

PIERCING THE VEIL OF SMALL BUSINESS: WHAT THE OWNERS OF LLCs AND CORPORATIONS NEED TO KNOW



“Piercing the veil is a remedy in which courts will disregard the corporation or LLC’s separate existence.”

One of the main reasons—if not the main reason—people [form corporations and limited liability companies](#) to own and operate their small businesses is to avoid personal liability for the business’ debts.

Corporations and LLCs have their own legal existence. It is the corporation or LLC that owns the business, its assets, debts, and liabilities. The shareholders or members own the corporation or LLC and their liability is limited to their investment.

Limited shareholder and member liability is a well-established and respected rule. Long ago legislators and judges recognized that few people could afford to start or invest in new businesses if they could lose everything if the business failed. However, as with most rules, there are exceptions. One is a legal concept known as “piercing the veil”. (It is also generally referred to as piercing the corporate veil. But because it applies to LLCs as well we will refer to it as piercing the veil or veil piercing.)

WHAT IS PIERCING THE VEIL?

Piercing the veil is a remedy in which courts will disregard the corporation or LLC’s separate existence. With the entity no longer in the picture the shareholder or member becomes liable for the business’ debts.

Piercing the veil can become an issue for businesses of all sizes. However, it is most often seen in the case of a corporation or LLC with one or only a few owners, where the corporation or LLC is unable to pay a debt. Typically, the creditor will successfully sue the corporation or LLC for the unpaid debt. Then, if the corporation or LLC fails to pay, the creditor will sue the [shareholders or members](#), asking the judge to pierce the veil to hold the shareholder or member personally liable.

In deciding whether to pierce, the courts apply various tests. One of the most frequently used tests looks for two things: first, “a unity of interest” between the corporation or LLC and its owners such that their separate identities cease to exist, and second, that the corporation or LLC was used to perpetrate a fraud or achieve an inequitable result.

UNITY OF INTEREST TEST

What the unity of interest test basically asks is whether the shareholders or members respected the fact that the corporation or LLC owns the business. There are a number of factors the courts will look at. The main ones are the following:

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1. Was the corporation or LLC undercapitalized?

This does not mean that the corporation or LLC was unable to pay its bills because it was not profitable. Courts recognize that many businesses lose money. Instead, undercapitalization means that the shareholders or members formed the corporation or LLC without providing it with enough capital to carry out its normal business functions and meet its reasonably anticipated obligations.

2. Were the business assets used by the shareholder or member for personal purposes?

If the shareholders or members use the business' asset for personal purposes this is a sign that they are not respecting its separate existence. An example would be where the company car is used to run personal errands.

3. Were the corporation or LLC's funds used for personal expenses?

Using the corporation or LLC's bank account to pay personal expenses is a major red flag for the courts. It not only indicates a disrespect for the entity's separate existence but is often one of the main reasons why the corporation or LLC could not pay its debt to the creditor.

4. Was there a failure to follow the compliance requirements of the governing business entity statute?

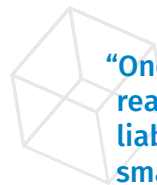
Especially in the case of a corporation, a court will look to see if formalities were followed - such as holding shareholder and director meetings, issuing stock, keeping minutes, and documenting the actions taken. Although an LLC can be run more informally, evidence that meetings were held, records were kept, and business actions documented, does show a respect for the LLC's own existence.

The courts may also look to see if other [compliance requirements](#) were met - such as filing an annual report, obtaining business licenses, making an assumed name filing if such a name is being used, and appointing and maintaining a registered agent (particularly one that is not a shareholder or member). A failure to do so will not be grounds for piercing the veil. But it is more evidence for the courts that the entity's separate existence is not being respected.

EVIDENCE OF INEQUITABLE RESULTS

A court will pierce the veil only if a failure to do so will result in an injustice. This requires more than evidence that a creditor will not get paid. It requires evidence that the corporation or LLC was used in some way to perpetrate

a fraud or accomplish some other wrongful purpose. For example, if the shareholders or members formed the entity knowing that they were not providing enough startup capital to satisfy its contractual obligations, or intentionally moved the company's assets out of a known creditor's reach so that the debt could not be paid.



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Actions such as those may be considered by courts as abusing the corporate or [LLC form](#). For example, an Alabama court pierced the veil of a solely owned corporation that was hired to do construction work on a house. The shareholder testified that the corporation had no money when the contract was made, that she made no attempt to make sure the corporation had enough money to complete the project, and that she and a friend used the corporation's bank account - which consisted only of the funds from the plaintiff - for personal purchases at jewelry and sporting goods stores, car services, restaurants, and more.

In another example, an Iowa court pierced the veil of an LLC owned by a husband and wife. The business hatched eggs and grew chickens. An expert witness testified that this type of business should have been capitalized with at least \$1 million at formation. However, the members never had a projection made about the capital needs and formed the LLC with almost no capital. They also provided financial statements of related solvent entities to the plaintiff - their egg supplier - and misrepresented that those entities backed the LLC. The members also continued to accept deliveries of eggs even though they knew there was no income coming in to pay for them.

CONCLUSION

By [incorporating](#) or forming an LLC, businessmen and women should be able to limit their personal liability to their investment. However, shareholders and members must respect the separate existence of the corporation or LLC they formed. A failure to do so could lead to piercing the veil of their corporation or LLC, putting their savings, house, and other personal assets at risk to satisfy a business debt.

This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.