

# LEGGO MY ALTER EGO!

## WHAT YOU NEED TO KNOW ABOUT PIERCING THE CORPORATE VEIL



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# Do You Really Know Your Customer?



## Who are They and What Are They?

# What Type of Legal Entity?



# SOLE PROPRIETORSHIP



- No legal distinction. Owner = Business
- Owner owns all of the assets of the business
- Owner is legally & personally responsible for all losses, debts, liabilities of the company
- No required registrations
- No required agreements, etc.

# PARTNERSHIP



## **General Partnership**

- Association of two or more persons for a common business enterprise
- Sharing of profits and losses – equally or in proportion to documented % ownership interests
- Profits, losses pass through to the partners
- Income taxed at partner level
  - ✦ “Pass-through taxation”

# PARTNERSHIP



## **General Partnership**

- All partners are personally liable for debts and obligations of partnership
  - ✦ .... AND the actions of their partners taken on behalf of the business
- No required registrations or agreements
- May not realize they are in a general partnership

# PARTNERSHIP



## Limited Partnership

### ○ **General Partners**

- Responsible for day-to-day management
- No shield - personal liability

### ○ **Limited Partners**

- ✦ Non-managing,
- ✦ Limited role in the operation of the partnership
- ✦ Limited personal liability

# PARTNERSHIP



## **Limited Partnership**

- o Written partnership agreement strongly recommended
- o Registration with the SOS is typically required
- o Use of “Limited” “Ltd.” “LP” required



# CORPORATION



- Corporation is a separate legal entity or “person”
- Separate from its Shareholders
  - ✦ Protected from personal liability for the actions/debts/liabilities of the corporation
  - ✦ Must make a contribution for shares
- Must use “Inc.” “Corp.” “Corporation”

# CORPORATION



- Proper formation important
- File Articles of Incorporation with SOS
- Charter issued by state
- Elect board of directors
- Appoint officers
- Adopt Bylaws
- Issue Stock
- Shareholder Agreement

# CORPORATION



- C Corp.
  - “Double taxation.” Income taxed at the corporation level and at the shareholder level
  - No limit on number of shareholders
  - Offers flexibility on attracting investment capital

# CORPORATION



- S Corp.
  - Passes profits and losses through to its owners in the manner of a partnership
  - Election of “S” status with the IRS
  - Limitations on shareholders and stock class:
    - ✦ Only individuals, certain trusts, and estates
    - ✦ No partnerships, corporations or non-resident aliens allowed
    - ✦ No more than 100 shareholders
    - ✦ One class of stock

# LLC



- Similar to corporations, LLCs are separate legal entities
- Have members rather than shareholders
- Provide limited liability to members
- May elect “Flow-through” taxation, like partnerships or S Corps.
- Must Use “LLC” “Limited Liability Company” etc.

# LLC



- More flexible internal structuring compared to corporations
  - ✦ No by laws or board of directors
  - ✦ May be member or managed by appointed manager (s)
  - ✦ May have officers (president, VP, Secretary) or not
  - ✦ Need a LLC company or operating agreement
- Must register with applicable SOS
  - ✦ File “certificate of formation” or “articles of organization”

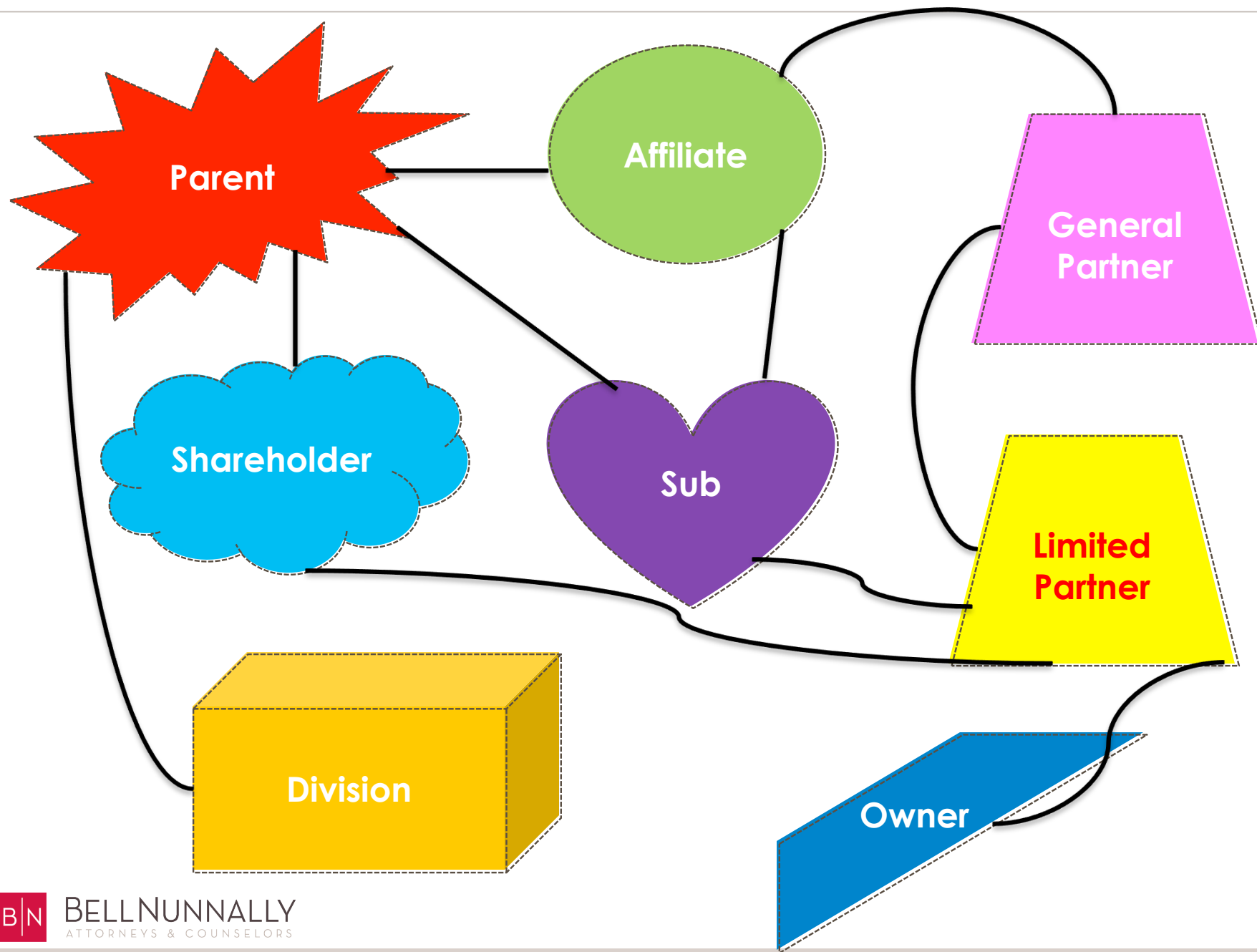
# PRESERVING THE CORPORATE FORM



- Proper formation
- Maintain all required corporate formalities
- Do not mix personal and company assets, money, bank accounts, etc.
- Separate personal and company expenses
- Pay taxes for the company
- File all required forms with the applicable Secretary of State

# What is the Relationship?





# Why Does This Matter?



# DO YOUR DUE DILIGENCE



- Know where assets (and liabilities) are and who owns them
- Know what kind of entity you're doing business with
  - Essential to determine creditworthiness
  - Important for collection purposes
- Verify information on credit application
- Secure personal guaranties
- Watch out for corporate guaranties

# SAMPLE CASE



1. Bad Subcontractor Inc. enters a Credit Application with Best Supplier Inc. Bad Subcontractor Inc. orders materials from Best Supplier Inc. and does not pay for them. There are no personal guaranties.
2. Bad Subcontractor Inc. is owned by Bill Gates. Gates is the sole shareholder of Bad Subcontractor. Gates is a billionaire.
3. Bad Subcontractor Inc. has no money and no available assets. Bad Subcontractor Inc., it turns out, rents all of its equipment from a corporate affiliate and it has factored all of its receivables.

# POLL-1



❖ Is Bill Gates legally responsible for paying the debt owed to Best Supplier Inc. by his company, Bad Subcontractor Inc.?

☐ Yes

☐ No

# POLL-2



❖ **Should** Bill Gates be held responsible for paying the debt owed to Best Supplier Inc. by his company, Bad Subcontractor Inc.?

☐ Yes

☐ No

# THE CORPORATE FORM



- A corporation/LLC is a separate and distinct entity or “Person”
- A corporation/LLC may:
  - Conduct business
  - Enter contracts
  - Own property
  - Have tax liabilities
  - Employ people
  - Loan and borrow money
  - Sue and be sued

# BENEFITS



- Corporate “Veil” or “Shield”
  - Protects shareholders/members from personal liability for the debts obligations, actions, and liabilities of the corporation/LLC
  - Only corporate/LLC assets can be used to satisfy a corporate debt
  - Encourages investment, business growth



# Piercing the Corporate Veil



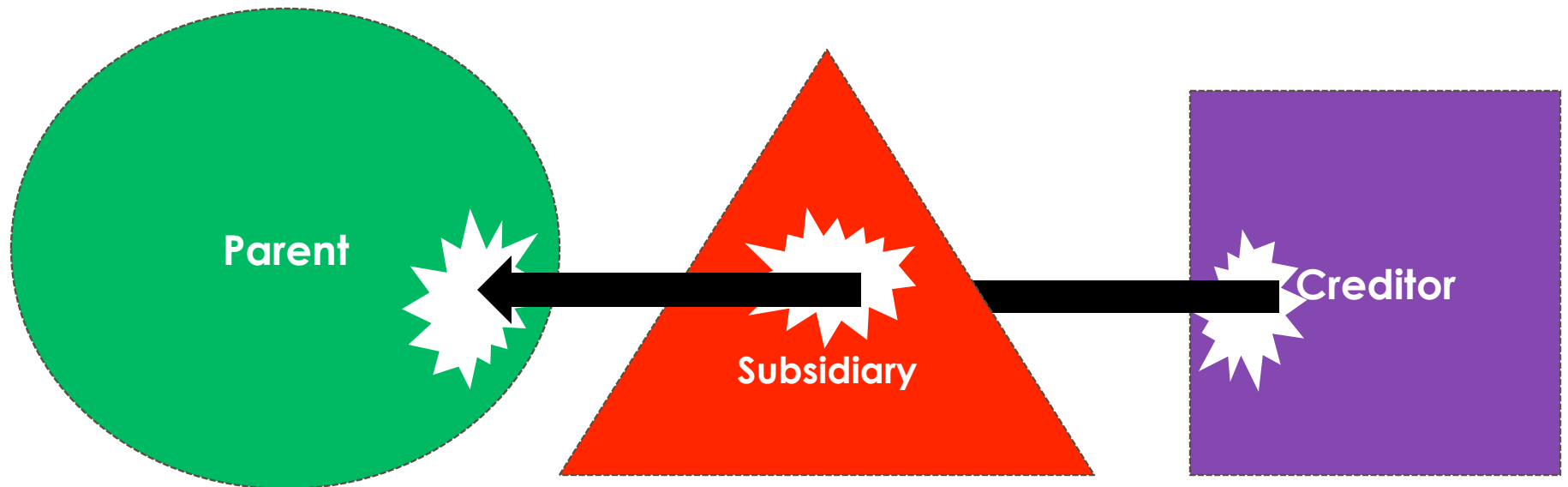
- Reach assets of the individual shareholders/members of the business
- Reach assets of an affiliated entity (parent, subsidiary, etc.)
- To satisfy corporate/company debt



Shareholders/  
Members

Corporation/ LLC

Creditor



# THE THEORIES...



1. Alter Ego Theory
2. Single Business Enterprise Theory
3. Reverse Veil Piercing Theory

# ALTER EGO



- Most common way of piercing the veil
- Standard varies from state to state
- **Unity**
  - Courts look at the extent of unity between the shareholder(s) and the company
  - If there was such unity between the company and the individual that the company was just a “hollow shell” used to **perpetrate a fraud**, the courts are more likely to pierce the veil

# ALTER EGO TEST



- **Courts consider various factors, including:**
  - Commingling of funds
  - Representations that the individual will financially back the company
  - Diversion of company funds to the individual
  - Inadequate capitalization
  - Failure to keep corporate and personal assets separate
  - Failing to observe corporate formalities
  - **Fraud**

# ALTER EGO TEST- FRAUD



- Because courts want to limit the circumstances in which the corporate veil can be pierced, the party seeking to pierce the veil will usually have to prove actual fraud – that is, the corporate form is being used to perpetrate a fraud





# Bernard L. Madoff Investment Securities LLC

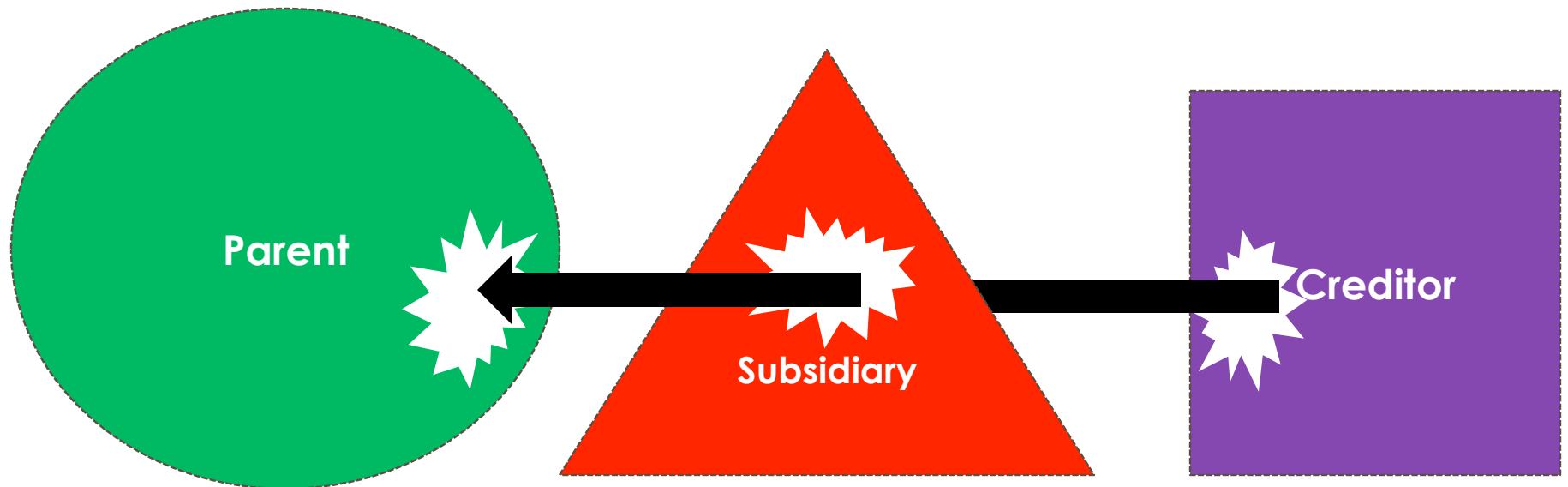




# SINGLE BUSINESS ENTERPRISE



- **Alter ego:** vertical veil piercing to reach the assets of the shareholders/members
- **Single Business Enterprise Theory:** lateral veil piercing to reach the assets of an affiliate company



# SINGLE BUSINESS ENTERPRISE



- Two companies with integrated assets to achieve a common business purpose
- “Single business enterprise” for liability purposes
- Reach the assets of an affiliate, parent, subsidiary, etc.

# SINGLE BUSINESS ENTERPRISE TEST

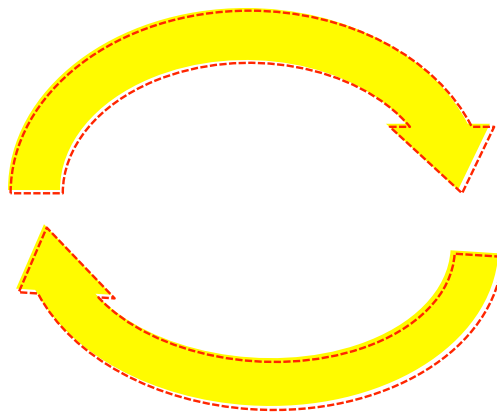


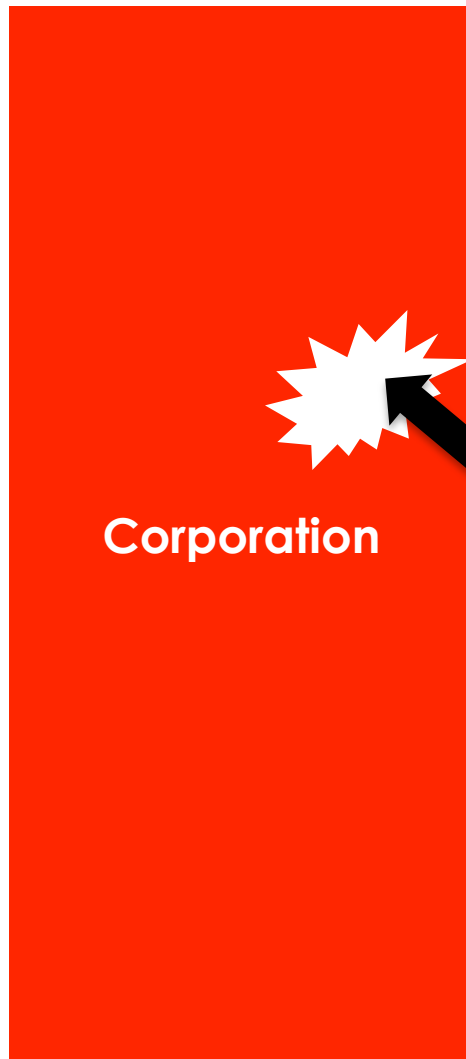
- Factors courts may consider:
  - Common employees
  - Common offices
  - Centralized accounting
  - Payment of wages by one company to the employees of another company
  - Common business name
  - Services rendered by the employees of one company on behalf of another company
  - Undocumented transfer of funds between the companies
  - Unclear allocation of profits/losses between the companies
  - ***Fraud – not always a requirement***

# REVERSE VEIL PIERCING



- Instead of trying to reach the assets of the individual, reverse veil piercing imposes liability on a corporation/LLC for the obligations of an individual shareholder or member
- Veil piercing is used to reach the assets of the corporation





# REVERSE VEIL PIERCING



- Generally same elements/factors of traditional veil piercing:
  1. Unity between the individual and the company
  2. FraudOr some form of inequitable result for creditors

# SLIDING SCALE(S)/STATE SPECIFIC





# CONCLUSION



- The best practice: know who you're doing business with at all stages of the relationship
- Continue to investigate and keep updated information on your customers and their corporate structures
- Avoid the “Shell Game” all together!



# Q & A

