate law is that a shareholder is not liable for debts of the corporation. Model Business Corporation Act ("MBCA") §622(b):

Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct. The articles of incorporation may impose personal liability on shareholders. MBCA §2.02(b)(2)(v); Del. Code Ann., tit. 8, §102(b)(6).
De Facto Doctrine

“All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting.” MBCA §2.04.

Several states have similar provisions, e.g. Colorado:

All persons purporting to act as or on behalf of a corporation without authority to do so and without good faith belief that they have such authority shall be jointly and severally liable for all liabilities incurred or arising as a result thereof. C. R. S. §7-102-104.

See, for example, Adams v. Mt. Pleasant Bank & Trust Co., 355 N.W.2d 868 (Iowa 1984), involving shareholder liability for debts incurred during a two year period following expiration of a corporation’s old charter and before reincorporation. The court held that in the absence of a clear statutory mandate to the contrary, limited liability did not exist for liabilities incurred during the interim period. The Iowa statute similar to section 105 of the 1969 version of the Revised Model Business Corporation Act was held not to provide protection against such liabilities. The court also stated that Iowa does not recognize the concept of de facto corporations in the context of an expiration of a corporation’s charter.
LLC Statutes Typically Provide that Failure to Follow Formalities, without More, is Not a Ground for Veil Piercing

See, e.g., Revised Uniform Limited Liability Company Act §304(b); Prototype Limited Liability Company Act §304; Del. Code Ann title 6, §18-103; C.R.S. §7-80-107(2).

If a client does not intend to hold regular meetings or otherwise conduct its business with regular formalities, it is best not to put formal meeting, etc. requirements in the LLC Agreement. Also, statutory ignoring of formalities does not prevent veil piercing if the owners of an LLC disregard its economic separateness.
De Facto Doctrine Applied to LLCs by Statute

All persons who assume to act as a limited liability company without authority to do so and without good faith belief that they have such authority shall be jointly and severally liable for all debts and liabilities incurred by such persons so acting. C. R. S. §7-80-105.
De Facto Doctrine in Absence of Statute

What if the owners of a planned but not formed corporation or limited liability company begin acting in the name of the unformed entity in a state that does not have a statutory provision like that of RMBA §2.04 or C. R. S. §§7-80-105, 7-102-104? Unless a third party dealing with an owner of an unformed entity agrees otherwise, the owner will be personally liable on a contract entered into in the name of the unformed entity:

Unless the third party agrees otherwise, a person who makes a contract with a third party purportedly as an agent on behalf of a principal becomes a party to the contract if the purported agent knows or has reason to know that the purported principal does not exist or lacks capacity to be a party to a contract. Restatement Third, Agency §6.04.
Another Theory of Agency Law May Apply Even if the Entity has been Validly Formed

If an owner of the entity (or someone else acting on behalf of the entity) doesn’t disclose that they are acting on behalf of an entity, the person so acting may be liable under the theory of undisclosed principal.

In *Water, Waste & Land, Inc. d/b/a Westec v. Lanham*, 955 P. 2d 997, (Colo. 1998), the court held that Larry Clark and Donald Lanham were personally liable where they entered into a contract without disclosing that they were acting on behalf of Preferred Income Investors, LLC, a Colorado limited liability company (“Preferred”). Lanham and Clark were members and managers of Preferred. Clark contacted and contracted with Westec for engineering services. Clark’s business card included his name, address, and the initials “PII,” but not the name of the LLC or his title.

- In reaching its decision in this case, the court said that agency law applies in the LLC context, “notwithstanding the LLC’s statutory notice rules,” continuing:
  - Under the common law of agency, an agent is liable on a contract entered on behalf of a principal if the principal is not fully disclosed. . . . If both the existence and identity of the agent’s principal are fully disclosed to the other party, the agent does not become a party to any contract which he negotiates…. But where the principal is partially disclosed (i.e., the existence of a principal is known but his identity is not), it is usually inferred that the agent is party to the contract. 955 P. 2d at 1001.
Undisclosed Principal (continued)

The court went on to say, “The duty of disclosure clearly lies with the agent alone; the third party with whom the agent deals has no duty to discover the existence of an agency or . . . the identity of the principal.” As a result, the court reversed the judgment of the District Court and reinstated the judgment of the County Court which had held Lanham and Clark personally liable as agents for (at best) a partially disclosed principal. See Restatement Third, Agency §6.03. Of particular note in this case is the court’s holding that the duty of disclosure lies solely with the agent and is not affected by the provisions of C. R. S. §7-80-208:

The fact that the articles of organization are on file in the records of the secretary of state is notice that the limited liability company is a limited liability company and is notice of all other facts stated therein that are required to be stated in the articles of organization by section 7-80-204.
Other Statutory Sources of Liability

- Liability to pay for shares.
  MBCA §622(a): A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued (section 6.21) or specified in the subscription agreement (section 6.20). The Delaware General Corporation Act contains a similar rule. Del. Code Ann., tit. 8 §162(a).

- Improper Distributions
  MBCA §8.33(a) A director who votes for or assents to a distribution in excess of what may be authorized and made pursuant to section 6.40(a) or 14.09(a) is personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating section 6.40(a) or 14.09(a) if the party asserting liability establishes that when taking the action the director did not comply with section 8.30.
(b) A director held liable under subsection (a) for an unlawful distribution is entitled to:

(1) contribution from every other director who could be held liable under subsection (a) for the unlawful distribution; and

(2) recoupment from each shareholder of the pro-rata portion of the amount of the unlawful distribution the shareholder accepted, knowing the distribution was made in violation of section 6.40(a) or 14.09(a). See also Del. Code Ann., tit. 8 §174(b).
Dissolution.

MBCA §14.07 (d) A claim that is not barred by section 14.06(b) [relating to claims by known creditors] or section 14.07(c) [relating to claims by other creditors] may be enforced:

(1) against the dissolved corporation, to the extent of its undistributed assets; or
(2) except as provided in section 14.08(d), if the assets have been distributed in liquidation, against a shareholder of the dissolved corporation to the extent of the shareholder’s pro rata share of the claim or the corporate assets distributed to the shareholder in liquidation, whichever is less, but a shareholder’s total liability for all claims under this section may not exceed the total amount of assets distributed to the shareholder.

3. See also *United States v. Seyler*, 142 F. Supp. 408 (W.D. Pa. 1956), holding that the United States can recover unpaid income tax assessments from transferees of the corporate assets who received dividends that reduced assets of the corporation to substantially less than its outstanding liabilities.
Liability for Improper Distributions

Liability for Unpaid State Taxes and Unpaid Employment and Withheld Income Taxes

State Taxes. Several states have adopted statutes that impose liability on the constituent members and managers of an entity when the taxes are not paid by the entity. Rutledge, “Limited Liability (or Not); Reflections on the Holy Grail,” 51 South Dakota Law Review (2006) 417, 443.

Federal Employment and Withheld Income Taxes.
1. “Any person required to collect, truthfully account for, or pay over” taxes, who willfully fails to do so, faces liability not only for the amount of the tax but a 100% penalty as well. Internal Revenue Code of 1986 §§3102(a)(withheld employment taxes), 3402(a)(liability for taxes withheld or collected), 6672(a)(100% penalty for failure to collect and pay over tax; exception for volunteer directors of tax-exempt organizations ((§6672(e))), 7501(liability for taxes withheld or collected).
2. Recent amendments to the applicable regulations have made single- member LLCs the responsible party for employment and withheld taxes on employees of the LLC. The owner is still treated as a self-employed person and presumably will be the first target of the IRS if the LLC fails to satisfy its withholding and payment obligations with respect to its employees. T.D. 9356, I.R.B. 2007-39 at 675. Treas. Reg. §301.7701-2(c)(2)(iv).
Liability for Actions of the Entity’s Employees and Agents

An owner who is active in the entity’s business is responsible for his or her own actions, including torts. *Valley Dev. Co. v. Weeks*, 364 P.2d 730, 734 (Colo. 1961). If the owner is an agent of the entity and commits the tort while acting for the entity, the entity will also be liable. Restatement Third, Agency §§7.03(2), 7.03 cmt. b, 7.03(2)(a), 7.07.

An owner may also face liability for negligent hiring, supervision, and retention of employees, contractors, and other agents. Restatement Third, Agency §§7.03, 7.05.
Veil Piercing in Single Member LLCS

- Although a single-member LLC is not necessarily evidence of the LLC being the *alter ego* of the single member, single member or closely-held membership may raise a red flag in many situations, and clearly single member LLCs are more subject to potential abuse. In fact, the *Great Neck Plaza* court says, specifically: “ownership of membership certificates or stock alone may not impute ownership of the assets of a corporate entity.” In that case, the court went on to note that: “the record indicates that Rhoads was the president or manager of all the corporations in question and that he financed both Grill and Restaurants. The assets were moved gymnastically among the corporations for what Rhoads claimed to be tax reasons, a claim unsubstantiated in the evidence and, inferentially, disbelieved by the trial court.”

Veil Piercing in Single Member LLCs

- In a detailed Second Circuit Court of Appeals decision discussing the piercing of a veil of a Delaware LLC, the plaintiffs sought to hold the sole member of a Delaware LLC liable for the breach of contract of the LLC on the basis that the member was the LLC’s alter ego. The trial court granted summary judgment in favor of the member on the ground that the plaintiffs had not set forth sufficient evidence to pierce the veil of the LLC. The Second Circuit Court of Appeals discussed Delaware corporate veil piercing principles and concluded that such principles are generally applicable to an LLC. In reaching a conclusion that the defendant was not entitled to summary judgment, the court examined the evidence that the LLC and its sole member operated as a single entity and found that the evidence, viewed most favorably to the plaintiffs, showed:

- **Lack of corporate formalities** – although corporate veil-piercing principles are generally applicable to an LLC, somewhat less emphasis should be placed on whether the LLC observed internal formalities in an alter ego analysis of an LLC. However, if two entities with common ownership “failed to follow legal formalities when contracting with each other, it would be tantamount to declaring that they are indeed one in the same.”

- **Inadequate capitalization** – the LLC was started with a capitalization of no more than $20,100, that it proceeded to invest millions of dollars supplied by its member,

- **Treating the LLC’s funds as if it were the member’s** – the member put money into the LLC as needed and took money out as the member needed it.
Veil Piercing in Single Member LLCs

- **Lack of financial segregation with other entities** – the LLC had only one officer other than its member, and the officer was paid by the member or one of his corporations. The LLC shared space with other companies owned by the member and shared employees with the member or other companies owned by the member.

- **Lack of independent decision-making** – the member formed the LLC to be used as an investment vehicle for him to make investments, and the ultimate decisions were always made by the member.

- **Personal use of LLC funds** – the court reviewed evidence relating to financial transactions involving the LLC, including
  - The LLC made transfers to the member or third-parties on his behalf in connection with living expenses.
  - The individual in charge of the LLC’s financial records testified that the member made the decision to treat moneys deposited into the LLC as loans so that the member could make withdrawals as he needed money without having to pay taxes on the money withdrawn.
  - The loans were not evidenced by written agreements, and there were no set repayment programs or terms.
  - The member decided when to put money in or take money out of the LLC.

The Second Circuit concluded that this evidence was ample to permit a reasonable fact-finder to find that the member completely dominated the LLC and treated its bank account as one of his pockets. The court then reviewed evidence relating to fraud, illegality, or injustice and stated that there may be overlap in the proof offered to show the LLC and member operated as a single entity and the proof relating to unfairness.
Veil Piercing in Single Member LLCs

The court found evidence of injustice in an affidavit submitted by the member to counter the plaintiffs’ contention that the LLC was undercapitalized. The affidavit stated that the member did not intend for the monies paid to the LLC to be treated as loans and that such payments were in fact capital contributions. At trial, the individual in charge of the LLC’s books testified that the member instructed him to treat the payments as loans so that the member could take money out of the LLC without tax consequences.

The court pointed out that the member’s withdrawals of money from the LLC would be properly characterized as distributions if the payments to the LLC were capital contributions and that distributions to the member may well have violated the prohibition on distributions under the Delaware LLC statute given that the LLC had ceased operating and was unable to pay its debt to the plaintiffs. The court stated that a fact-finder could infer that the member’s payments to the LLC were deliberately mischaracterized as loans to mask the fact that the member was making withdrawals prohibited by law. The court also stated that a reasonable fact-finder could find that the member operated the LLC in his own self-interest in a manner that unfairly disregarded the rights of the LLC’s creditors given various payments and withdrawals on the member’s behalf at a time when the LLC was unable to pay its debt to the plaintiffs and evidence that the member withdrew more money from the LLC than he put in. The court concluded by finding that neither the LLC member nor the plaintiffs were entitled to summary judgment on the veil piercing claim. *NetJets Aviation, Inc. v. LHC Communications, LLC*, 537 F.3d 168 (2d Cir. 2008).
Veil Piercing in Single Member LLCs

- A Texas case illustrates that a single-member LLC that the owner uses in accordance with the statute and without any commingling or disregard of the entity will not be pierced. *Metroplex Mailing Services, L.L.C. v. RR Donnelly & Sons Company*, 410 S.W. 3d 889 (Tex. App. 2013).

- **Single Member LLCs and Asset Protection in Bankruptcy.** Single member LLCs are LLCs and the single owner benefits from the liability protection available to LLCs in general. See, e.g., C.R.S. § 7-80-705, “Members and managers of limited liability companies are not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.”

- Owners of single member LLCs are also subject to the risk of liability for charging orders, improper distributions, and piercing the veil among other potential provisions seeking to hold owners liable for the debts of the entity. There are, however, some unique aspects of single member LLCs and the owner’s ability to use them to hide assets from the owner’s creditors that are worthy of mention. Consider the following discussion in light of the following fact pattern:

- An individual forms a single member LLC to hold income producing or appreciating assets. The individual is also the sole manager of the single member LLC. Creditors of the individual seek to collect the individual’s obligations from the individual, but the only asset remaining is her interest in one or more single member LLCs. Creditors realize that a charging order is only valuable to the extent the manager determines to make a distribution to herself. The circumstances for “reverse piercing” cannot be proven.
Veil Piercing in Single Member LLCs

- This was the situation in *In re Ashley Albright*. 291 B.R. 538 (Bankr. D. Colo. 2003). In that case, Albright filed bankruptcy and refused to admit the bankruptcy trustee as the assignee of her interest in a single member LLC as a member. Using its equitable powers, the bankruptcy court substituted the bankruptcy trustee for the single member. 11 U.S.C. § 541 of the Bankruptcy Code provides in relevant part that upon the commencement of a case in bankruptcy, an estate is created. That estate includes the bankruptcy debtor’s legal and equitable interests in real and personal property as of the commencement of the case. As provided in C.R.S. § 7-80-702(1), and every other LLC statute of which the author is aware, a membership interest in an LLC is personal property.

- Arizona courts and Maryland courts have reached similar conclusions. *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200 (Bankr. D.Ariz. 2005), (decided on a motion to dismiss) holding that when a member of an LLC files for bankruptcy protection, the debtor’s membership interest becomes an asset of the bankruptcy estate, entitling the estate to the rights of an assignee, including distributions. This decision was so negative for the LLC that it paid $85,000 to settle all creditor claims and all administrative costs in full. This payment was conditioned on the court’s withdrawal of its earlier opinion to “eliminat[e] any precedential effect” of the earlier opinion. *In re Ehmann*, 337 B.R. 228 (Bankr. D.Ariz. 2006) *vacating* 319 B.R. 200 (Bankr. D.Ariz. 2005).
Veil Piercing in Single Member LLCs

- See, also, *In re Modanlo*, Civ. Act 2006-1168 (Oct. 11, 2006) (US D.Ct. Md.), the Court held that since the bankruptcy trustee was the personal representative of the last remaining member, the bankruptcy trustee could (under 6 Del. C. § 18-801(a)) admit himself or nominee as a member and continue the LLC over the objections of the bankrupt debtor.

- *Scott A. Lowe and Allyson R. Lowe (In re Scott A. Lowe and Allyson R. Lowe, 07-10904 MER (Bankr. D.Colo.), transcript of oral ruling, Oct. 17, 2007)* dealt with an LLC in which the owners were a husband and wife, where both owners filed the bankruptcy petition. Because there were the two owners, the court ruled that “the [bankruptcy] trustee [in a chapter 7 case] does, indeed, have the member's interest. He is operating as a substitute member of [the LLC].” The court went on to say “[w]hether the trustee wishes to assert control and operate the entity, the LLC, is within the business discretion of the trustee. If it wishes to take actions in that regard, it’s within the business judgment and can take the benefits or detriments of asserting such control.” Similar arguments could be made where a husband and wife owned a partnership and attempted to defend against a creditor seeking recovery of the husband and wife's debts from the partnership’s assets other than through the charging order procedure.
Veil Piercing in Single Member LLCs

- As a matter of pure *dictum*, the *Ashley Albright* court addressed the possibility that it may have reached a different conclusion had there been other economic members. Footnote 9 to the *Albright* decision makes it clear that the additional members have to be members with a true interest in the LLC. “To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with ‘peppercorn’ co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse.”

- A person may grant economic interests to family members for no or little consideration, in an estate planning or even a business context. Based on the *Ashley Albright* reasoning, these actions may, or may not, be effective to avoid the single-member issues.

- If a charging order is intended to protect the rights of the other (non-debtor) members and partners as described in *Union Colony Bank of Greeley*, 832 P.2d 1112, 1114-15 (Colo. 1992), the rationale for a charging order does not apply to a single member LLC (or to a dual member LLC where both members are debtors under the same obligation). *See, also*, Norman W. Nash and Jeffery T. Bedingfield, “Charging Partnership and LLC Interests to Satisfy Creditors,” 23 *The Colo. L. 2743* (Dec. 1994); J. Gordon Gose, “The Charging Order Under the Uniform Partnership Act,” 28 *Wash. L. Rev.* 1 (1953).
Reverse Piercing

- *In re Phillips*, 139 P.3d 639, 644-45 (Colo. 2006). The *Phillips* court identified two types of reverse piercing:
  - (i) ‘inside claims’ involving a ‘controlling insider who attempts to have the corporate entity disregarded to avail the insider of corporate claims against third party claims’ which allow a shareholder to disregard the corporate form of which he is a part; and
  - (ii) ‘outside claims’ which occur when a corporate outsider ‘pressing an action against a corporate insider seeks to disregard the corporate entity [and] to subject corporate assets to the claim,’ involving an outsider seeking to obligate a corporation for the debts of a dominant shareholder or other corporate insider.

- The *Phillips* court limited its review to ‘outside claims.’
Reverse Piercing

- In an outsider reverse pierce, the creditor seeks to access the assets of the entity in order to satisfy the owner’s debt to the judgment-creditor. In the context of a corporation, outsider reverse piercing has traditionally been rare in that the judgment-creditor has had as an available remedy the seizure and sale of the judgment-debtor’s corporate stock. That seizure and sale has afforded a mechanism by which the judgment-creditor could at least in part made whole. As noted above, outsider reverse piercing has been recognized by the Colorado Supreme Court. Courts should categorically reject an effort to reverse pierce to permit the owners to enjoy the benefit of entity assets. One is reminded of the classic description of chutzpah, namely killing your parents and then throwing yourself on the mercy of the court because you are an orphan. See, e.g., Wingate v. Celebrity Cruises, Ltd., 79 So. 3d 180, 183 n.5 (Fla. Dist. Ct. App. 2012); Steven B. Spector, “Chutzpah and the Law,” 87 Law Libr. J. 357, 375 (1995); see also J. A. Simpson & E. S. C. Weiner, 3 THE OXFORD ENGLISH DICTIONARY 209 (2d ed. 1991) (defining the term “chutzpah”). As recently observed by the Kentucky Supreme Court in Turner v. Andrew, 413 S.W.3d 272 (Ky. Nov. 21, 2013), responding to the assertion that the single member of an SMLLC should be able to pursue on his own account a claim for lost profits suffered by the LLC:

- The LLC and its solitary member, Andrew, are not legally interchangeable. Moreover, an LLC is not a legal coat that one slips on to protect the owner from liability but then discards or ignores altogether when it is time to pursue a damage claim.
Reverse Piercing

- As a general proposition, courts have rejected efforts by members to ignore the LLC and to treat its assets as their own. For example:
  - Zipp v. Florian (member of a LLC lacked standing to bring suit based upon damage to property owned by LLC) 2006 WL 3719373 (Conn. Super. Ct. Nov. 13, 2006);
  - Finley v. Takisaki (members of a LLC lacked standing to assert a claim for injury to the LLC) 2006 WL 116794 (W.D. Wash. April 28, 2006);
  - Carey v. Howard (members of LLC lacked standing to sue for declaratory relief with respect to option agreement between LLC and third-party) 950 So. 2d 1113 (Ala. 2006);
  - In re Breece (refusing to allow a sole member of an LLC to reverse pierce the LLC holding title to the house in which she resided) 414 B.R. 499 (Bankr. D. Minn. 2009);
  - In re Hecker (rejecting insider reverse piercing to claim homestead exemption) 950 So.2d 1131 (Ala. 2006);
Reverse Piercing

- *In re Rehabilitation of Centaur Insurance Co.* (citing with approval the principle that general law mandates that piercing must never be made in favor of a corporation or its shareholders) 632 N.E. 2d 1015 (Ill. 1994);

- *Maine Bank of Chicago v. Baker* (stating that a party “cannot assert the equitable doctrine of piercing the corporate veil to disregard the separate corporate existence of a corporation he himself created to gain an advantage which would be lost under his present contention”) 427 N.E.2d 94 (Ill. 1981);

- *3519-3513 Realty, LLC v. Law* (holding the member of an LLC could not utilize the statutory right of property owner to “personally occupy a unit” in a multi-unit dwelling when the LLC, and not the member, was the owner of the property) 967 A.2d 954, 955-56 (N.J. Super. Ct. App. Div. 2009);

- *Northeast Realty, L.L.C. v. Misty Bayou, L.L.C.* (members of a LLC lacked standing to intervene in an action against a LLC to quiet the tax title because claim of ownership of property in dispute belongs to the LLC) 920 So.2d 938 (La. Ct. App. 2006);

- *Cortellessa v. Town of Smithfield Zoning Board of Review* (sole member of LLC lacked standing to appeal zoning decision on property that the sole member had conveyed to the LLC) 888 A.2d 979 (R.I. 2005).
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Piercing the Corporate Veil: Minimizing Alter Ego Liability for Subsidiaries, Affiliates and Related Entities

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