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## **PERSONAL LIABILITY: Piercing the Corporate Veil, a Trap for the Unwary Business Owner.**

### ***I. Limited Liability.***

Most business owners believe that their personal wealth is safe from business creditors when they conduct their business through a corporation or a limited liability company (LLC). Both types of companies can, when properly used, protect the owners and/or related companies from claims asserted by a company's creditors. This protection is particularly valuable when the business falls on hard times or when it is faced with a large law suit.

However, business owners are often not aware of the fact that a corporation or LLC may not always shield its owners and/or related companies from liability, because a Court may, under certain circumstances, rule that the claim against the corporation or LLC may also be asserted directly against the owners and/or related companies. When a Court does this, it is referred to as "piercing the corporate veil."

### ***II. Requirements for Piercing the Corporate Veil.***

A Court will pierce the corporate veil of a corporation when it finds: "(i) that the owner exercised complete domination over the corporation with respect to the transaction at issue; and (ii) that such domination was used to commit a fraud or wrong that injured the party seeking to pierce the veil."<sup>1</sup> This liability theory has also been applied to limited liability companies.<sup>2</sup>

More recently, the United States Bankruptcy Court in Manhattan listed ten factors to be considered in determining whether the control or domination was sufficient to pierce the

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<sup>1</sup> Thrift Drug, Inc. v. Universal Prescription Administrators, 131 F.3d 95 (2<sup>nd</sup> Cir. 1997)

<sup>2</sup> Courts may also pierce the "corporate" veil of Limited Liability Companies. See e.g. Matias v. Mondo Properties, LLC, 841 N.Y.S.2d 279 (1<sup>st</sup> Dept. 2007). The minimum formalities required of an LLC are outside the scope of this article, but should be considered by all LLC owners and their advisors.

corporate veil. The very first factor listed by that Court was: “the absence of corporate formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping corporate records”<sup>3</sup>

The purpose of this Newsletter is to show how corporate owners can take a significant step towards managing the risk of personal liability resulting from a pierced corporate veil by simply signing and filing some basic corporate papers that are enumerated in item IV below. While these papers are usually filed in the corporate minute book that the lawyer provided when the corporation was formed, they can be kept in a substitute minute book if the original book cannot be located...or on a computer hard drive...or in any other safe place.

### ***III. Multiple Company Businesses.***

Businesses are often conducted through multiple corporations and/or LLCs. For example, many retail businesses that operate through multiple retail outlets often set up a separate corporation or LLC for each store. These may be owned directly by the owners or indirectly through a “holding company.” This is also prevalent in the real estate business, where owners usually set up a separate corporation or LLC for each property. This is done to protect the assets of the owners and the separate stores or properties from judgments against another store or property.

However, if the owners are guilty of some combination of the activities described by the Bankruptcy Court in the *Flutie* case (see footnote 2) a Court may pierce the corporate veil to rule that the assets of the owners and/or all the related companies are available to the company’s creditors.

### ***IV. What Should a Business Owner Do?***

First, business owners should be aware of these concerns and treat each company as a separate and distinct entity. For example, each company should have its own separate books and records and separate banking facilities; each company’s inventory must be treated as its own property and not intermingled; any transfer of money from one company to another or to the owners should be treated as a loan or dividend, and if it is a loan it must be repaid; each company should be adequately capitalized; each company should either have its own payroll, or the payrolls should be treated in a way that reflects

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<sup>3</sup> *In re Flutie New York Corp.*, 310 B.R. 31 (US Bkcy. Ct., SDNY 2004). The other nine factors cited were: (2) inadequate capitalization; (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes; (4) overlap in ownership, officers, directors and personnel; (5) common office space, address and telephone number; (6) the amount of business discretion displayed by the allegedly dominated corporation; (7) whether the related corporations deal with the dominated corporation at arms length; (8) whether the corporations are treated as independent profit centers; (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group; and (10) whether the corporation in question had property that was used by other of the corporations as if were its own.

the appropriate allocation among the multiple companies between services rendered and compensation.

Moreover, every business that is conducted through a corporation or corporations should heed the Bankruptcy Court's admonition to observe the "corporate formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping corporate records" particularly since satisfying the minimum obligations of corporate procedure is quite easy. All it requires is that each corporation maintains a minute book – sometimes called a "corporate kit" - which should contain the documents required by the Business Corporation Law. At a minimum, each minute book should include or reflect:

- Certificate of Incorporation (and Amendments, if any)
- Incorporators Action
- By-laws (and Amendments, if any)
- A Stock Subscription and Stock Certificate (or stub) for each Shareholder
- A Stock Ledger which records each Stock Certificate and share transfer
- Resolutions<sup>4</sup> of the First Directors Meeting
- Annual Directors Resolutions for each year of existence
- Annual Shareholders Resolutions for each year of existence
- Special Directors Resolutions for other significant corporate events where another party requires formal proof of approval by the Directors<sup>5</sup>

#### ***IV. An Additional Benefit.***

When a corporation is or its asset are sold, the buyer's attorneys will conduct "corporate due diligence" which usually includes a careful review of the corporate minute book. While the missing documentation can be created at that time, sometimes this will be difficult, particularly if the required signatories are no longer affiliated with the company and/or if the deal must close within a short time span. This is a powerful additional reason for observing these minimal corporate formalities on a regular basis.

Richard H. Waxman, P.C. will answer your questions about this and other corporate law issues, and how they might apply to your business or to your clients' businesses; and we will help you prepare the required documents...all for a reasonable fee. Please call or e-mail if you have any questions.

Very truly yours,

*Richard H. Waxman*

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<sup>4</sup> Corporate resolutions may be adopted at an actual meeting of Directors or Shareholders. However, they may also be adopted, without a meeting, by the Directors or Shareholders signing a document known as a Unanimous Written Consent.

<sup>5</sup> For example, banks usually require Directors Resolutions when a company opens an account or engages in any other significant banking transaction. Also, in leasing transactions, landlords often require Directors Resolutions evidencing that the tenant's Board has authorized one of its officers to sign the lease. These documents should be maintained in the corporate kit.

*If you wish to learn more about our Corporate and Business Law practice, visit the Corporate Law section of our website at: <http://waxmanlaw.com/practice-areas/our-business-and-corporate-law-practice>*

**We encourage you to pass this Newsletter on to people within your organization, and to your clients and friends.**

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