Piercing the Corporate Veil

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Agenda

- Review of legal liability.
- How to “quack” like a corporation.
- When and why the corporate veil will be pierced.
- Review of fraud.
Ed’s Dump Truck Company (EDTCo)

Company Assets
- Dump truck ($100,000).
- Office furniture ($2,000).
- Office equipment ($1,000).
- Cash on hand ($10,000).
- Total = $113,000.

Ed’s Assets
- Residence ($250,000).
- Two vehicles ($75,000).
- Lake cabin ($125,000).
- Farm up in Tennessee ($200,000).
- Total = $650,000.

Event: Accident on Parkway 1
- EDTCo is sole proprietorship.
- Employees (other than Ed): 1.
  - Ed’s wife who answers phone at home.
- Ed is driving.
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed’s potential loss: EVERYTHING!
Event: Accident on Parkway 2

- EDTCo is sole proprietorship.
- Employees: 2.
  - Ed’s wife who answers phone at home.
  - Bubba who drives dump truck.
- **Bubba is driving.**
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed’s potential loss: **EVERYTHING!**

Vicarious liability, a.k.a. respondeat superior

- Principal is liable for the acts of agents.
- Bubba is Ed’s agent.
- Therefore, Ed is responsible for Bubba’s act in causing accident.
Event: Accident on Parkway 3

- EDTCo is incorporated.
- Employees: 1.
  - Ed's wife who answers phone at home.
- Ed is driving.
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed’s potential loss: EVERYTHING!

Individual Liability

- Corporate veil doesn’t protect a “real” person who commits a tort.
- In this example, plaintiff would be able to sue and collect from both—
  - Corporation.
  - Ed (because Ed was driving).
Event: Accident on Parkway 4

- EDTCo is incorporated.
- Employees: 2.
  - Ed’s wife who answers phone at home.
  - Bubba who drives dump truck.
- Bubba is driving.
- Jury verdict = $2 million.
- Insurance coverage = $1 million.
- Ed’s potential loss: only corporate assets.

**Scenario** | **Entity**  | **Driver** | **Potential Loss**  
---|---|---|---
1 | Sole Proprietor | Ed | Everything  
2 | Sole Proprietor | Bubba | Everything  
3 | Corporation (LLC) | Ed | Everything  
4 | Corporation (LLC) | Bubba | Only corporate assets ($113,000)
Notes on other entities

- General partnership does not limit individual liability as corporation does.
- Alabama limited liability company does limit individual liability in same way corporation does.
  - LLCs formed in other states may not limit in same way as Alabama LLCs do.

Summary of general principle of corporate tort liability

- Generally, shareholders will not be individually responsible for torts unless the shareholder actually committed the tort as an agent of the corporation.
Summary of general principle of corporate contract liability

- Generally, shareholders will not be individually responsible for breach of contract.

Shareholder liability for corporate debts

- Generally, shareholders will not be responsible for corporate debts unless shareholders undertake that responsibility.
- This explains why shareholder-president of small corporation will typically have to sign a note (bank loan) both as corporate officer and as individual.
How to “quack” like a corporation:

Observing corporate formalities

“Quack” like a corporation

- Have separate bank accounts for shareholder(s) and corporation.
- Don’t comingle funds.
  - Don’t use corporate funds for personal use.
  - Document loans from—
    - Shareholder to corporation.
    - Corporation to shareholder.
“Quack” like a corporation

- Use corporate name. (“Inc.” is important.)
  - Checks.
  - Invoices.
  - Purchase orders.
  - Letters (signature block especially).
  - Contracts.
  - Estimates.
  - Advertising materials.

“Quack” like a corporation

- Have shareholder meetings.
- Keep corporate minutes.
- Record stock transfers.
- Have corporate financial records (“books”).
- File required corporate reports (tax returns).
Why and when will the corporate veil be pierced?

Initial observation

- Piercing the corporate veil is like lightning:
  - Rare.
  - Severe.
  - Appears unprincipled.
But does have general principles

- To do justice.
- To prevent unethical, immoral, or otherwise illegal behavior from being protected by corporate structure.
- To place the burden of the loss upon the party who should be responsible.
- Arises from equity, not law.
  - Means it’s more in the discretion of the court.

Failure to observe corporate formalities

- Failure to observe by itself will almost never be enough to pierce corporate veil.
- No Alabama case has ever done this.
- Formula for piercing:
  Failure to observe + something else.
- Observing will not be an absolute defense, but observing is still good defensive evidence.
Conditions justifying piercing

1. Fraud in formation, operation, or dissolution of corporation.
2. Use of the corporation to avoid a just obligation.
3. Use of corporation as an instrumentality of its controlling shareholder.

These conditions often overlap.

Example of fraud: Deupree v. Ruffino
505 So.2d 1218 ( Ala. 1987)

Shareholder of BDC
“Skip” Deupree
Bay Development Corp. (BDC)

Sellers, Defendants

Mr. & Mrs. Roy Anderson
Buyers, Plaintiffs
**Fraud (continued)**

- Plaintiffs bought townhouse that was supposed to have a boat dock.
- At time of closing, Deupree told Andersons that approval of boat dock was expected “at any time.”
- Money put in escrow for boat dock.
- Boat dock never built.

**Fraud: At closing, Deupree knew—**

- Docks had to be approved by Bureau of Land Management (BLM) and Dept. of Natural Resources (DNR).
- Other landowners had objected to boat docks.
- A public hearing was required.
- He had done some unauthorized construction, which had been discovered.
- He had told BLM and DNR that townhouse owners would be responsible for building docks.
Fraud (continued)

- At trial, court found Deupree had committed fraud.
- Deupree raised defense of corporate veil.

Fraud (continued)

- Court pierced corporate veil because BDC—
  - Was a paper corporation.
  - Had never issued stock.
  - Had never adopted bylaws.
  - Had no accounting books.
  - Had no employees.
  - Funds were comingled with Deupree’s finances, as well as with two other entities.
Fraud (continued)

- Court concluded that Deupree had—
  - Committed fraud.
  - Was therefore individually responsible for fraud, despite corporate veil.

Example of avoiding just obligation: Southern Sash v. Wiley
631 So.2d 968 (Ala. 1994)

Elton Darby and SSI
- Owned 93% of stock
- Chairman of Board
- Chief Executive Officer

Elton Darby and Decatur
- Owned 100% of stock
- Chairman of Board
- Chief Executive Officer

Southern Sash, Inc. (SSI)
Decatur Co., Inc. Lessee-Debtor
Ann Wiley, Lessor-Creditor
Just obligation example (continued)

- **1977**: Darby loaned Decatur Co. $920,980.
- **1983**: Darby filed financing statement with Ala. Secretary of State. All of Decatur Co.’s assets secured the loan.
- **1988**: Continuation statement filed 5 years later.

- **Dec. 14, 1989**: Because Decatur Co. hadn’t paid its rent, Wiley got judgment against Decatur Co.
- **Jan. 1990**: Decatur Co. didn’t pay Darby.
  So Darby notified Decatur Co. to assemble all its assets for possession and sale by the creditor.
- **Feb. 15, 1990**: Assets of Decatur Co. sold to Southern Sash for $411,295 in private sale.
Just obligation example (continued)

- **After Feb. 15, 1990**: Because Decatur Co. had no assets, Wiley not able to satisfy judgment.
- Wiley sued Darby and Southern Sash.
- Wiley won. Jury found Darby and Southern Sash liable for $95,536.
  - $83,036 in compensatory damages.
  - $12,500 in punitive damages.

Corporate veil pierced because—

- **Feb. 8, 1990**: Southern Sash took over bank account of Decatur Co.
- **Feb. 12, 1990**: Directors of Southern Sash voted to transfer Decatur Co. bank account to Southern Sash.
  - This was 3 days before Southern Sash acquired assets of Decatur Co. by private sale.
  - Didn’t even change bank account number.
Corporate veil pierced because—

- After purchasing Decatur Co., Southern Sash operated Decatur Co.—  
  - At same location.  
  - Under same name.  
  - With same company sign.  
  - With same employees.  
  - Same telephone number and same directory listing.

- Purchased privilege license in name of Decatur Co. 5 days after purchase of assets.

Corporate veil pierced because—

- State, county, and city sales tax returns continued to be filed in name of Decatur Co. for 7 months after purchase of assets.

- Darby’s security interest in Decatur Co. assets was allegedly collateral for a loan made by Darby to Decatur Co.
  - But no interest was paid on loan from 1983 forward.
  - No interest was reported on Decatur Co. corporate tax returns.
Court’s conclusion

- Transactions between Southern Sash, Decatur Co., and Darby nothing more than sham and subterfuge.
- Corporate veil will not be used to enable corporation to become vehicle to evade just responsibility.
- **Special observation:** Lots of corporate formalities were observed, but didn’t protect shareholder.

**Domination,**

a.k.a.

alter-ego approach or instrumentality tests for piercing corporate veil
Domination elements

- Shareholder (parent corporation) completely dominates and controls finances, policy, and business practices of (subservient) corporation.
- Shareholder used domination and control to commit wrong against plaintiff.
- Domination and control caused the plaintiff’s injury or loss.
- May apply even in absence of fraud.

Evidence that will support piercing because of domination

- All of these items don’t have to be present, but their presence in a set of facts makes it more likely that corporate veil will be pierced.
- Remember that controlling shareholder may be parent corporation (PC).
Shareholder may be liable when—

- Corporate formalities are not observed.
- Shareholder owns all or most of the capital stock of corporation.
- Shareholder and corporation have common directors or officers.
- Shareholder finances corporation.
- Shareholder owns all stock in corporation and caused its formation.
Shareholder may be liable when—

- Corporation has grossly inadequate capital.
- Shareholder pays salaries, other expenses, and losses of corporation.
- Most or all of the corporation’s business comes from shareholder.
- Corporation has no assets except those given to it by shareholder. (May have no assets.)

Shareholder may be liable when—

- Shareholder (parent corporation) describes the corporation as one of its departments or divisions.
- Invoices of corporation are to be paid to shareholder.
- Shareholder uses corporate property as if it were the shareholder’s own property.
- Corporation’s directors and officers don’t act independently in interest of corporation, but take orders from shareholder.
Domination Example: 
Duff v. Southern Railway Co., 
496 So.2d 760 (Ala. 1986)

Defendant: Southern Ry. Co., Inc.
Defunct: Lenoir Car Works, Inc.
 Plaintiff: Dallas Duff, Injured Employee of Lenoir

L. R. Garner, Officer of Southern, Managed Lenoir, Director of Lenoir

Lenoir made products used in operation of railroad.

Plaintiff’s objective

- Wanted to receive benefits under Federal Employer’s Liability Act (FELA) for injuries plaintiff suffered during his employment at Lenoir.
- FELA applies to employees of railroads similar to Alabama Workers’ Compensation Act applies to most Alabama employees.
- Since Lenoir was defunct, Duff would receive no compensation through workers’ compensation.
Key facts allowing piercing

1. Southern owned all of Lenoir’s stock.
2. Garner was officer of Southern and director of Lenoir.
4. 99% of Lenoir’s business was from Southern.
5. Southern inspected Lenoir plant for safety problems; told Garner to make changes to protect workers.

Other facts

- Duff’s W-2 forms showed him as an employee of Southern.
- W-2 showed that Southern had paid for “social security” insurance under Railroad Retirement Act.
- W-2 showed “sickness” benefits to Duff from Provident Life Ins. Co.
  - Provident was not Lenoir’s workers’ compensation carrier.
Injustice averted

- Duff was injured on the job.
- Duff would have gotten no benefits if Southern hadn’t been held liable.
- Therefore, corporate veil of Lenoir pierced and Southern held liable for injuries to Duff.

Review of Fraud
Remember formula for piercing

- Failure to observe corporate formalities + _____.
- The blank is most often filled with fraud.

What most people think

- Fraud is lying about something having to do with business deal.
- But under Alabama law, there are three types of fraud:
  1. Intentional fraud (deceit).
  2. Reckless fraud.
  3. Innocent fraud (constructive fraud).
Better summary: Fraud is—

- Willfully deceiving another.
  - Asserting truth of something when person doesn’t believe it’s true.
  - Asserting truth of something when the person has no reasonable way of knowing whether it’s true.
  - Suppression of facts when the person has a duty to reveal.
  - Promise made without any intent to perform it.

Better summary: Fraud is—

- Reckless misrepresentation of fact.
  - Saying something is true without checking on truth when there is an easy way to check.
- Mistaken but innocent misrepresentation of fact.
  - Will not support punitive damages.
Duty to disclose: Considerations

1. Relationship of parties:
   • Confidential?
   • Fiduciary?
2. Relative knowledge of parties.
3. Value of the fact not disclosed.
4. Plaintiff’s opportunity (ability) to ascertain fact.
5. Customs of the trade.
6. Other relevant circumstances.

Best practices

- Never deliberately lie or misrepresent.
- Don’t volunteer information unless you know you have a duty to disclose.
- Answer questions truthfully: “To the best of my knowledge . . . .”
- When a question is asked and you don’t know for sure, admit that fact. Offer to check and follow up.
- When there is an independent way to verify facts, don’t trust others who’ve told you something.
Big takeaway: You can unintentionally (accidentally) commit fraud!

Questions?

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