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“PIERCING THE CORPORATE VEIL”

Corporations are routinely used to protect the owners of a business from personal liability for claims made against the business. For California corporations, this limitation on liability is by judge-made “common” law and not by statute. Courts have also recognized situations in which the general limitation on shareholder liability will not be respected. In these situations, the courts are said to “pierce the corporate veil.”

Attempts are made to pierce the corporate veil in hundreds of California cases each year. For business owners, it is important to avoid a false sense of complacency that leads to sloppiness about the “corporate formalities” (listed below). The marketing folks might not want to use “Inc.” at the end of the corporation’s name, but the shareholders -- and not the marketing folks -- are going to pay the judgment if the “corporate veil” is “pierced.”

Overview

The failure of corporate officers, directors and shareholders to respect the corporate formalities may have serious adverse consequences.

- The corporation could be disregarded as a taxable entity in certain circumstances, resulting in direct taxation

of the shareholders on corporate income.

- Significant transactions between the corporation and third parties could be attributed to the shareholders, resulting in tax consequences to the shareholders rather than to the corporation.

- The form of transactions and agreements between the shareholders and the corporation could be disregarded, potentially resulting in various adverse income tax consequences (for example, unintended dividends to the shareholders).

- Third parties could succeed in piercing the corporate veil, potentially resulting in shareholder liability for corporate obligations.

The Corporate Formalities

To minimize the risk of the corporate veil being pierced, the shareholders and officers must respect the “corporate formalities,” such as:

1. Regular shareholders’ and directors’ meetings should be held, and documented by minutes (or consents to action taken without meeting), and these should be signed and inserted in a minute book;

2. Stationery, business cards, invoices and web pages should have the corporate name (including “Inc.”);

3. Shareholders who are officers should sign in their capacity as officers (not as “owners” and not as directors);

4. Eliminate the word “partner” from your business vocabulary;

5. Maintain separate personal and corporate bank accounts;

6. When there are several entities, each should have its own bank account;

7. Carefully document and account for transactions between the shareholders and the corporation (such

as salary, bonuses, rents, royalties, loans, contributions to capital, distributions to shareholders); and

8. When there are multiple corporations under common control, document intercorporate transactions with leases, invoices, promissory notes and corporate resolutions, and make adequate bookkeeping entries for the transactions.

9. The Board of Directors should approve each distribution when it is made (including distributions from a subsidiary to a parent). The directors can do this by consenting in writing to action taken without meeting, so long as they all sign the consent.

In addition to these formalities, the corporation must be adequately capitalized to satisfy reasonably anticipated claims against the business.¹

To avoid confusion regarding the capacity in which a particular document is signed, any document requiring the signature of the corporation should set forth the name of the corporation, the name of the person signing on behalf of the corporation, and the title of the office held by such person.

¹ Shafford v. Otto Sales, 149 Cal. App. 2d 428, 431 (1957); Pan Pacific Sash & Door Co. v. Greendale Park, 166 Cal. App. 2d 652 (1958). Most or all of the reported “low capitalization” cases in California are really “no capitalization” situations and they are claims of creditors, not injured parties. The courts focus on paid-in capital, not total equity, probably because these cases involve failed

businesses with no retained earnings. These claims would not have been covered by liability insurance. For claims that would be covered by liability insurance, it seems that the courts would be satisfied with a reasonable combination of capital and insurance coverage, but I can’t point to cases that reach this conclusion.

Here is an example of a proper signature block:

ANYCORP, INC.,
a California corporation

By _____
Donna Any, President

This form of signature clearly indicates that the document is being signed by and on behalf of the corporation and not by an individual. The word "Inc." is an important part of the signature block. A proper signature provision can minimize the risk of individual liability and, in addition, helps preserve the corporation as a separate entity.

The Two Steps

In some states, courts can pierce the corporate veil if the owner or owners of the corporation have disregarded the corporate formalities. When a court finds that a corporation that has not sufficiently respected the corporate formalities, the court concludes that

the corporation is the "alter ego" of the shareholder or shareholders.

Before courts applying California law can pierce the corporate veil, the court must also find that respecting the corporate form would work an injustice.² In 1921 the California Supreme Court stated:

Before the acts and obligations of a corporation can be legally recognized as those of a particular person, and vice versa, the following combination of circumstances must be made to appear: First, that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of the said person and corporation has ceased; [S]econd, that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.³

² "The issue is not so much whether, for all purposes, the corporation is the 'alter ego' of its stockholders or officers, nor whether the very purpose of the organization of the corporation was to de-fraud the individual who is now in court complaining, as it is an issue of whether in the particular case presented and for the purposes of such case justice and equity can best be accomplished and fraud and unfairness defeated by a disregard of the distinct entity of the corporate form." *Kohn v. Kohn*, 95 Cal. App. 2d 708 (1950). "In general the two requirements for

application of the alter ego doctrine are (1) that there [is] such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow." *Shapoff v. Scull*, 222 Cal. App. 3d 1457, 1469-70 (1990) (quoting *Automotriz etc. De California v. Resnick*, 47 Cal. 2d 792, 796 (1957)).

³ *Minifie v Rowley*, 187 Cal. 481, 487 (1921).

LLCs

A California limited liability company offers to its members protection from the LLC's obligations that is similar to the protections that using a corporation offers to its shareholders.

One could say that the LLC's protection is stronger, because it is provided by statute, whereas the shareholders' protection is under the common law, which judges can change.⁴ In addition, the failure to hold meetings or to have minutes of them is not a factor that can influence a court to treat the LLC as the alter ego of its owners – unless the articles of organization or operating agreement require such meetings.⁵

Otherwise, a court can pierce the “corporate” veil of an LLC for the

same reasons that it could pierce the corporate veil of a corporation.⁶ However, LLCs have existed in the USA only since the 1980s and in California only since 1994. While there are hundreds of cases in the USA and the UK denying attempts to pierce the corporate veil, there are only a few for LLCs. This more of a concern when LLCs were new. As the years go by and bankruptcy courts routinely respect the protection that the LLC provides to its members from the liabilities of the LLC, this concern lessens, but does not disappear.

Conclusion

Because shareholders of a corporation or LLC can never be certain how a court will decide the second prong (avoiding an injustice), it is important to take all reasonable steps to respect

⁴ Cal. Corp. Code § 17703.04(a).

⁵ Cal. Corp. Code § 17703.04(b).

⁶ *Id.*

the “corporate” formalities. Think of the corporation or LLC as a knight’s shield. A shield is useful when the knight holds it up. It is not useful when the knight leaves the shield with the squire because the shield is too heavy to carry in combat. A more current analogy would be a police officer who leaves his or her Kevlar vest in the locker because it is too hot to wear.

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I regularly help officers update their minutes and review their compliance with the corporate formalities. Contact me if you would like to discuss your situation.

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