

QUESTIONS AND ANSWERS

"Piercing The Corporate Veil"

Q: What is this thing called "piercing the corporate veil?"

A: "Piercing the corporate veil" is the popular name for a remedy used by creditors and their attorneys in a legal action to hold the individual behind a corporation personally liable for the debts of the corporation.

Q: When can a creditor receive this type of remedial relief from the courts?

A: The general rule is that a corporation and its shareholders are to be recognized as having a separate existence, but equity in some instances will treat a corporation and its owners as identical. Courts reason that since the idea of a corporate entity is only a legal fiction, i.e., a creature of law, it can be disregarded when it's necessary to do so in order to afford justice and prevent fraud.

Q: Can you be more specific? What kinds of things does the court look for before allowing creditors to reach the individuals behind the corporation?

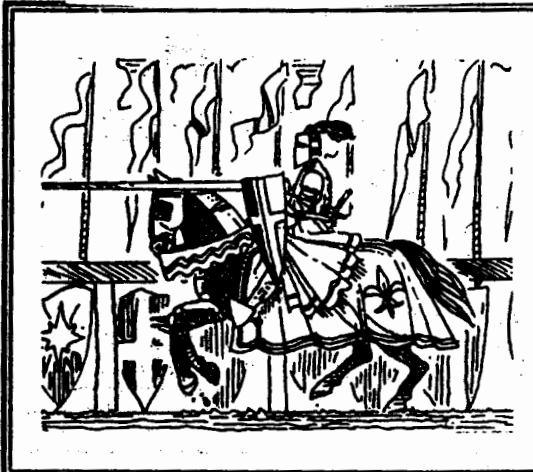
A: Generally, there are five factors which a court will examine closely. These factors are: 1) who controls the corporation, 2) whether the corporation is undercapitalized, 3) whether the corporate formalities are maintained, 4) estoppel, and 5) the splitting of the economic unit.

Q: How does the factor of control enter into it?

A: Well, control of a corporation by a single shareholder, of course, does not itself trigger a piercing of the corporate veil. If you are seeking the remedy as a creditor, however, ownership and control of the corpora-

tion by those you are seeking to hold individually liable is necessary.

The shareholder you are seeking to hold liable must himself have totally disregarded the corporate entity by reducing it to what the courts call a mere "instrumentality" or "alter ego" of himself. His control must be pervasive and also exercised in such a way as to defraud or otherwise injure you as the creditor. If the shareholder always acted, however, as if he and the corporation were one and the same, then the element of control is present.



Q: What about lack of sufficient capitalization?

A: Inadequate capitalization depends upon a variety of circumstances, including the corporation's reasonably anticipated liabilities. But the general rule is well established that once demonstrated, inadequate capitalization may be a factor in a decision to disregard the corporate entity by the court.

The time that the corporation is formed is usually the time to look at the question of whether capitalization is adequate. Subsequent insolvency

due to gross mismanagement by the owners, however, may also be considered.

Q: How does the maintaining of corporate formalities figure into this?

A: In small corporations particularly, corporate formalities are frequently disregarded. Typically, the owner might conduct business under his individual rather than his corporate name, might fail to hold directors' meetings on a regular basis, and fail to keep corporate minutes. More seriously, the owner may mingle corporate with individual funds.

Q: What does "estoppel" mean, and how does it fit into piercing the corporate veil?

A: "Estoppel" is a legal doctrine by which a person is prohibited by his own prior actions from claiming a right to the detriment of another party entitled to rely upon the first party's prior conduct. That is, the prior actions are inconsistent with the defense the person is now asserting. In the context of piercing the corporate veil, estoppel is used to describe the court's response if misrepresentations have been made or deceptive appearances have been permitted to go uncorrected to such a point that it would be unfair to allow a corporation's owner to limit his liability.

For example, a stockholder may represent himself as being personally liable for corporate obligations, thus disregarding the division between himself and his corporation. Another example occurs when a creditor is not even informed that he is dealing with a corporation and is thus misled into

believing that the individual's personal assets are available for his recovery should he have to sue for payment of the debt.

Q: The fifth factor you mentioned was the splitting of the economic unit. What do you mean by that?

A: Some debtors, either because they wish to spread liability out or are simply experiencing financial difficulty, choose to set up a number of different corporate entities under which to conduct business. Each individual corporation might have very limited assets, but significant liabilities. If the court believes that the debtor has gone too far in thus thinning out the assets available to his creditors, especially when creditors are of the belief that they are dealing with an individual rather than any corporate entity, those creditors seeking to pierce the corporate veil of any of the corporate units may find a court sympathetic to their plight.

Q: Must a creditor seeking to pierce the corporate veil show all five of these factors in order to prevail?

A: No, not necessarily. The more such factors a creditor can establish in any case, the more likely it is to prevail. This is because the more of these elements which are present, the more likely it is that a court will find it inequitable to allow an individual debtor to hide behind the legal fiction of the corporate veil.

Q: Is piercing the corporate veil an easy remedy to obtain?

A: No. The shielding of the individual from personal liability is not only a perfectly legitimate reason to incorporate a business, but also frequently the principal motivation for incorporation. The legal fiction of the corporation is an essential part of our modern commercial world. Nevertheless, abuse of the corporate entity, when present in the right case, can result in a creditor receiving this rare form of relief.

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