Piercing the Corporate Veil

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Agenda

- Review of legal liability.
- How to “quack” like a corporation.
- When and why the corporate veil will be pierced.
- Review of fraud.

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Ed's Dump Truck Company (EDTCo)

Company Assets

- Dump truck ($100,000).
- Office furniture ($2,000).
- Office equipment ($1,000).
- Cash on hand ($10,000).
- **Total = $113,000.**

Ed's Assets

- Residence($250,000).
- Two vehicles ($75,000).
- Lake cabin ($125,000).
- Farm up in Tennessee ($200,000).
- **Total = $650,000.**

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Event: Accident on Parkway 1

- EDTCo is sole proprietorship.
- Employees (other than Ed): 1.
  - Ed's wife who answers phone at home.
- Ed is driving.
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed's potential loss: **EVERYTHING!**

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Event: Accident on Parkway 2

- EDTCo is sole proprietorship.
- Employees: 2.
  - Ed’s wife who answers phone at home.
  - Bubba who drives dump truck.
- **Bubba is driving.**
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed’s potential loss: **EVERYTHING!**

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Vicarious liability, a.k.a. respondeat superior

- Principal is liable for the acts of agents.
- Bubba is Ed’s agent.
- Therefore, Ed is responsible for Bubba’s act in causing accident.

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Event: Accident on Parkway 3

- **EDTCo is incorporated.**
- Employees: 1.
  - Ed's wife who answers phone at home.
- **Ed is driving.**
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed's potential loss: **EVERYTHING!**

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Individual Liability

- Corporate veil doesn't protect a "real" person who commits a tort.
- In this example, plaintiff would be able to sue and collect from both—
  - Corporation.
  - Ed (because Ed was driving).

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Event: Accident on Parkway 4

- **EDTCo is incorporated.**
- Employees: 2.
  - Ed's wife who answers phone at home.
  - Bubba who drives dump truck.
- **Bubba is driving.**
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed's potential loss: **only corporate assets.**

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Scenario	Entity	Driver	Potential Loss
1	Sole Proprietor	Ed	Everything
2	Sole Proprietor	Bubba	Everything
3	Corporation (LLC)	Ed	Everything
4	Corporation (LLC)	Bubba	**Only corporate assets ($113,000)**

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Notes on other entities

- General **partnership** does **not** limit individual liability as corporation does.
- **Alabama** limited liability company **does** limit individual liability in same way corporation does.
  - LLCs formed in other states may not limit in same way as Alabama LLCs do.

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Summary of general principle of corporate tort liability

- Generally, shareholders will not be individually responsible for torts unless the shareholder actually committed the tort as an agent of the corporation.

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Summary of general principle of corporate contract liability

- Generally, shareholders will not be individually responsible for breach of contract.

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Shareholder liability for corporate debts

- Generally, shareholders will not be responsible for corporate debts unless shareholders undertake that responsibility.
- This explains why shareholder-president of small corporation will typically have to sign a note (bank loan) both as corporate officer and as individual.

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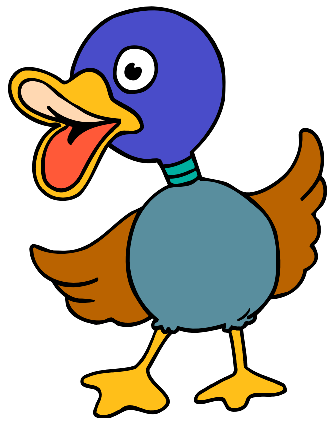
How to "quack" like a corporation:



Observing corporate formalities

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"Quack" like a corporation

- Have separate bank accounts for shareholder(s) and corporation.
- Don't comingle funds.
  - Don't use corporate funds for personal use.
  - Document loans from—
    - Shareholder to corporation.
    - Corporation to shareholder.

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"Quack" like a corporation

- Use corporate name. ("Inc." is important.)
  - Checks.
  - Invoices.
  - Purchase orders.
  - Letters (signature block especially).
  - Contracts.
  - Estimates.
  - Advertising materials.

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"Quack" like a corporation

- Have shareholder meetings.
- Keep corporate minutes.
- Record stock transfers.
- Have corporate financial records ("books").
- File required corporate reports (tax returns).

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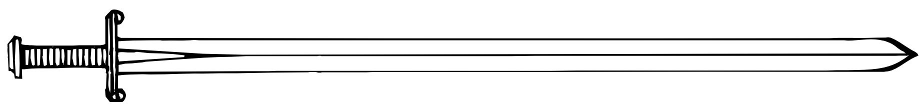
Why and when will the corporate veil be pierced?



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Initial observation

- Piercing the corporate veil is like lightning:
  - Rare.
  - Severe.
  - Appears unprincipled.

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But does have general principles

- To do justice.
- To prevent unethical, immoral, or otherwise illegal behavior from being protected by corporate structure.
- To place the burden of the loss upon the party who should be responsible.
- Arises from equity, not law.
  - Means it's more in the **discretion** of the court.

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Failure to observe corporate formalities

- Failure to observe **by itself** will almost never be enough to pierce corporate veil.
- No Alabama case has ever done this.
- Formula for piercing:

  Failure to observe + something else.
- Observing will not be an absolute defense, but observing is still good defensive evidence.

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Conditions justifying piercing

1. Fraud in formation, operation, or dissolution of corporation.
2. Use of the corporation to avoid a just obligation.
3. Use of corporation as an instrumentality of its controlling shareholder.

These conditions often overlap.

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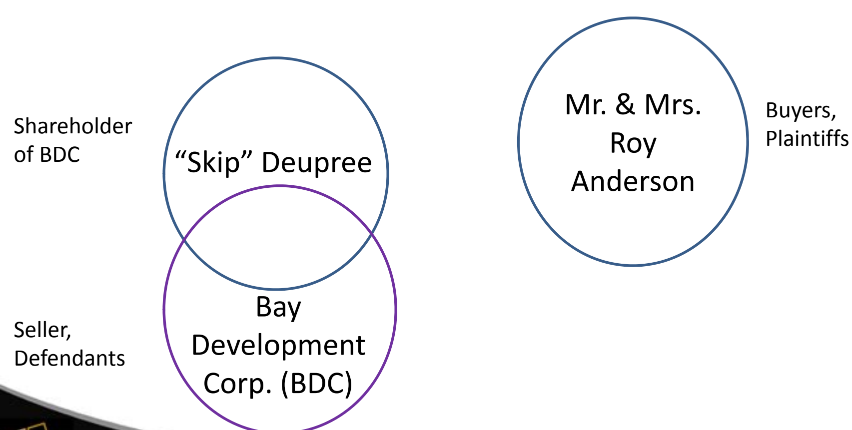
Example of fraud: Deupree v. Ruffino

505 So.2d 1218 (Ala. 1987)



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Fraud (continued)

- Plaintiffs bought townhouse that was supposed to have a boat dock.
- At time of closing, Deupree told Andersons that approval of boat dock was expected "at any time."
- Money put in escrow for boat dock.
- Boat dock never built.

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Fraud: At closing, Deupree knew—

- Docks had to be approved by Bureau of Land Management (BLM) and Dept. of Natural Resources (DNR).
- Other landowners had objected to boat docks.
- A public hearing was required.
- He had done some unauthorized construction, which had been discovered.
- He had told BLM and DNR that townhouse owners would be responsible for building docks.

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Fraud (continued)

- At trial, court found Deupree had committed fraud.
- Deupree raised defense of corporate veil.

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Fraud (continued)

- Court pierced corporate veil because BDC—
  - Was a paper corporation.
  - Had never issued stock.
  - Had never adopted bylaws.
  - Had no accounting books.
  - Had no employees.
  - Funds were comingled with Deupree's finances, as well as with two other entities.

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Fraud (continued)

- Court concluded that Deupree had—
  - Committed fraud.
  - Was therefore **individually** responsible for fraud, despite corporate veil.

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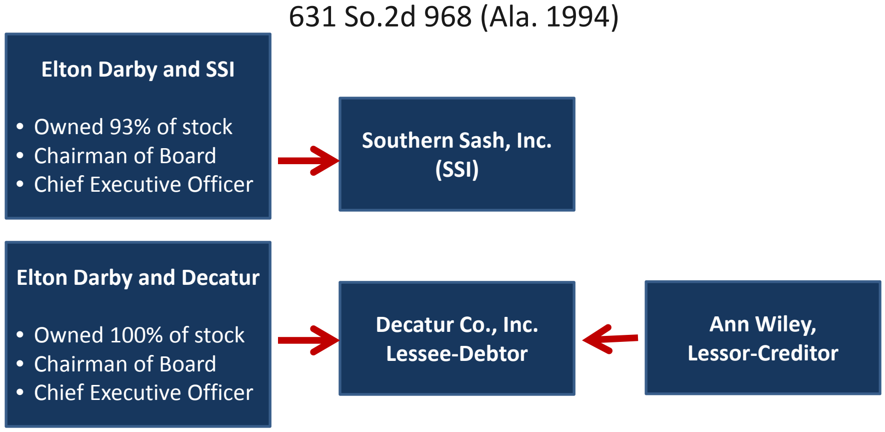
Example of avoiding just obligation: Southern Sash v. Wiley

631 So.2d 968 (Ala. 1994)



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Just obligation example (continued)

- **1977:** Darby loaned Decatur Co. $920,980.
- **1983:** Darby filed financing statement with Ala. Secretary of State. All of Decatur Co.'s assets secured the loan.
- **1988:** Continuation statement filed 5 years later.
- **Sept. 4, 1989:** Darby demanded Decatur Co. make full payment by Dec. 31, 1989.

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Just obligation example (continued)

- **Dec. 14, 1989:** Because Decatur Co. hadn't paid its rent, Wiley got judgment against Decatur Co.
- **Jan. 1990:** Decatur Co. didn't pay Darby.

  So Darby notified Decatur Co. to assemble all its assets for possession and sale by the creditor.
- **Feb. 15, 1990:** Assets of Decatur Co. sold to Southern Sash for $411,295 in private sale.

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Just obligation example (continued)

- **After Feb. 15, 1990:** Because Decatur Co. had no assets, Wiley not able to satisfy judgment.
- Wiley sued Darby and Southern Sash.
- Wiley won. Jury found Darby and Southern Sash liable for $95,536.
  - $83,036 in compensatory damages.
  - $12,500 in punitive damages.

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Corporate veil pierced because—

- **Feb. 8, 1990:** Southern Sash took over bank account of Decatur Co.
- **Feb. 12, 1990:** Directors of Southern Sash voted to transfer Decatur Co. bank account to Southern Sash.
  - This was 3 days before Southern Sash acquired assets of Decatur Co. by private sale.
  - Didn't even change bank account number.

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Corporate veil pierced because—

- After purchasing Decatur Co., Southern Sash operated Decatur Co.—
  - At same location.
  - Under same name.
  - With same company sign.
  - With same employees.
  - Same telephone number and same directory listing.
- Purchased privilege license in name of Decatur Co. 5 days after purchase of assets.

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Corporate veil pierced because—

- State, county, and city sales tax returns continued to be filed in name of Decatur Co. for 7 months after purchase of assets.
- Darby's security interest in Decatur Co. assets was allegedly collateral for a loan made by Darby to Decatur Co.
  - But no interest was paid on loan from 1983 forward.
  - No interest was reported on Decatur Co. corporate tax returns.

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Court's conclusion

- Transactions between Southern Sash, Decatur Co., and Darby nothing more than sham and subterfuge.
- Corporate veil will not be used to enable corporation to become vehicle to evade just responsibility.
- **Special observation:** Lots of corporate formalities were observed, but didn't protect shareholder.

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Domination,

a.k.a.
alter-ego approach
or instrumentality tests
for
piercing corporate veil

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Domination elements

- Shareholder (parent corporation) completely dominates and controls finances, policy, and business practices of (subservient) corporation.
- Shareholder used domination and control to commit wrong against plaintiff.
- Domination and control caused the plaintiff’s injury or loss.
- May apply even in absence of fraud.

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Evidence that will support piercing because of domination

- All of these items don’t have to be present, but their presence in a set of facts makes it more likely that corporate veil will be pierced.
- Remember that controlling shareholder may be **parent corporation (PC).**

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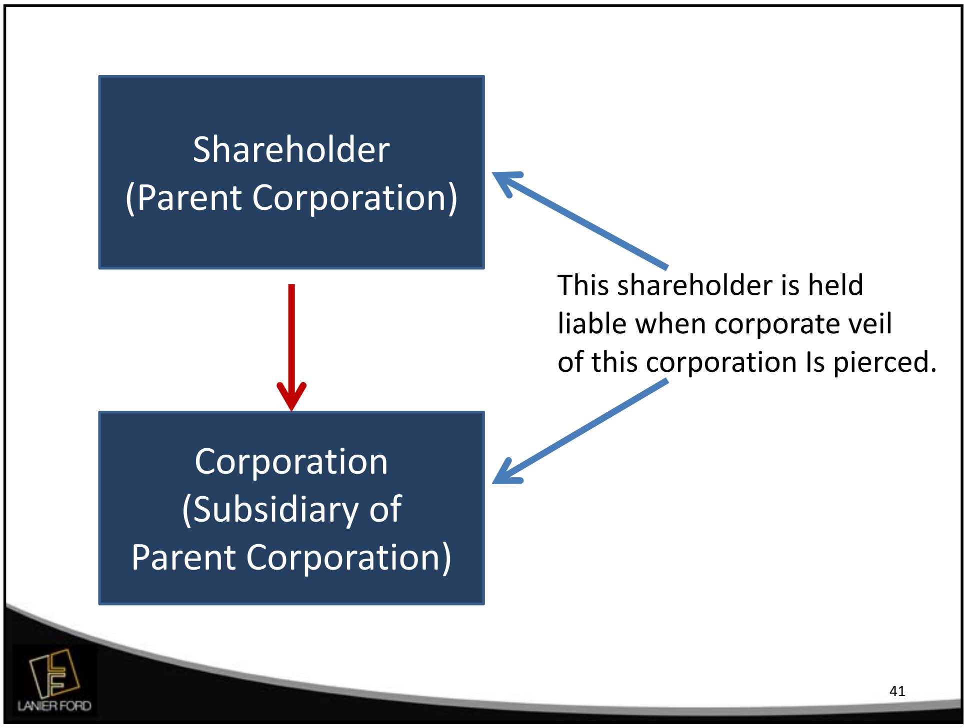

Shareholder may be liable when—

- Corporate formalities are not observed.
- Shareholder owns all or most of the capital stock of corporation.
- Shareholder and corporation have common directors or officers.
- Shareholder finances corporation.
- Shareholder owns all stock in corporation and caused its formation.

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Shareholder may be liable when—

- Corporation has grossly inadequate capital.
- Shareholder pays salaries, other expenses, and losses of corporation.
- Most or all of the corporation's business comes from shareholder.
- Corporation has no assets except those given to it by shareholder. (May have no assets.)

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Shareholder may be liable when—

- Shareholder (parent corporation) describes the corporation as one of its departments or divisions.
- Invoices of corporation are to be paid to shareholder.
- Shareholder uses corporate property as if it were the shareholder's own property.
- Corporation's directors and officers don't act independently in interest of corporation, but take orders from shareholder.

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Domination Example:
Duff v. Southern Railway Co.,

496 So.2d 760 (Ala. 1986)

Defendant — **Southern Ry. Co., Inc.**

Defunct — **Lenoir Car Works, Inc.**

Plaintiff — **Dallas Duff,** Injured Employee of Lenoir

L. R. Garner, Officer of Southern, Managed Lenoir, Director of Lenoir

Lenoir made products used in operation of railroad.

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Plaintiff's objective

- Wanted to receive benefits under Federal Employer's Liability Act (FELA) for injuries plaintiff suffered during his employment at Lenoir.
- FELA applies to employees of railroads similar to Alabama Workers' Compensation Act applies to most Alabama employees.
- Since Lenoir was defunct, Duff would receive no compensation through workers' compensation.

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Key facts allowing piercing

1. Southern owned all of Lenoir's stock.
2. Garner was officer of Southern and director of Lenoir.
3. Southern paid salaries of Lenoir's workers.
4. 99% of Lenoir's business was from Southern.
5. Southern inspected Lenoir plant for safety problems; told Garner to make changes to protect workers.

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Other facts

- Duff's W-2 forms showed him as an employee of Southern.
- W-2 showed that Southern had paid for "social security" insurance under Railroad Retirement Act.
- W-2 showed "sickness" benefits to Duff from Provident Life Ins. Co.
  - Provident was not Lenoir's workers' compensation carrier.

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Injustice averted

- Duff was injured on the job.
- Duff would have gotten no benefits if Southern hadn't been held liable.
- Therefore, corporate veil of Lenoir pierced and Southern held liable for injuries to Duff.

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Review of Fraud

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Remember formula for piercing

- Failure to observe corporate formalities + _______.
- The blank is most often filled with **fraud.**

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What most people think

- Fraud is **lying** about something having to do with business deal.
- But under Alabama law, there are three types of fraud:
  1. Intentional fraud (deceit).
  2. Reckless fraud.
  3. Innocent fraud (constructive fraud).

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Better summary: Fraud is—

- Willfully deceiving another.
  - Asserting truth of something when person doesn't believe it's true.
  - Asserting truth of something when the person has no reasonable way of knowing whether it's true.
  - Suppression of facts when the person has a duty to reveal.
  - Promise made without any intent to perform it.

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Better summary: Fraud is—

- Reckless misrepresentation of fact.
  - Saying something is true without checking on truth when there is an easy way to check.
- Mistaken but innocent misrepresentation of fact.
  - Will not support punitive damages.

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Duty to disclose: Considerations

1. Relationship of parties:
   - Confidential?
   - Fiduciary?
2. Relative knowledge of parties.
3. Value of the fact not disclosed.
4. Plaintiff's opportunity (ability) to ascertain fact.
5. Customs of the trade.
6. Other relevant circumstances.

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Best practices

- Never deliberately lie or misrepresent.
- Don't volunteer information unless you know you have a duty to disclose.
- Answer questions truthfully: "To the best of my knowledge . . . ."
- When a question is asked and you don't know for sure, admit that fact. Offer to check and follow up.
- When there is an independent way to verify facts, don't trust others who've told you something.

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Big takeaway:

You can unintentionally (accidentally) commit fraud!

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Questions?

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