Title: When You are Personally Liable for Corporate Debt: Piercing the Corporate Veil

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Owners and managers of corporations and limited liability companies (LLCs) form corporations and LLCs so they can't be held personally liable for debts of the business, should the business be unable to pay its debts. However, sometimes courts will hold corporate owners, members, and shareholders personally liable for business debts. When this happens it's called "piercing the corporate veil."

In these tough economic times, many small business owners are scrambling to keep their companies afloat, or are closing down. If a corporation or LLC ends up having to shut its doors, the last thing a small business owner wants is to have to pay the business's debts. But when cash is tight and owners aren't careful, and an unpaid creditor sues for payment, a court might "pierce the corporate veil" (lift the corporation or LLC's veil of limited liability) and hold the owners personally liable for their company's business debts.

Need to Pierce a Corporate Veil?

> If you are a business or service provider who provided goods or services to a company and didn't receive payment, you are on the other side of the problem. You may have tried to sue for payment, but when you attempted to collect the court judgment or debt, you found out the company is "defunct" (closed down) and has no assets. If you're lucky, the defunct company's owners may still have assets (and may even plan to go on to use their assets and contacts to start a new corporation or LLC and defraud more creditors). You may be able to access the owners' assets by "piercing the corporate veil." We'll discuss this further below.

Corporate Liability for Business Debts

Corporations and LLCs are legal entities, separate and distinct from the people who create and own them (called corporate shareholders or LLC members). One of the principal advantages of forming a corporation or an LLC is that, because the corporation or LLC is considered a separate entity (unlike partnerships and sole proprietorships), the owners and managers have limited personal liability for the company's debts. This means that the people who own and run the corporation or LLC cannot be held personally responsible for the debts of the business.

However, there are some exceptions to this general rule. In certain situations, courts can ignore the limited liability status of a corporation or LLC and hold its officers, directors, and shareholders or members personally liable for its debts. When this happens, it is called piercing the corporate veil. Closely held corporations and small LLCs are most likely to get their veils pierced (corporations that are owned by one or just a few people are called closely held corporations, or close corporations for short).

Effects of Piercing the Corporate Veil

If a court pierces a company's corporate veil, the owners, shareholders, or members of a corporation or LLC can be held personally liable for corporate debts. This means creditors can go after the owners' home, bank account, investments, and other assets to satisfy the corporate debt. But courts will impose personal liability only on those individuals who are responsible for the corporation or LLC's wrongful or fraudulent actions; they won't hold innocent parties personally liable for company debts.

When Courts Will Pierce the Corporate Veil

Courts might pierce the corporate veil and impose personal liability on officers, directors, shareholders, or members when all of the following are true.

- **There is no real separation between the company and its owners.** If the owner(s) fail to maintain a formal legal separation between their business and their personal financial affairs, a court could find that the corporation or LLC is really just a sham (the owner's "alter ego") and that the owners are personally operating the business as if the corporation or LLC didn't exist. For instance, if the owner pays personal bills from the business checking account or ignores the legal formalities that a corporation or LLC must follow (such as making important corporate or LLC decisions without recording them in minutes of a meeting), a court could decide that the owner isn't entitled to the limited liability that the corporate business structure would ordinarily provide.
- **The company's actions were wrongful or fraudulent.** If the owner(s) recklessly borrowed and lost money, made business deals knowing the business couldn't pay the invoices, or otherwise acted recklessly or dishonestly, a court could find financial fraud was perpetrated and that the limited liability protection shouldn't apply.
- **The company's creditors suffered an unjust cost.** If someone who did business with the company is left with unpaid bills or an unpaid court judgment and the above factors are present, a court will try to correct this unfairness by piercing the veil.

Factors Courts Consider in Piercing the Corporate Veil

The most common factors that courts consider in determining whether to pierce the corporate veil are:

- whether the corporation or LLC engaged in fraudulent behavior
- whether the corporation or LLC followed corporate formalities
- whether the corporation or LLC was adequately capitalized (if the corporation never had enough funds to operate, it was not really a separate entity that could stand on its own), and
- whether one person or a small group of closely related people were in complete control of the corporation or LLC.

Some corporations and LLCs are especially vulnerable to violating the above factors inadvertently, simply because of their size and business practices. Closely held companies are more susceptible to losing limited liability status than large, publicly traded corporations. There are several reasons for this.

Failure to Follow Corporate Formalities
Small corporations are less likely to observe corporate formalities than their larger counterparts, which makes them more vulnerable to piercing the corporate veil.

To avoid trouble, it's best to play it safe. It's important for small corporations and LLCs to comply with the rules governing formation and maintenance of a corporation, including:

- holding annual meetings of directors and shareholders or members
- keeping accurate, detailed records, called "minutes," of important decisions that are made at the meetings
- adopting company bylaws, and
- making sure that officers and agents abide by those bylaws.

Commingling Assets
Small business owners may be more likely than their larger counterparts to commingle their personal assets with those of the corporation or LLC. Some small business owners divert corporate assets for their own personal use, for example, by writing a check from the company account to make a payment on a personal mortgage. Or, by depositing a check made payable to the corporation into the owner's personal bank account. This is called "commingling of assets."

To avoid trouble, the corporation should maintain its own bank account and the owner should never use the company account for personal use or deposit checks payable to the company in a personal account.

How to Avoid Getting Your Veil Pierced
If you are a director, shareholder, or member of a corporation or LLC, take the following steps to ensure that a court won't pierce your corporate veil.

- Comply with formal rules for forming and maintaining a corporation or LLC.
- Maintain a separate bank account for the corporation or LLC.
- Don't commingle personal assets with those of the corporation or LLC.
- Don't divert corporate or LLC assets for personal use.
- Make a reasonable initial investment in the corporation or LLC so that it is adequately capitalized.
- Don't tell a creditor that you will personally guarantee payment of the corporation or LLC's debts.
- Don't use the corporation or LLC to engage in illegal, fraudulent, or reckless acts.
- Make sure the world knows they are dealing with a corporation or LLC by conspicuously identifying the company status (that is, "Inc." or "LLC") on all business cards, letters, quotes, invoices, statements, directory listings, advertisements, and all other forms of company communication. When signing company documents, clearly state your representative capacity (such as, "Jane Doe, President, Acme LLC.")

If you are sued personally for the debts of your business (a lawsuit names you and your business as defendants, or a creditor threatens to name you personally in a lawsuit), you may need the help of a business attorney to defend yourself.

How to Pierce a Corporation or LLC's Veil

If you're on the other side of the fence, trying to collect from a defunct corporation or LLC on an unpaid debt or court judgment, you may be able to pierce the corporation or LLC's veil and obtain a court judgment against the owners of the company.

First, read the information above to see if the business from which you want to collect seems susceptible to getting its veil pierced. If it's a small business, you'll have an easier time of it. Many small businesses operate without sufficient funding and without following corporate or LLC formalities. When these businesses make deals that can be considered reckless or fraudulent, a court may lift their corporate veil so that the owners' personal assets can be taken.

Large corporations are not immune from losing their limited liability status either. Courts will often pierce the corporate veil of a large corporation when the officers or directors create a subsidiary corporation and transfer debts to that subsidiary. In one scheme, the owners of a large corporation incorporate several undercapitalized subsidiaries (companies that do not have enough money to support their operations). The large corporation (called the "parent corporation") finances the operations of and exerts control over the subsidiaries. Such subsidiaries are commonly called dummy corporations or corporate shells.

When creditors seek to collect debts from or enforce a court judgment against a dummy corporation, they are often out of luck because the dummy corporation does not have sufficient assets to collect. In this situation, a court might pierce the corporate veil of the parent corporation, allowing the creditor to collect from the owners or members of the parent corporation. This prevents the creditor from suffering "unjust cost."