
**Leggo My Alter Ego!
What You Need to Know About
Piercing the Corporate Veil.**

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By Karen L. Hart and Anneke Cronje¹

I. Introduction

This paper provides a general overview of the corporate form and what is known as the corporate “veil,” which protects the shareholders or members of a corporation or limited liability company (LLC) from personal liability for the debts, obligations, and liabilities of the corporation or LLC. This article discusses several different types of entities that you may encounter, explaining basic differences between each, including what personal liability protections, if any, are afforded by each to their respective owners. A brief overview of how and when the corporate veil may be pierced to hold, typically, shareholders or members, individually liable for a company’s debts is provided.

The legal standards for piercing the corporate veil vary from state to state and often involve a fact intensive analysis in each case, which must be presented to a court

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at law for a legal, and equitable, resolution and finding. A showing of actual fraud is a common requirement in order to meet many states' veil piercing standards.

The concept of "alter ego" is addressed and is a factor considered in establishing that the corporate "fiction" should be disregarded by a court in order to reach the assets of shareholders or members to satisfy the debts or liabilities of the corporation or LLC. The concepts of "single business enterprise" theory, which typically involves lateral veil piercing between different companies, and "reverse alter ego," which typically involves holding the company (and its assets) responsible for the debts or liabilities of an individual shareholder or member, are also briefly introduced in this article. This article is intended for educational purposes only and is not intended to serve as legal advice.

II. Understanding the Corporate Form and the Corporate "Veil"

Legally, a corporation is a separate and distinct entity and is considered to be a "person" in many respects. Assuming valid formation and compliance with corporate laws and requirements, as a "person," a corporation has rights, responsibilities, and duties under the law. A corporation may conduct business and enter contracts, giving rise to contractual rights and obligations. A corporation may own real and personal property. A corporation may loan and borrow money. A corporation is responsible for paying applicable taxes. A corporation may have employees. A corporation may also commit and be liable for tortious actions, since a corporation, just like an actual person, has certain legal duties to avoid intentionally or negligently injuring or harming others. A corporation may sue or be sued.

As a “person” under the law, a corporation is separate and distinct from its owners – the shareholders. As such, the corporate form is attractive because it affords certain benefits to shareholders who are investing in the corporate venture. For example, the corporate form allows for centralized fundraising, capital and asset amassment, and decision-making for the business, along with a structured leadership platform, in the form of corporate officers and a board of directors. Importantly, the corporate form generally protects or shields shareholders from personal liability for the debts, obligations, actions, and liabilities of the corporation. This personal liability “shield” for shareholders is often referred to as the corporate “veil.”

The corporate “veil” or “shield” allows shareholders, who may be individuals or corporations or other types of entities themselves, to invest in a corporation without fearing that their personal or individual assets, beyond what they are investing into the corporation, might be exposed to the risks, debts, obligations and liabilities undertaken or incurred by the corporation. Shareholders are afforded this risk shifting protection under the law as a way, from a public policy standpoint, to encourage corporate investment and growth of businesses and, in theory, the economy. The idea is to minimize shareholders’ personal liability risk to increase capitalistic venture. Some legal scholars have even asserted that the advent of the corporate form stems from democracy itself, giving small business owners the opportunity and foundation, through sole shareholder or closely held corporations, to fairly compete in the world of cutthroat capitalism.

Beyond small business, corporate conglomerates have also capitalized on the risk mitigation benefits of the corporate form through corporate parent, subsidiary, and affiliate relationships. These corporate relationships and layers are usually not transparent to outsiders and can even be unclear to corporate employees who may not be aware of the actual legal corporate structure(s) of their “company.”

For example, a parent corporation may hold certain assets and liabilities of the business, and various subsidiary entities may be created to hold and separate certain specific assets and liabilities, including contractual obligations, from the parent and other subsidiaries and affiliates. As such, generally speaking, the liabilities of any particular subsidiary would be isolated, exposing only the assets of that particular subsidiary to liability and purposefully shielding the parent, and other subsidiaries and affiliates, and their respective assets, from liability for the debts, obligations, actions, and liabilities of that particular subsidiary.

As discussed in more detail below, there are limitations to the personal liability protections offered by the corporate form when it is used abusively and fraudulently to evade creditors and to otherwise perpetuate fraudulent acts. When used appropriately and fairly, the corporate form, in and of itself, is not necessarily a negative concept. Terms like “veil” and “shield” commonly bantered about tend to cast a negative hue on the concept of the corporate form. Whether the corporate “fiction” has a good or bad connotation to you will clearly depend upon whether you are a creditor or debtor and where and by whom any assets at issue are held.

III. Types of Legal Entities and Personal Liability Limitations

In addition to corporations, there are other types of entities that offer forms of personal liability limitations and protections. These other types of entities include limited liability companies (LLCs) and limited partnerships (LPs). The corporation, LLCs, and LPs, contrast with sole proprietorships and general partnerships (GPs), which generally do not shield their individual owners from personal liability for the debts, obligations, actions and liabilities of the business.

A. Do You Know Who You Are Doing Business With?

It is important to know the type of entity and business with which your company is contracting and to which your company is also potentially extending credit. Properly identifying the entity that you are doing business with is essential to adequately determining the creditworthiness of a party. It will also be critical later on for collection purposes. For example, if you are doing business with a sole proprietorship or a general partnership, the credit worthiness of, not only the business, but also the individual owners or partners must be considered. In the case of a corporation or an LLC, the track record and credit of the business will obviously be paramount. You need to be clear about what entity -- parent, subsidiary, affiliate -- you are contracting with and to whom you are extending credit and what entity(s) financials you are using to support your decision to extend credit. For example, a parent company may have an excellent credit track record, but its spun-off subsidiary, who may be on the contract, may be debt ridden and asset poor.

Personal guarantees should be obtained where possible, and especially for closely held companies, putting the track record of an individual shareholder(s) who may be signing the guarantee(s) front and center in evaluating credit risk. Corporate guarantors should be carefully evaluated, including the relationship between the principal account holder and the corporate guarantor, including whether there is a parent, subsidiary or other affiliate relationship, the financial dynamics of such relationship, and a solid understanding of asset and capital holdings.

Thorough due diligence at the beginning of a business relationship will assist you in ferreting out who and what you are dealing with and will aid in smoking out a potential shell company, before you venture too far down the credit road. However, it is important to check back in with your customers and re-evaluate who, and what, they are and their financial status periodically during the business relationship. Ongoing due-diligence will assist in catching credit problems before they become out of hand.

Public resources are great places to start your investigation into who and what you may be doing business with. Companies (e.g., corporations, LLCs, and LPs) are typically required to register and file certain information and reports with secretaries of state, and these state offices frequently offer free or low cost corporate or company search services on their on-line portals. Records on file with the secretary of state will often reveal multiple addresses for the company, the identities and addresses of officers, directors, and managers, registered trade names of the company, and will assist in confirming what type of entity your customer may be and where the company was incorporated or formed. You typically, however, will not find transparent

information revealing the identities of all shareholders or members, nor will you usually find corporate structures and relationships neatly laid out for you. This information will have to come from your customer, if appropriate and if you can convince them to give it to you voluntarily.

But, significantly, records on file with the secretary of state will often reveal whether the company is in good standing with the secretary of state and/or the state comptroller, and if the company is not in good standing, this information will be revealed by notices issued and filed by the secretary of state and/or state comptroller's office. Companies may not be in good standing for a variety of reasons, including failing to file required annual reports and failing to pay required taxes, typically franchise taxes. If a company fails to remedy a default as required by a secretary of state/state comptroller, its corporate charter may be forfeited and the company may be involuntarily dissolved by the secretary of state, until reinstated, depending upon particular state laws and procedures. Forfeiture of a corporate charter or involuntary dissolution is obviously a red flag that should be carefully evaluated. Depending upon particular state law, a forfeiture may even subject officers or directors (but not necessarily shareholders or members) to automatic personal liability for the debts of a corporation incurred during the period of forfeiture.² On-line county resources may

² See, e.g., TEX. TAX CODE § 171.255(a) ("If the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived.").

also be available to investigate your prospective customers, including registered trade names.

Brief descriptions of the various legal entities are below to help you distinguish between the different types of businesses you may encounter.

B. Sole Proprietorships

A sole proprietorship consists of an individual who typically operates a business under a business or trade name. For sole proprietorships, a separate legal entity does not exist and the individual owner is liable for all debts and obligations of the business. There are typically no formal registrations with state or local governing authorities required to form a sole proprietorship. Generally speaking, there is no “shield” for personal liability of the owner of a sole proprietorship.

C. General Partnerships

A general partnership (GP) is an organization or association of two or more participants, or partners, who together operate a business under a business or trade name. The partners of the GP own the business and may be personally liable for the debts, obligations, and liabilities of the business. Generally speaking, there is no shield for personal liability for the partners, or owners of a general partnership.

D. Corporations

A corporation is a separate legal entity that has been incorporated pursuant to state law, typically by registering with the secretary of state in the applicable state of incorporation and filing all required documentation and paying all required registration fees. A corporation is separate from its owners, which are its shareholders,

who are typically shielded from personal liability for the company's debts, obligations, actions, and liabilities, except in certain circumstances, as discussed below where the corporate shield or "veil" may justifiably be pierced pursuant to applicable law. A corporation may have one or more shareholders.

A corporation may conduct business under a trade name (doing business as or d/b/a), but a corporation is typically required to mark its incorporated status with "Inc.," "Corp.," or "Corporation" in its formal name. A corporation typically has officers and a board of directors and operates pursuant to its by-laws.

A corporation may be designated a "C-Corp." or an "S-Corp." for tax purposes. For a "C-Corp.," income is taxed at the corporate level and at the shareholder level, resulting in "double taxation," one of the commonly cited pitfalls to incorporation as a "C-Corp." For an "S-Corp.," income, in the form of profits and losses, is "passed-through" or "flows-through" to the shareholders and is only taxed one time at that level. There are certain limitations on stock classes (only one class of stock is permitted), who can be a shareholder (partnerships, corporations, and non-resident aliens are not allowed), and how many shareholders are permitted in S-Corps. (limited to 100 shareholders). "C-Corp." and "S-Corp." are tax designations for the I.R.S. and do not change the legal entity status of a corporation.

E. Limited Liability Companies

A limited liability company (LLC) is similar to a corporation, but offers more flexibility in its structure and governance. Instead of shareholders, a LLC is owned by one or more "members." The LLC may be managed by its members or the members

may appoint a designated manager(s) to run the company. The LLC may or may not have officers. LLCs are not required to have a board of directors or by-laws, and are instead are typically operated pursuant to a company operating agreement.

LLCs are typically registered with the secretary of state in the state of formation and must file all required documentation and pay all required registration fees to be properly formed pursuant to state law. A limited liability company must denote its limited status with reference to “LLC” or the like in its formal name. LLCs may register and use a trade name and operate under a “d/b/a,” similar to a corporation.

LLCs can elect to be taxed like a C-Corp., an S-Corp. or a partnership, allowing for “flow-through” taxation where appropriate and permissible. An LLC is a separate legal entity from its members, who are typically shielded from personal liability for the company’s debts, obligations, actions, and liabilities, except in certain circumstances, as discussed below, where this “shield” or “veil” may be justifiably pierced pursuant to applicable law.

F. Limited Partnerships

Like a general partnership, a limited partnership (LP) is an association of two or more individuals (or entities) that conduct a business as co-owners. However, with limited partnerships, there are two types of partners in the business: 1) the general partner(s) and 2) the limited partner(s). The general partner manages and operates the business on a day-to-day basis and is subject to liability for the debts, obligations, actions, and liabilities of the partnership. The limited partner does not manage the business and is typically shielded from liability for the debts, obligations, actions, and

liabilities of the partnership. Limited partners may be subject to partnership liabilities when they migrate into more of a general partner role in the business, which is a topic outside the scope of this article. There are also different types of limited partnerships, which is another topic outside the scope of this article.

III. Piercing the Corporate Veil

As stated, one of the principal advantages of forming a corporate entity, or a LLC, is the limited liability protection available to shareholders or members. Unlike general partnerships and sole proprietorships, corporations and LLCs are considered to be separate legal entities from the individuals managing the business, and therefore, the owners generally have limited personal liability for the company's debts, protected by the corporate “veil.”

However, the corporate “veil” is not absolute and may be “pierced” under certain factual and legal circumstances when courts disregard the corporate fiction and hold individual shareholders or members personally liable for the debts, obligations, actions, and liabilities of the corporation or LLC.³ This is called "piercing the corporate veil."

Traditionally, courts have consistently emphasized the importance of recognizing and maintaining the separate identities of the entities and their individual (or other corporate) owners. As one court described it, it is a “bedrock principle of

³ Traditionally, piercing the corporate veil was limited to corporations. However, with the advent of new entity forms, such as LLCs, the principles of corporate veil piercing have also been applied other entities. Generally, the test for piercing the veil does not vary greatly between entities.

corporate law” “that an individual can incorporate a business and thereby [. . .] shield himself from personal liability for the corporation's contractual obligations.”⁴ Most jurisdictions consider piercing the corporate veil an extraordinary remedy to be applied only in limited circumstances. Courts are therefore often reluctant to pierce the corporate veil absent some compelling reason. While the legal parameters of piercing the veil vary from state to state, generally courts will allow veil piercing when there has been some abuse of the corporate form that resulted in the entity’s creditors being treated unfairly.⁵ Veil piercing jurisprudence is well established and, despite some differences in formulation, followed throughout courts in the United States.

Veil piercing can be a useful tool when a creditor wants to reach the assets of an individual, or, in some cases, the assets of an affiliate or owner company, to satisfy a debtor’s obligation. It is important to remember that a company’s agent may be held liable for his own tortious or fraudulent actions, so it is not always necessary to pierce the veil to hold an individual liable.

A. Alter Ego

One of the most common ways to pierce the corporate veil is through the theory of alter ego. While the exact standard varies by jurisdiction, generally the courts look to see whether the shareholders (or the members in the case of an LLC) maintained an identity separate than that of the company. If there was such unity between the

⁴ *Sparks v. Booth*, 232 S.W.3d 853, 868 (Tex. App. — Dallas 2007, no pet.) (citing *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006)).

⁵ See, e.g., *Goya Foods, Inc. v. Unanue*, 233 F.3d 38 (1st Cir. 2000) (quoting *Morris v. New York State Dep't of Taxation & Fin.*, 623 N.E.2d 1157 (1993)).

corporation and the individual so that the company was merely a “hollow shell” used to perpetrate a fraud, courts are more likely to pierce the veil.⁶ The ultimate goal of using the theory of alter ego to reach the assets of the individuals involved is to avoid an inequitable result.

The specific requirements for asserting alter ego varies from state to state and is a factual inquiry that will depend on the circumstances of each case. However, courts have established some general characteristics of situations in which veil piercing may be appropriate. For example, the Florida the Supreme Court has imposed a strict standard which requires a showing of improper conduct⁷. Under this standard, it must be shown that the corporation was organized or used to mislead creditors or to perpetrate a fraud upon them. In setting forth the requirements of alter ego veil piercing, courts across the country have articulated several common factors: (1) the payment of alleged corporate debts with personal checks or other commingling of 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. In some states, the failure of a corporation to observe corporate formalities may also be a factor in considering whether alter ego veil piercing is appropriate.⁸ Because courts

⁶ *Gasparini v. Pordomingo*, 972 So. 2d 1053 (Fla. Dist. Ct. App. 2008).

⁷ *Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So. 2d 1114, 1121 (Fla. 1984); *Steinhardt v. Banks*, 511 So. 2d 336 (Fla. Dist. Ct. App. 1987).

⁸ See TEX. BUS. ORGS. CODE ANN. § 21.223(a)(3). In some states, like California, this is still a relevant factor that the courts consider in the alter ego analysis. See *Misik v. D'Arco*, 130 Cal. Rptr. 3d 123, 127 (Cal. Ct. App. 2011).

want to limit the circumstances in which the veil can be pierced, a creditor will usually have to show actual fraud, which, similar to Florida, is a statutory requirement in Texas.⁹ Undercapitalization or the failure to adhere to corporate formalities, alone, generally speaking, will not likely be sufficient to support alter ego or, more generally, piercing of the corporate veil.

The California courts articulate the test for alter ego in a slightly different and more lenient manner. Specifically, two essential factors must be present: (1) a unity of interest and (2) alter ego liability must be necessary to avoid inequitable result.¹⁰ It must appear that the corporation was influenced and governed by the persons sought to be held liable for its conduct; and there must be such “unity of interest” and ownership that the individuality or separateness of the corporation has ceased to exist. Furthermore, courts look to see if adherence to the “fiction” of the corporation's “separate existence” would sanction a fraud or promote injustice.¹¹ One important difference is that, unlike some states, a showing fraud is not required. Rather, “bad faith in one form or another” is sufficient to justify a court's disregarding the corporate entity.¹²

There are two procedural means for bringing an alter ego claim. First, although it is not a cause of action as such, the factual bases for an alter ego claim can be alleged

⁹ The Texas legislature has enacted a statute specifying that a shareholder or affiliate may not be held liable for a contractual obligation of the corporation, or any matter relating to or arising from the contractual obligation, unless the shareholder or affiliate used the corporation to perpetrate an actual fraud for the direct personal benefit of the shareholder or affiliate. *See* TEX. BUS. ORGS. CODE ANN. § 21.223(a)(2) and (b).

¹⁰ *Mesler v. Bragg Management Co.*, 702 P.2d 601 (Cal. 1985).

¹¹ *Automotriz Del Golfo De California S. A. De C. V. v. Resnick*, 306 P.2d 1 (Cal. 1957).

¹² *Associated Vendors, Inc. v. Oakland Meat Co.*, 26 Cal. Rptr. 806 (Cal. Ct. App. 1962).

in a complaint, along with other causes of action against the defendant and its claimed alter ego. Thus, the potentially liable parties are all brought into the suit at the outset, and the issue of alter ego is litigated as part of the underlying case. Alternatively, alter ego can be raised after the judgment has been rendered. For example, in California, upon the motion of the creditor, the judgment can be amended to bring in additional judgment debtors after alter ego is established.¹³

B. Single Business Enterprise Theory

Another recognized theory of piercing the corporate veil is the single business enterprise theory. Unlike alter ego, which allows a creditor to reach the assets of an individual to satisfy the debts of a company, the single business enterprise theory is a method of laterally piercing the veil.¹⁴ It allows a creditor to reach the assets of one company to satisfy the debts of another company. Courts generally allow this form of veil piercing on the basis that the corporation and its affiliate have integrated their assets to achieve a common business purpose. By allowing this, courts are essentially treating separate corporations as a “single business enterprise” for liability purposes.

When courts find that a single business enterprise exists, they will hold each corporation liable for the obligations relating to the common business purpose to avoid an “inequitable outcome.” In other words, the single business enterprise theory allows a successful plaintiff to reach the pockets of a corporation affiliated with the

¹³ See CAL. CODE CIV. PROC. § 187.

¹⁴ Alter ego and the single business enterprise theory are two separate and distinct theories utilized for veil piercing but the purpose and effect of the two theories is the essentially the same.

defendant/debtor company. Piercing the veil using the single business enterprise theory is sometimes easier than using alter ego to satisfy a debt because it does not always have the same strenuous requirement of showing actual fraud.¹⁵

In examining whether two separate entities should be treated as one for liability purposes and in determining whether corporations operated as a single business enterprise, courts have considered whether the corporations had: (1) common employees, (2) common offices, (3) centralized accounting, (4) payment of wages by one corporation to another corporation's employees, (5) common business name, (6) services rendered by the employees of one corporation on behalf of another corporation, (7) undocumented transfers of funds between corporations, and (8) unclear allocation of profits and losses between corporations.¹⁶

The availability of the single enterprise theory as a method to pierce the veil depends on state law. Some states, like Texas, have held that there is nothing inherently unjust or abusive about the single enterprise factors such as sharing names, offices, accounting, employees, services and finances.¹⁷ Therefore, in Texas and in other states, there is no basis for imposing liability on an affiliate company based upon a single enterprise theory.¹⁸ Other states, like California, continue to recognize the

¹⁵ *Paramount Petroleum Corp. v. Taylor Rental Ctr.*, 712 S.W.2d 534, 536-37 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

¹⁶ See, e.g., *Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, 150 S.W.3d 718, 744 (Tex. App.—Austin 2004) *rev'd sub nom. Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, 235 S.W.3d 695 (Tex. 2007); *Pan Pacific Sash & Door Co. v. Greendale Park, Inc.*, 333 P.2d 802 (Cal. Ct. App. 1958); *Las Palmas Assoc. v. Las Palmas Ctr. Assoc.*, 1 Cal. Rptr. 2d 301 (Cal. Ct. App. 1991).

¹⁷ *SSP Partners v. Gladstrong Investments*, 275 S.W.3d 444 (Tex. 2008).

¹⁸ *Id.*

single business enterprise theory as a valid means of piercing the corporate veil.¹⁹ Specifically, California allows for liability to be established as between two or more corporations under common ownership if own corporation is “but an instrumentality or conduit of another in the pursuit of a single business venture.”²⁰ The result is that the separateness of the corporate identities is disregarded to prevent an injustice upon creditors.²¹

C. Reverse Veil Piercing

While traditional veil piercing seeks to hold an individual (or corporate) shareholder liable for the acts of a corporation, reverse piercing imposes liability on a corporation for the obligations of an individual shareholder. In other words, the creditor seeks to pierce the corporate veil to impose liability on the corporation in order to satisfy the debt of an individual shareholder.²² Despite the difference in who is being held liable, reverse veil piercing initially requires the same two-pronged analysis of unity and promotion of fraud or injustice.²³

IV. Conclusion

Whether or not a shareholder, or member, is an “alter ego” of a corporation or LLC, or *vice versa*, will be a legal and factual determination decided in court. Compelling circumstances must exist before courts will typically disregard the

¹⁹ See *Las Palmas Assoc. v. Las Palmas Ctr. Assoc.*, 1 Cal. Rptr. 2d 301 (Cal. Ct. App. 1991); *SSP Partners v. Gladstrong Investments*, 275 S.W.3d 444 (Tex. 2008).

²⁰ See *Las Palmas Assoc. v. Las Palmas Ctr. Assoc.*, 1 Cal. Rptr. 2d 301 (Cal. Ct. App. 1991); *F.T.C. v. Network Servs. Depot, Inc.*, 617 F.3d 1127, 1136 (9th Cir. 2010).

²¹ See *Las Palmas Assoc. v. Las Palmas Ctr. Assoc.*, 1 Cal. Rptr. 2d 301 (Cal. Ct. App. 1991).

²² *In re Phillips*, 139 P.3d 639, 645 (Colo. 2006).

²³ See *State v. Easton*, 647 N.Y.S.2d 904, 909 (N.Y. Sup. Ct. 1995).

corporate fiction or form. When push comes to shove and a payment problem persists, you should work with your attorney to gather all of the information you developed in investigating your customer at the beginning of the business relationship and afterwards to determine whether a viable alter ego claim exists to be able to pursue a shareholder/member or other corporate parent, subsidiary or affiliate. Corporate affiliations and financial information concerning the company, and its affiliates, and shareholder or member involvement, and use of the company, will be an important part of building your case. Keep in mind, that you, as the creditor/plaintiff, along with your counsel, will have the burden of proof to establish and prove, by a preponderance of the evidence, alter ego or other compelling circumstances, namely evidence of fraud or other wrongdoing, to justify piercing the corporate veil in any particular case.

Because the factors for establishing alter ego and generally for piercing the corporate veil are so fact intensive, alter ego/piercing cases are not typically open and shut. They will take time, usually involve heavy discovery, and, thus, can involve expenditures of significant legal resources. The best position to be in is to know who you are dealing with at all stages of the business relationship to avoid being pressed to make a case for alter ego or veil piercing. Therefore, investigate and continue to keep updated on your customers and their corporate structure and, of course, financial status throughout the relationship to cut off credit and payment problems before they rise to the level of necessitating legal action.