



# FLORES GROUP ATTORNEYS & ADVISORS

Member of



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## CORPORATE VEIL MEMORANDUM

### I. INTRODUCTION

The general rule is that corporate form normally insulates shareholders, officers, and directors from liability for corporate obligations.<sup>1</sup> However, when these individuals abuse the corporate privilege, courts will disregard the corporate fiction and hold them individually liable.<sup>2</sup> Piercing the corporate veil is not itself a cause of action, but rather is only a remedy, a means of imposing liability on an underlying cause of action.<sup>3</sup> Piercing the corporate veil refers to pierce the protection or shield that the company serves to its shareholders, officers, and directors.

### II. LIABILITY FOR OBLIGATIONS

The issue is to what extent is a manager or member held accountable for the actions or omissions of the company. A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate of such a holder, owner, or subscriber of the corporation, may not be held liable to the corporation or its obliges with respect to: shares; any contractual obligation of the corporation; any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality.<sup>4</sup> However, this does not mean that a holder, beneficial owner, subscriber, affiliate, beneficial owner, or subscriber is fully protected by the corporate shield. If an obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the corporation to be used for the purposes of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the

<sup>1</sup> Castleberry v. Branscum, 721 S.W.2d 270, 271-272 (Tex.1986).

<sup>2</sup> See *id.*

<sup>3</sup> Peacock v. Thomas, 516 U.S. 349, 354, 116 S. Ct. 862, 866, 133 L. Ed.2d 817, 824 (1996); Int'l Fin. Servs. Corp. v. Chromas Techs. Canada, Inc., 356 F.3d 731, 736 (7th Cir. 2004); Leek v. Cooper, 194 Cal. App.4th 399, 418-19, 125 Cal. Rptr.3d 56, 71 (2011); Gass v. Anna Hosp. Corp., 392 Ill. App.3d 179, 185, 911 N.E.2d 1084, 1091, 331 Ill. Dec. 854 (2009); Wilson v. Davis, 305 S.W.3d 57, 68 (Tex. App. 2009).12 Business Organizations with Tax Planning § 154.03 (2018).

<sup>4</sup> TBOC § 21.223(a)(1-3).

holder, beneficial owner, subscriber, or affiliate, that holder, beneficial owner, subscriber, or affiliate will be held liable.<sup>5</sup>

### **A. Corporate Veil in limited liability companies**

The issue is whether the provisions of the piercing the corporate veil in a corporation applies to a limited liability company (LLC). The business organization code further explains and analyzes liability on obligations of holders or owners only in corporations. However, the Texas Business Organization Code §101.002 imports the piercing provisions of §21.223 into the realm of the LLCs.<sup>6</sup> So, the same standards apply to both corporations and LLCs even though provisions of the statute may only refer to corporations and to shareholders rather than members. LLC members can expect to receive the same treatment as shareholders of a corporation.<sup>7</sup>

## **III. PIERCING THE CORPORATE VEIL**

The issue or concern is when will the court pierce the corporate veil. Under Texas law, there three broad categories in which a court may pierce the corporate veil: (1) the corporation is the alter ego of its owners and/or shareholders; (2) the corporation is used for illegal purposes; and (3) the corporation is used as a sham to perpetrate fraud.<sup>8</sup> Therefore, the court will pierce the corporate veil if it finds any facts that support any of the categories mentioned above.

### **A. Corporation is the alter ego of its owners and/or shareholders**

The issue is when will the alter ego doctrine will apply to pierce a corporate veil. Alter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased.<sup>9</sup> As proof of alter ego, a court may consider, but not limited to: (1) the payment of alleged corporate debts with personal checks or other commingling funds; (2) representations that the individual will financially back the corporation; (3) the diversion of company profits to the individual for his personal use; (4) inadequate capitalization; and (5) other failure to keep corporate and personal assets separate.<sup>10</sup> The above list are important factors that courts have taken into consideration and are crucial when courts decide to pierce a corporate veil.

In *Tryco Enterprises, Inc. v. Robinson*, the Court of Appeals listed the following factors in determining the piercing of a corporate veil: (1) whether the entities shared a common business name, common offices, common employees, or centralized accounting; (2) whether one entity paid the wages of the other entity's employees; (3) whether one entity's employees rendered services on behalf of the other entity; (4) whether one entity made undocumented transfers of funds to the other entity; and (5) whether the allocation of profits and losses between the entities

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<sup>5</sup> TBCO §21.223(b)

<sup>6</sup> TBCO §101.002

<sup>7</sup> *Penhollow Custom Homes, LLC v. Kim*, 320 S.W.3d 366 (Tex. App. El Paso 2010, no pet.).

<sup>8</sup> *Rimade Ltd. v. Hubbard Enters.*, 388 F.3d 138, 143 (5<sup>th</sup> Cir.2004).

<sup>9</sup> *In re smith*, 192 S.W.3d 564, 568 (Tex.2006).

<sup>10</sup> *Sparks v. Booth*, 232 S.W.3d 853, 868-69 (Tex.App.- Dallas 2007, no pet.).

is unclear.<sup>11</sup> Therefore, it is important to follow and have clear distinction of all of the corporation's activities. The factors mentioned above could be used as a checklist to determine if a corporation might be exposed to pierce its corporate veil.

### **B. Common Business Enterprise and Common Directors**

The next issues is what factors are considered by the court in assessing whether a subsidiary is the alter ego of its parent by doing common businesses. The Fifth Circuit observed that there are twelve (12) factors to be used when assessing whether a subsidiary is the alter ego of its parent.<sup>12</sup> The assessment is based on a consideration of totality of the circumstances.<sup>13</sup> The twelve (12) factors are: the parent and the subsidiary have common stock ownership; (2) the parent and the subsidiary have common directors or officers; (3) the parent and the subsidiary have common business departments; (4) the parent and the subsidiary file consolidated financial statements and tax returns; (5) the parent finances the subsidiary; (6) the parent caused the incorporation of the subsidiary; (7) the subsidiary operates with grossly inadequate capital; (8) the parent pays salaries and other expenses of the subsidiary; (9) the subsidiary receives no business except that given to it by the parent; (10) the parent uses the subsidiary's property as its own; (11) the daily operations of the corporations are not kept separate; and (12) the subsidiary does not observe the basic corporate formalities, such as keeping separate books, records, and holding shareholder and board meetings.<sup>14</sup> Therefore, the above mentioned factors are red flags that the court will considered on piercing the corporate veil of a parent corporation.

### **C. Failure to Observe Corporate Formalities**

The next issues is when will the veil will be pierced due to failure of corporate formalities. When an individual is the sole, or dominant, shareholder of a corporation, he or she may tend to forget that the enterprise is incorporated and may run the business as if it were a sole proprietorship. In that situation, when the corporation's creditors seek to hold the individual liable for corporate debts, liability may attach on the ground that, because the individual treated the corporation as an alter ego, so will its creditors.<sup>15</sup> In a closely held corporation, it is not unusual for the sole shareholder to control the corporation. Therefore, so long as that control is done in accordance with appropriate corporate formalities, such as through appropriate shareholder and board of director meetings and by duly appointed officers, the corporate veil should not be pierced. It is also true that in a close corporation there is often a certain degree of informality in the operation of corporate affairs.<sup>16</sup> However, failure to adhere to minor formalities does not give the reason to pierce the corporate veil.<sup>17</sup> Such informality by itself will not lead to piercing the corporate veil unless the sole or dominating shareholder used the corporate form for an improper purpose such as avoiding just obligations.

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<sup>11</sup> *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497 (Tex.App.-Houston [1<sup>st</sup> Dist.] 2012).

<sup>12</sup> *U.S. North Am. Constr. Corp.*, 101 F.Supp2d 500, 528-29 (S.D.Tex.200).

<sup>13</sup> *Alpine View Co. v. Atlas Copco AB*, 205 F.3d 208 (5<sup>th</sup> Cir.200).

<sup>14</sup> *See id.*

<sup>15</sup> *Alabama: Gilbert v. James Russell Motors, Inc.*, 812 So.2d 1269, 1275 (Ala. App. 2001) (corporate veil not pierced, partly because the corporate formalities were observed).

<sup>16</sup> *Amsted Indus., Inc. v. Pollak Indus., Inc.*, 65 Ill. App.3d 545, 551, 382 N.E.2d 393, 398 (1978)

<sup>17</sup> *See id.*

Nonetheless, because there are courts that emphasize failure to follow corporate formalities in deciding whether or not to pierce the corporate veil, a shareholder is well advised to completely comply with all necessary formalities including holding shareholder and board of directors' meetings, when transacting business on behalf of the corporation.<sup>18</sup>

#### **D. Intermingling of Individual and Corporation Funds.**

The next issue is what would happen if there is intermingling of individuals and funds. It is somewhat easy to observe corporate formalities. However, an individual may observe corporate formalities and still fail to treat the corporation as a separate entity. It is common that individual both neglects the required formalities and fails to keep and use the corporation's assets in appropriate separate accounts to pay appropriate corporation obligations. The fact that an individual is the sole or dominating shareholder of a corporation is not, in and of itself, sufficient cause for piercing the corporate veil, although substantial ownership of a corporation and dominance of its management may be major indicators that the individual and the corporation might be found to be alter egos.<sup>19</sup> Instead, a shareholder will only be liable when the corporation has become the "mere instrumentality" of the individual.<sup>20</sup>

Actions that indicate that an individual has disregarded the corporate entity to such an extent that its creditors may do likewise generally involve financial transactions.<sup>21</sup> For example, impermissible intermingling has been found where the shareholders regularly paid their personal expenses out of corporate funds.<sup>22</sup> Likewise, transfers of title to property between the individual and the corporation without adequate attention to the source of the consideration will support disregard of the corporate entity.<sup>23</sup> In addition, if an individual shareholder of two corporations inappropriately diverts money from one corporation to another, the corporate veil could be pierced and the individual liable for each of the corporation's debts. Therefore, it is important to keep track of monies and purchases of the corporation.

#### **E. Inadequate Capitalization**

The next issue is what would happen if the corporation is inadequately capitalized. In some jurisdictions, it has been held that there is a public policy obligation on the part of organizers of a corporation to ensure that it is adequately capitalized so that any risk of loss falls upon it rather than upon its creditors.<sup>24</sup> Although failure to adequately capitalize the corporation may be viewed as some evidence of bad faith, it has been held that inadequate capitalization, by itself, is not enough to require piercing the corporate veil.<sup>25</sup> The requirement is simply a matter of not

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<sup>18</sup> 12 Business Organizations with Tax Planning § 154.03 (2018)

<sup>19</sup> *Kansas: Amoco Chemicals Corp. v. Bach*, 222 Kan. 589, 594, 567 P.2d 1337, 1341 (1977)

<sup>20</sup> 12 Business Organizations with Tax Planning § 154.03 (2018)

<sup>21</sup> *See id.*

<sup>22</sup> *See id.*

<sup>23</sup> *See id.*

<sup>24</sup> *Wachovia Sec., LLC v. Banco Panamericano, Inc.*, 674 F.3d 743, 752–53 (7th Cir. 2012)

<sup>25</sup> *Louisiana: Johansen v. Port Jewell, Inc.*, 351 So.2d 184, 187 (La. App. 1977).

*Texas: Ramirez v. Hariri*, 165 S.W.3d 912, 916 (Tex. App. 2005).

*Wyoming: Gasstop Two, LLC v. Seatwo, LLC*, 2010 WY 24, 225 P.3d 1072, 1077–78.

permitting shareholders to shield themselves from corporate creditors when the corporation had insufficient capital from the get go to pay its debts.<sup>26</sup>

There are no established rules for determining when a corporation's capital will be deemed inadequate so that the corporate existence may be disregarded. On the other hand, capitalization at the statutory minimum or capitalization obviously inadequate for the type of business conducted by the corporation may, if combined with other factors, lead to piercing of the corporate veil. However, inadequate capitalization will not normally cause this result unless there are additional reasons for piercing.

#### **IV. PIERCING THE CORPORATE VEIL – FRAUD**

The next issue is when will the corporate veil will be pierced due to fraud. The veil may be pierced where the defendant shareholder caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder.<sup>27</sup> Texas law defines fraud as the misrepresentation of material fact with intention to induce action or inaction, reliance on the misrepresentation by a person who, as a result of such reliance, suffers injury.<sup>28</sup> Therefore, if there is any signs of fraud, in consideration of the circumstances, the court will pierce the veil of a corporation.

#### **V. JURISDICTION**

Personal jurisdiction may exist over a nonresident defendant if the relationship between the foreign corporation and its parent corporation, that does business in Texas, is one that would allow the court to impute the parent corporation's 'doing business' to the subsidiary.<sup>29</sup> Courts should determine whether the subsidiary is separate and distinct from its parent corporation for personal jurisdiction purposes, taking into account the amount of the subsidiary's stock owned by the parent corporation, the existence of separate headquarters, the observance of corporate formalities, and the degree of the parent's control over the general policy and administration of the subsidiary.<sup>30</sup>

#### **VI. CONCLUSION**

Piercing the corporate veil is very important and crucial because it is an important factor in asset protection. Piercing the corporate veil is a remedy that is applied by the courts depending on the circumstances. The safest practice is to establish and maintain a corporation with proper documentation that is contained in the bylaws or in the company agreement if LLC. A corporation should periodically document significant activities and events affecting the corporation. Fortunately, it is legal to go back in time and document a company's activities, so

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<sup>26</sup>12 Business Organizations with Tax Planning § 154.03 (2018).

<sup>27</sup>TBOC §21.223; *Rimade Ltd. V. Hubbard Enters.*, 388 F3d 138, 143 (5<sup>th</sup> Cir.2004).

<sup>28</sup> *See id.*

<sup>29</sup>TBOC §21.223; *PHC-Minded, L.P. v. Kimberly-Clark Corp.*, 235 S.W.3d 163, 173 (Tex.2007).

<sup>30</sup> *See id.*

long as it is not linked to actual fraud. Such documents are signed by the members as of a retroactive effective date, regardless of the date of actual signature.<sup>31</sup>

The above mentioned factors that courts considered in deciding whether or not to pierce the corporate veil could be use as a checklist to avoid any risk of having the veil of the corporation pierced.

Please let me know if you have any questions on these matters.

Sincerely,

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<sup>31</sup> Wills, David J., J.D., LL.M. *Piercing the Veil in Texas*. 2018