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# Veil Piercing to Non-Owners: A Practical and Theoretical Inquiry

*Mark J. Loewenstein\**

Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.<sup>1</sup>

## I. INTRODUCTION

Limited liability for corporate shareholders<sup>2</sup> and for members of a limited liability company (LLC)<sup>3</sup> is the default rule in every jurisdiction in the United States.<sup>4</sup> Under this rule, the “veil” of the entity shields its owners from liability for the debts, obligations, and tortious conduct of the entity, unless the owner personally guaranteed the obligations or personally engaged in tortious conduct.<sup>5</sup> Every jurisdic-

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<sup>1</sup> *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926).

<sup>2</sup> *See, e.g.*, MODEL BUS. CORP. ACT § 6.22(a) (2008) (“Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.”).

<sup>3</sup> *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 303(a), 6B U.L.A. 587 (1996) (“A member or manager of [an LLC] is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.”).

<sup>4</sup> *See, e.g.*, LARRY E. RIBSTEIN & ROBERT R. KEATING, RIBSTEIN & KEATING ON LIMITED LIABILITY COMPANIES § 12:1 (West 2005 & Supp. 2010).

<sup>5</sup> Partners in both limited liability partnerships (LLPs) and limited liability limited partnerships, as well as limited partners in limited partnerships (LPs), all enjoy limited liability but also theoretically face the prospect of liability through veil piercing. There are, however, virtually no cases in which limited liability partners are held liable on a veil-piercing theory. This is likely due to the fact that a creditor desiring to reach the assets of, for example, a limited partner in an LP could prevail if the creditor could establish that the limited partner participated in control of the business. *See* REVISED UNIF. LTD. P’SHIP ACT, § 303(a) (amended 1985), 6B U.L.A. 180 (2008); *see also* *Zeiger v. Wilf*, 755 A.2d 608, 617 (N.J. Super. Ct. App. Div. 2000) (describing “a number of activities which . . . do not constitute participating in ‘the control of’ a business so as to impose a general partner’s liability on a limited partner”); *Trans-Am Builders, Inc. v. Woods Mill, Ltd.*, 210 S.E.2d 866, 869 (Ga. Ct. App. 1974) (explaining that “[i]t would be unreasonable to hold that a limited partner may not

tion, however, has an important judicially created exception to this rule; under certain circumstances this veil will be pierced, and the owner will be held personally liable.<sup>6</sup> Precisely what those circumstances are has been the subject of numerous court opinions; indeed, no issue in corporate law has been litigated more frequently,<sup>7</sup> and the number of cases involving piercing in LLCs has grown rapidly.<sup>8</sup> Scholarly commentators—always on the lookout for meaty topics—have not overlooked this, and thus, there are many articles arguing the benefits, as well as the detriments, of limited liability and veil piercing.<sup>9</sup> Nearly all such articles focus on the entity owner as the party at risk when veil piercing occurs.<sup>10</sup> In fact, these articles simply assume that the entity owner is the only party at risk.<sup>11</sup> Little has been written about the risk to other actors in the entity, yet as two recent Colorado

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advise with the general partner and visit the partnership business, particularly when the project is confronted with a severe financial crisis”). LLPs will provide courts with a new opportunity to apply veil-piercing doctrines, but to date, there are no reported cases doing so.

While this Article focuses on LLCs and corporations, much of what is written in this Article may apply to LLPs as well. As Bill Callison so perceptively observes, however, we should be careful before we carry corporate doctrines forward to unincorporated entities. See J. William Callison, *Rationalizing Limited Liability and Veil Piercing*, 58 BUS. LAW. 1063, 1072 (2003) (“The entity rationalization movement provides the opportunity for scholars, practitioners, and legislators to take a step back and to consider the various rationale for offering limited liability protection to firm owners and to determine the extent to which such protection should be given.”).

<sup>6</sup> See Peter B. Oh, *Veil Piercing*, 89 TEX. L. REV. 81, 116 (2010).

<sup>7</sup> Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036 (1991).

<sup>8</sup> Restricted to the year 2000, there were six cases found in Westlaw using the search terms “pierc! the veil” and “LLC.” In contrast, the same search restricted to the year 2008 produced thirty-five cases. A similar search of LexisNexis turned up four cases in 2000 and twenty-three cases in 2008.

<sup>9</sup> See, e.g., Rebecca J. Huss, *Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95 (2001); Douglas C. Michael, *To Know a Veil*, 26 J. CORP. L. 41 (2000); David Million, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 EMORY L.J. 1305 (2004).

<sup>10</sup> See, e.g., Robert Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 541 (1977) (“Cases attempting to pierce the corporate veil are unified more by the remedy sought—subjecting to corporate liabilities the personal assets directly held by shareholders—than by repeated and consistent application of the same criteria for granting the remedy.”); see also STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* § 1.1 (Supp. 2010); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1 (1997).

<sup>11</sup> See generally sources in notes 9–10.

cases, *Sheffield Services Co. v. Trowbridge*<sup>12</sup> and *McCallum Family L.L.C. v. Winger*,<sup>13</sup> demonstrate, this risk is real.<sup>14</sup>

This Article focuses on the other actors in the entity and analyzes whether they should be liable under a veil-piercing theory. A considered discussion of this question, however, must begin with the rationale for veil piercing in the owner context. What is the rationale for piercing an entity's veil to reach its owners, and does this rationale apply with equal force to other actors? This Article suggests that the rationale for holding an owner liable for an entity's obligations is weak at best and weaker still when applied to other actors.<sup>15</sup>

Part II of this Article proceeds with a brief review of the veil-piercing doctrine as applied to entity owners.<sup>16</sup> Next, it considers theories under which the LLC manager or corporate officers may be liable to the entity's creditors (both in tort and contract) apart from a veil-piercing theory. This inquiry is important because if alternative theories impose liability when, as a matter of public policy, liability is appropriate, veil piercing may be superfluous. In fact, this Article demonstrates that this may be the case. Finally, Part III of this Article considers veil-piercing cases involving these other actors and concludes with some observations about veil piercing.

Preliminary to this inquiry, however, one must consider whether it is sensible to consider corporation and LLC cases together. They are, after all, quite different entities. The LLC is characterized as a "contractual entity;" its organizers enter into an operating agreement

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<sup>12</sup> 211 P.3d 714 (Colo. App. 2009).

<sup>13</sup> 221 P.3d 69 (Colo. App. 2009).

<sup>14</sup> Several other reported cases have dealt with this issue. See, e.g., *Wordtech Sys. v. Integrated Networks Solutions, Inc.*, 609 F.3d 1308, 1313 n.2 (Fed. Cir. 2010); *Faulkner v. Kornman (In re Heritage Org., L.L.C.)*, 413 B.R. 438, 516 (Bankr. N.D. Tex. 2009).

<sup>15</sup> See, e.g., Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 515 (2001) ("The present state of veil piercing doctrine allows judges to impose their own brand of rough justice without being overly concerned with precedent or appellate review.").

<sup>16</sup> Commentary on veil piercing often includes a discussion of "enterprise liability," the theory under which all participants in a single business enterprise ought to be liable for the conduct of any one of the participants. This theory is typically important in corporate groups, but it may arise in other contexts as well. See, e.g., Daniel W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1614–15 (1991) (advocating abolishing limited liability for wholly owned subsidiaries under some circumstances); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 35–40 (1994) (advocating extending liability in the context of the corporate family). See generally PRESSER, *supra* note 10, § 1:9. Because the focus of this Article is on the liability of individual managers of limited liability entities, enterprise liability is of no moment and will not be considered further.

containing such provisions as to which they agree.<sup>17</sup> Indeed, a number of state's LLC statutes specifically provide that courts should honor the "freedom of contract."<sup>18</sup> The applicable statute typically consists of default rules with very few non-waivable "mandatory provisions."<sup>19</sup> In this regard, there are no mandatory "formalities" to which those operating the LLC must adhere.<sup>20</sup>

In contrast to the informality of the LLC and the flexibility of LLC acts, corporate statutes contain a number of mandatory provisions and required corporate formalities. Although there is some opt-out flexibility,<sup>21</sup> corporations typically are required to have a board of directors,<sup>22</sup> hold annual meetings of shareholders,<sup>23</sup> designate certain specified officers,<sup>24</sup> provide minimum notice for shareholder meetings<sup>25</sup> and special director meetings,<sup>26</sup> and establish appraisal rights for shareholders who dissent from certain transactions.<sup>27</sup> While corporate law has been trending towards affording greater flexibility in the way a corporation structures its affairs, a great deal of rigidity exists and is likely to persist for the foreseeable future.<sup>28</sup>

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<sup>17</sup> See, e.g., Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and LLCs*, 46 AM. BUS. L.J. 221, 221 (2009).

<sup>18</sup> See, e.g., ARK. CODE ANN. § 4-32-1304(a) (2011) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."); COLO. REV. STAT. § 7-80-108(4) (2010) ("It is the intent of this article to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."); DEL. CODE ANN. tit. 6, § 18-1101(b) (2011) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of LLC agreements.").

<sup>19</sup> Common mandatory provisions often relate to members' access to company books and records and the duty of loyalty for those managing the company. See, e.g., UNIF. LTD. LIAB. CO. ACT § 103(b), 6B U.L.A. 596 (1996).

<sup>20</sup> *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 328 (Wyo. 2002).

<sup>21</sup> See, e.g., JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* § 3.10, 57 (2d ed. 2004); see also MODEL BUS. CORP. ACT § 6.30(a) (2008) (allowing articles of incorporation to provide shareholders with preemptive rights to purchase unissued shares).

<sup>22</sup> MODEL BUS. CORP. ACT § 8.01(a) (2008).

<sup>23</sup> *Id.* § 7.01(a).

<sup>24</sup> ALASKA STAT. § 10.06.483(a) (2011) (requiring each corporation to have a president, secretary, and treasurer).

<sup>25</sup> MODEL BUS. CORP. ACT § 7.05(a).

<sup>26</sup> *Id.* § 8.22(a).

<sup>27</sup> *Id.* § 13.02(a).

<sup>28</sup> Mark J. Loewenstein, *A New Direction for State Corporate Codes*, 68 U. COLO. L. REV. 453, 466 (1997) (noting that many jurisdictions have "produced a hybrid corporate code that pleases neither those who advocate shareholder protection nor those who prefer complete freedom of contract").

As discussed below, the failure to follow corporate formalities often looms large in corporate veil-piercing cases.<sup>29</sup> This failure suggests, at least to courts, that the shareholder did not treat the corporation as a separate legal entity and paves the way for the court to do likewise. As LLCs have only self-imposed formalities, if any, the failure to adhere to formalities cannot logically be a factor in deciding whether the veil of an LLC should be pierced.<sup>30</sup> This, however, has not proven to be a barrier in the LLC veil-piercing cases.<sup>31</sup> Instead, the courts have focused on other facts, indicating that the LLC owners did not treat the LLC as a separate legal entity.<sup>32</sup> This doctrine may bleed back into corporate veil-piercing cases, but this remains to be seen. As the law stands currently, except for the continuing importance of the formalities test in corporate cases, the articulated veil-piercing tests for corporations and LLCs are substantially the same.<sup>33</sup> Thus, this Article considers veil piercing for incorporated and unincorporated entities together.

## II. THE DOCTRINE OF VEIL PIERCING

### A. *The Traditional Rubric: The “Privilege Theory”*

Although courts have considered whether a shareholder may be held liable for a corporation’s debts since at least the 1800s,<sup>34</sup> Professor Maurice Wormser first popularized the phrase “piercing the corporate veil” in the early 1900s.<sup>35</sup> Professor Wormser argued that the issuance of a corporate charter is a “privilege” granted by the state

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<sup>29</sup> See discussion *infra* Part II.

<sup>30</sup> *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 328 (Wyo. 2002).

<sup>31</sup> See, e.g., *Sec. Investor Prot. Corp. v. R.D. Kushnir & Co.*, 274 B.R. 768, 775 (Bankr. N.D. Ill. 2002) (“[M]embers’ or ‘managers’ of an Illinois [LLC] cannot be held liable for the mere failure to observe corporate formalities or repayment, but nothing in the statute bars piercing of the ‘corporate veil’ for other grounds on which that may be done for ordinary corporations.”); *Bonner v. Brunson*, 585 S.E.2d 917, 919 (Ga. Ct. App. 2003) (holding that “[i]n the absence of any evidence that [defendant] abused the form of the LLC by commingling or confusing LLC business with his personal affairs, the trial court correctly granted summary judgment dismissing the claim that [defendant] was personally liable for the alleged debt of the LLC”).

<sup>32</sup> See, e.g., *Sheffield Servs. Co. v. Trowbridge*, 211 P.3d 714 (Colo. App. 2009).

<sup>33</sup> See Oh, *supra* note 6, at 84; see also Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063 (2006) (examining sixty-one LLC veil-piercing cases up to and including 2005).

<sup>34</sup> See, e.g., *Booth v. Bunce*, 33 N.Y. 139 (1865).

<sup>35</sup> PRESSER, *supra* note 10, § 1.5 (2009) (citing Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 COLUM. L. REV. 496 (1912)).

and that, if abused, that privilege (or at least its grant of limited liability for the shareholders) can be revoked.<sup>36</sup>

The privilege theory assumes that a corporation has the responsibility to operate in accordance with the public interest, strictly pursuant to the purpose for which the charter was granted.<sup>37</sup> Under this theory, if the corporation is operated in a way that is "counter to the spirit" of the privilege granted, its existence can be ignored. Professor Wormser wrote that:

Since the element of personality is an extraordinary privilege conferred upon the corporation by the law, and involves the employment of a fiction, it follows that "it must be used for legitimate business purposes and must not be perverted," and, just as night follows day, so the courts should and will disregard this fiction "when it is urged for an intent or purpose not within its reason and policy."<sup>38</sup>

In support of this view, Professor Wormser discussed *People's Pleasure Park Co. v. Rohleder*.<sup>39</sup> This case involved an attempt by African-American citizens to avoid the racially restrictive covenants on vacant property by forming a corporation to acquire the property and build an amusement park for people of color.<sup>40</sup> The court held that the covenant was not breached because the corporation was an "artificial person" with "a distinct existence—an existence separate from that of its stockholders."<sup>41</sup>

Professor Wormser argued that the court erred in the decision because it "entirely overlook[ed] that the sole purpose of organization of the corporation was obviously to evade and circumvent the title restriction forbidding negroes from taking the land."<sup>42</sup> Therefore, because the formation of the corporation was an abuse of the incorporation privilege, the court should have disregarded the fiction. Professor Wormser's dictum was consistent with *United States v. Milwaukee Refrigerator Transit Co.*, a 1905 opinion that has been frequently quoted:

[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when

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<sup>36</sup> MAURICE WORMSER, THE DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 8-9 (1927).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* (internal citations omitted).

<sup>39</sup> 61 S.E. 794 (Va. 1908); WORMSER, *supra* note 36, at 26.

<sup>40</sup> *Rohleder*, 61 S.E. at 794.

<sup>41</sup> *Id.* at 796 (internal citation omitted).

<sup>42</sup> WORMSER, *supra* note 36, at 27.



the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime,<sup>43</sup> the law will regard the corporation as an association of persons.

Justice Cardozo adopted a somewhat more nuanced approach to veil piercing in *Berkey v. Third Avenue Railway Company*.<sup>44</sup> In *Berkey*, the court considered an attempt by a personal injury claimant to pierce the veil of a street-car company to reach its owner, a corporation that owned all of the company's stock.<sup>45</sup> What is so instructive about this case is that the court assumed that if it held the parent company liable for the torts of its subsidiary, it would have the legal effect of treating the two companies as one.<sup>46</sup> That, in turn, would mean that the parent corporation was operating a railroad without the authority to do so because New York law required any operator of a railway franchise to obtain the prior approval of the Public Service Commission; and furthermore, lack of approval was a criminal offense.<sup>47</sup> Only the subsidiary had the necessary approval to operate the line on which the plaintiff was injured.<sup>48</sup> Although the lack of approval was not at issue, Justice Cardozo treated the case as though it were, thus implying that piercing cannot be considered only in light of the claim at issue.<sup>49</sup> Rather, the opinion implies that a court should ignore a corporation's separate existence for purposes of satisfying a tort claim only if it would ignore that separateness for all purposes. This more holistic approach to veil piercing is instructive. It requires a court to consider what a decision to pierce says about the pierced entity and the party being held liable under a piercing theory. Though frequently cited for its compelling language,<sup>50</sup> the nuanced approach of *Berkey* has been eclipsed by a more formalistic approach to veil piercing. Typically, courts have operationalized the notion of "abusing the corporate privilege" with tests or factors to determine, in a rather rote

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<sup>43</sup> *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (E.D. Wis. 1905).

<sup>44</sup> 155 N.E. 914 (N.Y. 1927).

<sup>45</sup> *Id.* at 915.

<sup>46</sup> *See id.* ("The acceptance of that conclusion would reduce the statute to futility. The defendant, if it uses or operates its subsidiary's route, is either a coadventurer or a principal or at least a licensee.").

<sup>47</sup> *See id.*

<sup>48</sup> *See id.*

<sup>49</sup> *See id.*

<sup>50</sup> *See, e.g.,* Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95, 109 n.81 (2001) (noting that *Berkey* is "one of the most frequently cited opinions" in the veil piercing context).

fashion, whether the "corporate privilege" has been abused. Although there is some variation from state to state and from opinion to opinion, commonly this approach employs two tests: (1) whether the controlling shareholder and the corporation are alter egos of one another, or, in other words, whether the controlling shareholder dominated the corporation so that it had no separate existence of its own; and (2) whether justice requires ignoring the corporate fiction because it is utilized to perpetrate a fraud or injustice.<sup>51</sup> Some courts add a third test: whether an equitable result will be achieved by disregarding the corporate form.<sup>52</sup> It would be an odd case, however, where the first two tests are satisfied but the third is not. Moreover, the equitable aspect of the piercing doctrine<sup>53</sup> has the effect of providing a post-hoc rationalization for the apparently haphazard way in which the doctrine is applied.<sup>54</sup>

Under the first test, courts often consider whether corporate formalities such as the creation of a board of directors, the appointment of corporate officers, and the maintenance of corporate bank accounts and records have been observed.<sup>55</sup> The absence of such ac-

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<sup>51</sup> See, e.g., *Van Dorn Co. v. Future Chem. & Oil Corp.*, 753 F.2d 565, 569-70 (7th Cir. 1985) ("First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice."); *Micciche v. Billings*, 727 P.2d 367, 373 (Colo. 1986).

[I]f it is shown that shareholders used the corporate entity as a mere instrumentality for the transaction of their own affairs without regard to separate and independent corporate existence, or for the purpose of defeating or evading important legislative policy, or in order to perpetrate a fraud or wrong on another, equity will permit the corporate form to be disregarded and will hold the shareholders personally responsible for the corporation's improper actions.

*Micciche*, 727 P.2d at 373.

<sup>52</sup> See, e.g., *Phillips v. Englewood Post No. 322 Veterans of Foreign Wars, Inc.*, 139 P.3d 639, 644 (Colo. 2006) ("Third, the court must evaluate whether an equitable result will be achieved by disregarding the corporate form and holding the shareholder personally liable for the acts of the business entity.").

<sup>53</sup> See, e.g., *Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc.*, 447 A.2d 406, 411 (Conn. 1982).

<sup>54</sup> See, e.g., *Thomson v. L.C. Roney & Co.*, 246 P.2d 1017 (Cal. Ct. App. 1952).

<sup>55</sup> Courts have identified a number of factors relevant to the first test; one fairly comprehensive list is presented in *Assoc. Vendors, Inc. v. Oakland Meat Co.*, 26 Cal. Rptr. 806, 813-15 (Cal. Dist. Ct. App. 1962) (internal citations omitted):

[1] Commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; [2] the treatment by an individual of the assets of the corporation as his own; [3] the failure to obtain authority to issue stock or to subscribe to or issue the same; [4]

tions indicates that the controlling shareholder is not respecting the corporation as a separate legal entity and supports a judicial decision to ignore it as well. Under this test, courts also consider whether the entity has been adequately capitalized—although, technically, adequate capitalization has little to do with corporate separateness.<sup>56</sup> Capitalization does, however, have salience in the second test, which inquires into the consequences of piercing the veil. But this second test is reached only if the first test is satisfied.

The second veil-piercing test typically is not a major hurdle to a plaintiff's recovery. Of necessity, a plaintiff has already proven that the owners did not respect the separate existence of the entity—that is, the owners have abused the privilege granted to them by the state—and that the plaintiff's claim has not been paid. A "fraud or

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the holding out by an individual that he is personally liable for the debts of the corporation; [5] the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities; [6] the identical equitable ownership in the two entities; [7] the identification of the equitable owners thereof with the domination and control of the two entities; [8] identification of the directors and officers of the two entities in the responsible supervision and management; [9] sole ownership of all of the stock in a corporation by one individual or the members of a family; [10] the use of the same office or business location; [11] the employment of the same employees and/or attorney; [12] the failure to adequately capitalize a corporation; [13] the total absence of corporate assets, and undercapitalization; [14] the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation; [15] the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities; [16] the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; [17] the use of the corporate entity to procure labor, services or merchandise for another person or entity; [18] the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another; [19] the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions; [20] and the formation and use of a corporation to transfer to it the existing liability of another person or entity.

*Id.*

<sup>56</sup> Nevertheless, there is some authority for the idea that inadequate capitalization alone is sufficient to justify piercing. See PRESSER, *supra* note 10, § 1:9 (citing cases from California). As Professor Clark notes, however, state legislatures could mandate minimal initial capitalization for corporations and what he calls "capital maintenance rules" to protect involuntary corporate creditors. See Robert Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 551–52 (1977); see also William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 868–69 (1982) (developing the same idea).

injustice” would result, some courts have said, if the plaintiff’s claim remains unpaid.<sup>57</sup> In an oft-cited case, *Kinney Shoe Corp. v. Polan*, the creditor was a lessor, and the corporate debtor, the lessee, was without assets.<sup>58</sup> This lack of capitalization, together with the fact that the individual defendant bought no stock, made no capital contributions, kept no minutes, and elected no officers, was sufficient to justify piercing the corporate veil.<sup>59</sup> The fraud or injustice would seem to be simply nonpayment. One court has said that creating a corporation to avoid personal liability “constitutes the type of injustice” that satisfies the second test.<sup>60</sup>

Analysis in the LLC context follows a similar pattern, with courts focusing on the extent to which the owners treated the LLC as a separate entity.<sup>61</sup> Because “formalities” are not an issue in the operation of an LLC,<sup>62</sup> courts generally focus on other factors, such as the use of the entity’s bank accounts to pay personal expenses, failure to maintain separate records, use of common facilities by the owners and the company, and inadequate capitalization.<sup>63</sup> If the plaintiff establishes that the entity is so dominated, the court turns its attention to the second test where, as in corporate cases, the plaintiff is likely to prevail.<sup>64</sup>

Courts and scholars often consider a second doctrine in concert with veil piercing—the law of agency. Under this doctrine, the owners of an entity may be held liable for the entity’s obligations in both tort and contract if the entity is an agent of the owners because, under traditional agency principles, the principal is liable for the obligations if the agent was acting within the scope of its employment.<sup>65</sup> This is not, strictly speaking, veil piercing because it does not turn on

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<sup>57</sup> See, e.g., *N.L.R.B. v. West Dixie Enters., Inc.*, 190 F.3d 1191, 1194 (11th Cir. 1999) (noting, with reference to the second test, that funds siphoned out of the corporation by the shareholders were “unavailable to meet [the corporation’s] remedial obligations”).

<sup>58</sup> 939 F.2d 209 (4th Cir. 1991).

<sup>59</sup> *Id.* at 212–13.

<sup>60</sup> *Autrey v. 22 Tex. Servs. Inc.*, 79 F. Supp. 2d 735, 746 (S.D. Tex. 2000).

<sup>61</sup> See generally Ann K. Wooster, *Construction and Application of LLC Acts—Issues Relating to Personal Liability of Individual Members and Managers of LLCs as to Third Parties*, 47 A.L.R. 6th 1 (2009) (collecting cases).

<sup>62</sup> See *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 328 (Wyo. 2002); *Westmeyer v. Flynn*, 889 N.E.2d 671, 678 (Ill. App. Ct. 2008).

<sup>63</sup> See *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298, 313 (Conn. App. Ct. 2002).

<sup>64</sup> See *id.* (Second, the court “consider[s] whether the court properly found that Mary Ann Howell used that control and dominance to perpetrate a wrong.”).

<sup>65</sup> See RESTATEMENT (THIRD) OF AGENCY § 7.03 (2006).

factors such as whether corporate formalities were followed or whether there was adequate capitalization. Yet when applying agency principles, courts often look to these factors, perhaps because a key factor in determining whether one is an agent of another is the degree of control exercised over the purported agent.<sup>66</sup> If a corporation or LLC does not have the indicia of a separate entity—a functioning governing body, separate bank accounts, etc—it is more likely that it was subject to the domination and control of its owners. Nevertheless, the agency theory generally is confined to instances in which the owner is an entity—typically a corporation—and the agent is a wholly owned subsidiary.<sup>67</sup> While there are other theories rationalizing veil piercing, the “privilege theory” has been dominant.<sup>68</sup>

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<sup>66</sup> See, e.g., *A. Gay Jensen Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981) (holding that lender’s control over debtor was sufficient to render the debtor an agent of the lender).

<sup>67</sup> See, e.g., *Henry v. St. Croix Alumina, LLC*, No. 1999/0036, 2007 WL 6030275, at \*8 (D.V.I. Aug. 10, 2007) (“In Delaware, [a] court can pierce the corporate veil of an entity . . . under an agency theory where the parent exercises dominion over the subsidiary. . . . Thus, [agency theory] require[s] the parent corporation to exercise a certain degree of control over the subsidiary that would warrant piercing the corporate veil.”) (citations omitted).

<sup>68</sup> See, e.g., *Clark*, *supra* note 56, at 541 (arguing that veil piercing is employed by the courts when other doctrines, principally, fraudulent conveyance, are found lacking and moral precepts support denying limited liability for an entity’s owner). In addition, some courts tweak the traditional two-factor test to develop what has been called the “instrumentality rule” and the “identity rule.” PHILLIP I. BLUMBERG ET AL., *BLUMBERG ON CORPORATE GROUPS* §§ 6.02–06, 10.03 (Aspen Pub. 2009) (addressing “instrumentality” and “identity” doctrines). See also *Bergesen v. Lindholm*, 760 F. Supp. 976, 987–88 (D. Conn. 1991) (comparing the two rules). The former is a three-factor test requiring proof of

“(1) [c]ontrol, not mere majority or complete stock control, but complete domination, not only of finances but of policy and business practice *in respect to the transaction attacked* so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; (2) that such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of plaintiff’s legal rights; and (3) that the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.”

*Litchfield*, 799 A.2d at 312–13 (quoting *Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc.*, 447 A.2d 406, 410 (1982)). The identity rule is a two-factor test:

If a plaintiff can show that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise.

*Id.* at 315 (quoting *Tomasso*, 447 A.2d. at 411). It would appear that the identity rule is more appropriate in the parent-subsidary context, but the tests are not materially

Piercing can occur in both tort and contract cases.<sup>69</sup> Arguably, the case for the former is more compelling than the latter. After all, the creditor in a contract case chose its debtor and had an opportunity to assess the ability of the debtor to discharge its obligations. The tort victim typically does not enjoy that luxury. Nevertheless, it appears that contract creditors, sometimes called voluntary creditors, are at least as successful as tort creditors, or involuntary creditors.<sup>70</sup> In either case, the judicial focus on “formalities” makes little sense because there is no causal connection between the failure to observe some level of formality and the loss to the creditor. Yet, as Professor Thompson’s data indicate, formalities clearly matter—courts pierce the corporate veil in two-thirds of the cases in which it is found that the individual defendant failed to observe corporate formalities, and courts decline to pierce in over ninety percent of the cases in which there was a finding that formalities were observed.<sup>71</sup> These factors, combined with the apparently random nature of veil piercing, have prompted calls for its elimination as a legal doctrine. Professor Stephen Bainbridge, in an exhaustive analysis, concluded that no persuasive justification for the doctrine could be identified.<sup>72</sup>

### B. Economic Analysis

When an entity bears the consequences of torts committed by its agents, it can insure against those torts and/or capitalize the entity sufficiently to bear those costs. Some have argued that the owners of the entity, or certain senior managers, should bear these costs if the entity cannot, so as to deter entities from being undercapitalized or underinsured and externalizing these costs to tort creditors.<sup>73</sup> This externalization is commonly characterized as a moral hazard—“the incentive created by limited liability to transfer the cost of risky activities to creditors.”<sup>74</sup> Such proposals, however, are problematic. To

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different. In any event, in the *Litchfield* case the court found that both tests had been satisfied.

<sup>69</sup> See, e.g., John H. Matheson, *Why Courts Pierce: An Empirical Study of Piercing the Corporate Veil*, 7 BERKELEY BUS. L.J. 1, 20 (2010) (providing data regarding court piercing statistics for both contract and tort cases).

<sup>70</sup> See Thompson, *supra* note 10, at 1050.

<sup>71</sup> *Id.* at 1063–65.

<sup>72</sup> Bainbridge, *supra* note 15, at 514.

<sup>73</sup> See Timothy P. Glynn, *Beyond “Unlimiting” Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 396 (2004) (pertaining to senior managers); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1990–1991) (pertaining to entity owners).

<sup>74</sup> Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 104 (1985).

start, the risk of personal liability would naturally discourage investment in business entities if investors risk liability,<sup>75</sup> and employment, if managers bear the risk. This is a social cost that must be weighed against the presumed social benefit of limiting the externalization of risk.<sup>76</sup> Second, it is not altogether clear that businesses systematically under-invest in avoiding loss.<sup>77</sup> Indeed, businesses risk the investment of their owners if they under-invest in safety measures and insurance. Moreover, managers whose investment in the firm consists not only of any equity they may own but also of the human capital they have invested have a strong incentive to protect that human capital by insuring against risks.<sup>78</sup> Owners and managers also have reputations to protect, and under-investment that results in uncompensated claimants places those reputations at risk. Finally, and apart from reputational harm, managers and owners may recognize a moral obligation to compensate those injured by the entity that they manage or in which they invest and thus capitalize and/or insure the firm appropriately.

Of equal importance is the question of who is the more efficient risk bearer.<sup>79</sup> For some risks, it may be the case that an injured party is better able to insure against the risk and to do so at a lower cost. Expanding the liability of owners and managers for such risks under some notion of veil piercing would, of course, be economically ineffi-

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<sup>75</sup> *Id.* at 91; see also William H. Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L. REV. 371, 371 (1981) ("The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting all of their personal wealth to the risks of the business."); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967).

<sup>76</sup> Easterbrook & Fischel, *supra* note 74, at 104 ("Externalization of risk imposes social costs and thus is undesirable."). *But see* PRESSER, *supra* note 10, § 1:7 (arguing that investors are focused on the amount of potential returns from an investment, not the potential liability). Professor Presser also argues that the costs of monitoring that would arise from unlimited liability are manageable and not, alone, a reason for limited liability. *Id.* § 1:7, at 1-39.

<sup>77</sup> Easterbrook & Fischel, *supra* note 74, at 104 ("[T]he magnitude of the externality under limited liability has been exaggerated. As Richard Posner has demonstrated, there is no externality with respect to voluntary creditors. In addition, firms have incentives to insure for amounts greater than their existing capital. The insurance company becomes a contract creditor, reducing the externality.") (footnote omitted).

<sup>78</sup> *Id.* at 107 ("A firm with insurance against tort claims is less likely to become bankrupt, and thus less likely to impose costs on managers and other employees. Insurance thus induces people to make firm-specific investments of human capital.").

<sup>79</sup> *Id.* at 101-02 ("In some circumstances creditors might have a comparative advantage in assessing the riskiness of a transaction initially and superior ability to monitor the conduct of the firm for the duration of the agreement.").

cient. Moreover, even in those instances in which the entity was the most efficient risk bearer and, *ex ante*, under-invested in safety and insurance, we must consider whether a broad rule that imposes liability on individuals is warranted. Such a rule may cause owners and managers to over-invest in precautionary behavior and insurance so as to avoid uncompensated, or under-compensated, injury to relatively few injured parties.

Professor Timothy Glynn, in a recent article, seeks to overcome these concerns by arguing that imposing vicarious liability on senior officers for an entity's torts is justified because they are the most efficient risk bearers and "are in the best position to monitor and avoid risks."<sup>80</sup> Managerial aversion to risk and the risk of over-deterrence are not concerns under his approach because such officers are now part of a mobile "managerial class" and that mobility means that their human capital investment is therefore reduced.<sup>81</sup> Professor Glynn also argues that over-deterrence "will be constrained by their incentive-based compensation, the equities markets, controlling shareholder oversight, and other factors."<sup>82</sup> But these responses miss the mark for several reasons. First, only officers of publicly held corporations are part of any managerial class. Officers in closely held entities may have a considerable human capital investment in their firms, which makes them risk averse.<sup>83</sup> Of equal importance, the degree of human capital one has invested in his or her firm and the extent to which that investment motivates the manager to be risk averse is entirely separate from the affect of potential personal liability. One's human-capital investment may not affect one's aversion to risk, but liability surely will.

Second, it seems doubtful that any mix of compensation and other factors could adequately compensate for the risk of unlimited liability in many settings.<sup>84</sup> The only obvious contractual undertaking that would compensate for the risk is a right to indemnification by the firm. Of course, such a right already exists as a matter of agency

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<sup>80</sup> Glynn, *supra* note 73, at 334.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1472 (1989).

<sup>84</sup> See, e.g., Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 434 (1992) ("Making officers and directors personally liable may create undesirable incentives to be too cautious, may drive capable people away from such jobs, and may provide inadequate compensation if complete insurance coverage is not available.").



law,<sup>85</sup> and if, somehow, the law were to impose vicarious liability on managers, contractual indemnification would become the norm.

Finally, and most importantly, one might question Professor Glynn's premise that officers are efficient risk bearers.<sup>86</sup> This view assumes that senior officers should be vicariously liable, as is an employer under the doctrine of respondeat superior,<sup>87</sup> because a senior officer is "the person most able to prevent the tortious conduct and spread the risk."<sup>88</sup> But often, that is simply not the case. In complex businesses—and many closely held entities operate such businesses—it is unrealistic to expect any officer to be able to assess the risk and monitor the activities of numerous employees and other agents. With regard to tortious conduct, which is the focus of Professor Glynn's proposal, injured plaintiffs do have a claim against the wrongdoer and possibly against the person or persons who had a duty to supervise or control the wrongdoer.<sup>89</sup> By assumption, then, Professor Glynn's theory of vicarious liability for officers only applies when the officer did not have the responsibility to monitor the tortfeasor.

By comparison, traditional notions of respondeat superior impose liability on an employer in part because the employer hired the wrongdoer and was in the best position to monitor and control his or her performance.<sup>90</sup> An officer is not necessarily in that position, and the risk of vicarious liability would deter non-owners from agreeing to serve as managers or would result in their retention at a higher level of compensation. If one were committed to identifying natural persons within a firm to bear liability, the logical persons would be the board of directors or other governing body of the firm. Imposing vicarious liability on that body, however, would radically change its responsibilities and composition. That is, perhaps, why no one has ever suggested that, as a matter of public policy, boards should be personally liable for the tortious conduct of a firm.

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<sup>85</sup> RESTATEMENT (THIRD) OF AGENCY § 8.14 (2006).

<sup>86</sup> Glynn, *supra* note 73, at 334.

<sup>87</sup> This is the doctrine under which liability is imposed upon an employer for the acts of his employees committed in the course and scope of their employment. 3 AM. JUR. 2D *Agency* § 261 (2011).

<sup>88</sup> Glynn, *supra* note 73, at 335.

<sup>89</sup> *See, e.g., Godfrey v. Iverson*, 559 F.3d 569, 571 (D.C. Cir. 2009) (holding professional athlete liable for negligent supervision of his bodyguard); *Estate of Countryman v. Farmers Coop. Ass'n*, 679 N.W.2d 598 (Iowa 2004) (holding manager liable for negligent supervision); RESTATEMENT (THIRD) OF AGENCY § 7.05 (2006).

<sup>90</sup> *See, e.g., Huggins v. FedEx Ground Package Sys., Inc.*, 592 F.3d 853, 858 (8th Cir. 2010); RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006).

Conventional economic analysis generally recognizes that a regime of limited liability is economically efficient and exceptions to it ought to rest on a sound basis. For instance, Professors Frank Easterbrook and Daniel Fischel considered the appropriateness of veil piercing in their article on limited liability, *Limited Liability and the Corporation*.<sup>91</sup> They argue that limited liability for corporations is justified because it facilitates trading in corporate shares and business diversification by corporate managers.<sup>92</sup> Thus, veil piercing does, and ought to, occur "where limited liability provides minimal gains from improved liquidity and diversification, while creating a high probability that a firm will engage in a socially excessive level of risk taking."<sup>93</sup> This is, of course, most likely in close corporations, which account for all veil-piercing cases.<sup>94</sup> There are no reported cases in which shareholders of a publicly held, or even a widely held, corporation were held liable on a piercing theory.

Professors Easterbrook and Fischel then assert that veil piercing is more appropriate in cases involving tort than in cases involving contract because voluntary creditors can protect themselves while involuntary creditors cannot.<sup>95</sup> Moreover, the moral hazard problem exists with respect to involuntary creditors because they do not have the ability to assess the risk that they face and, thus, cannot price it accordingly.<sup>96</sup> But Professors Easterbrook and Fischel maintain that even voluntary creditors should be able to pierce the veil when they have been misled as to the entity's financial situation because, under those circumstances, they cannot accurately assess the risk.<sup>97</sup> This view might be questioned, as the actors who misled the creditor should be personally liable on a theory of fraud or, at least, negligent misrepresentation. In either case, the piercing remedy would seem to be superfluous.

Finally, Professors Easterbrook and Fischel argue that undercapitalization should be a basis for piercing for both voluntary and invo-

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<sup>91</sup> See Easterbrook & Fischel, *supra* note 74.

<sup>92</sup> *Id.* at 96-97.

<sup>93</sup> *Id.* at 109.

<sup>94</sup> See Oh, *supra* note 6, at 110 ("Veil-piercing claims prevail exclusively against close corporations.").

<sup>95</sup> See Easterbrook & Fischel, *supra* note 74, at 112.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at 106. While not mentioned in their article, arguably veil piercing is inappropriate under those circumstances because the creditor should have an independent tort claim arising out of the misrepresentation, and this claim would be valid against any individuals who made the misrepresentation.

luntary creditors.<sup>98</sup> With respect to the former, they argue that creditors, particularly smaller trade creditors, should be able to assume that firms have adequate capitalization, which they define as “an amount of equity that is within the ordinary range for the business in question,” and can pierce the veil if it is inadequate, unless such inadequacy was disclosed.<sup>99</sup> They note that the firm is in a better position to assess its capitalization than are its creditors.<sup>100</sup> As to involuntary creditors, it would follow a priori that if veil piercing is appropriate for voluntary creditors in the event of undercapitalization, it is more appropriate for involuntary creditors.

The problem with this rather generous view of veil piercing is that judging the adequacy of a firm’s capitalization is no easy matter. Using the rubric of Professors Easterbrook and Fischel, one might ask what the “ordinary range” of capitalization is in any business.<sup>101</sup> Should the question be litigated, the parties would likely be limited to expert testimony, which would surely be in conflict. The problem is particularly acute because the judgment is made in retrospect, after the liability has been incurred and after the judgment against the entity has been returned unsatisfied. Moreover, this view of veil piercing raises a thorny fairness problem—why should the shareholders of inadequately capitalized closely held entities risk personal liability while those in publicly held entities do not? Would this not discourage investment in closely held entities and thereby result in a social cost? Finally, allowing veil piercing on the basis of undercapitalization alone would generate a delicate question of damages: Should the recovery be limited to the amount that plaintiff would have recovered if the entity had been adequately capitalized, even if that amount is less than the plaintiff’s loss? This recognizes, of course, that even well-capitalized entities suffer financial reversals and the inability to pay their debts. This is perhaps why veil piercing on the basis of undercapitalization alone is rare, if not nonexistent.<sup>102</sup>

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<sup>98</sup> *Id.* at 113.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> See Easterbrook & Fischel, *supra* note 74, at 113.

<sup>102</sup> See BRANSON ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY 220 (2008) (“[A]s case law shows, inadequate capitalization alone is rarely sufficient to pierce the corporate veil.”); Bainbridge, *supra* note 15, at 521 (observing the “courts’s well-nigh universal refusal to treat undercapitalization, standing alone, as dispositive”); Glynn, *supra* note 73, at 355 (“The mutual exclusivity of limited shareholder liability and ‘undercapitalization’ is why no court, to my knowledge, has pierced based on this factor alone.”).

Consistent with this view, Professor Stephen Presser has observed that the concept of limited liability for corporate shareholders arose in the nineteenth century to encourage less wealthy but enterprising entrepreneurs to create new businesses.<sup>103</sup> The creation of new businesses continues to be an important societal goal, and the centrality of limited liability continues to be a legislative priority. The last few decades have seen the advent and dramatic growth of the LLC, now the predominant form of new business in America.<sup>104</sup> Moreover, state legislatures have afforded limited liability for partners in general partnerships by providing the option of a limited liability partnership,<sup>105</sup> and for general partners in limited partnerships through the limited liability limited partnership.<sup>106</sup> These developments send a message that limited liability is a legislative priority that should not be undercut by judicial exceptions.

### C. Summary

The economic analysis of veil piercing ignores the standard rubric of veil-piercing language and instead focuses more broadly on whether limited liability is economically efficient. Under this view, whether the entity was meticulous in its record keeping is irrelevant. The third party who suffered a loss, whether in contract or tort, is not protected from that loss by any such formalities. Rather, what is relevant for contract creditors is the extent to which the entity provided misleading information and, for tort creditors, the extent to which the entity adequately insured itself against loss. But the veil-piercing doctrine, although recognizing that such considerations are relevant, has proceeded instead on a formalistic basis. The results of applying the formula are unpredictable, which accounts for the large body of litigation on the issue.

For well-advised companies, veil piercing is thus easy to avoid.<sup>107</sup> It seems fair to conclude, then, that the doctrine has a punitive aspect

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<sup>103</sup> Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155–56 (1992).

<sup>104</sup> “The number of new LLCs formed in America in 2007 now outpaces the number of new corporations formed by a margin of nearly two to one.” Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010). In several “bellwether” states such as Delaware and Colorado, over three new LLCs are formed for every one new corporation formed. *Id.*

<sup>105</sup> UNIF. P'SHIP ACT § 306(c) (1997).

<sup>106</sup> UNIF. LTD. P'SHIP ACT § 404(c) (2001).

<sup>107</sup> See *supra* note 71 and accompanying text.

and a deterrent effect. The message to entity organizers is clear: if you seek limited liability, take care to treat the entity you formed as a separate entity, on pain of personal liability. Thus, to the extent that moral hazard exists, it is inadequately addressed by the traditional rubric. A survey of reported veil-piercing cases conducted by Professor Robert Thompson disclosed that courts pierce the corporate veil about 40% of the time that such a claim is asserted,<sup>108</sup> but surprisingly, courts do so more often in contract cases than in tort cases.<sup>109</sup> In fact, tort claimants successfully pierced the veil in just 31% of the cases,<sup>110</sup> compared to 42% for contract claimants.<sup>111</sup> The data suggest that deterring moral hazard may not be a large factor in piercing decisions. In addition, while the proof of misrepresentation was highly correlated with a decision to pierce,<sup>112</sup> misrepresentation was a factor in only 169 cases, or about 10% of the pool of cases.<sup>113</sup> This suggests that the strongest basis for piercing in contract cases was rarely present.

In short, the basis for holding the owners of any entity liable for the entity's obligation is thin, resting on formalism with little attention paid to the economic consequences of limited liability. The privilege doctrine, which is the underlying basis for the veil-piercing tests, is itself difficult to rationalize. It is founded on little more than the assertion that if the owner of the entity does not respect its separate existence, then neither should the courts. In the decades since Professor Wormser posed that argument, the incorporation process has become increasingly simplified and available as a matter of right.<sup>114</sup> Organizing an LLC is similarly quite easy.<sup>115</sup> Finally, even if operating as a corporation or LLC could fairly be characterized as a privilege, it does not follow that failing to adhere to formalities constitutes an "abuse" of that privilege or that a claimant should be able to reach the personal assets of the owners. A more logical result from a finding of abuse would be that the "privilege" should be revoked by the state but not retroactively. Section 14.30(a)(1)(ii) of the Model Business Corporation Act (MBCA) authorizes the court to dissolve a

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<sup>108</sup> Thompson, *supra* note 10, at 1048.

<sup>109</sup> *Id.* at 1058.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 1063 (Piercing occurred in 94% of the cases in which the presence of misrepresentation was cited by the court.).

<sup>113</sup> *Id.*

<sup>114</sup> BRANSON ET AL., *supra* note 102, at 5.

<sup>115</sup> All that is necessary is a simple filing, typically called "Articles of Organization" and containing minimal information about the entity, with the Secretary of State. See UNIF. LTD. LIAB. CO. ACT §§ 202-03 (1996).

corporation if “the corporation has continued to exceed or abuse the authority conferred upon it by law.”<sup>116</sup> Thus, because the statutory drafters have provided a remedy, judicial veil piercing is arguably unauthorized.<sup>117</sup>

In addition, the privilege notion of corporate law is of questionable value in characterizing limited liability entities. Many scholars and commentators view corporations (and, by extension, all limited liability entities) as a “nexus of contracts.”<sup>118</sup> That is, the entity ought not be characterized as a separate legal person but rather as a series of separate contracts, both implicit and explicit, among and between the various actors within the firm and providers of goods and services from outside the firm.<sup>119</sup> Under this view, the corporate or other limited liability entity statute merely provides default rules. The parties can contract around these default rules, but for the sake of efficiency, the default rules ought to be those that the parties would likely agree to were they to bargain over them. While it is beyond the scope of this Article to provide an analysis of whether limited liability is the appropriate default rule under this contractarian approach, two observations are in order. First, all corporate codes and LLC acts provide that limited liability is a default rule, so it is implicitly a part of all dealings between the entity and third parties. Second, sound analysis supports the idea that this default rule is efficient for both publicly held and closely held entities and in both contract and tort settings.<sup>120</sup>

Veil piercing raises yet another fundamental question, this one of prudential importance: Do courts exceed their prudential role when grafting a remedy onto a statute? This question should be considered in light of other provisions in the corporate code and LLC acts that address the equitable concerns that underlie the veil-piercing doctrine. Most veil-piercing cases, whether concerning corporations or LLCs, involve situations in which the owners of the enti-

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<sup>116</sup> MODEL BUS. CORP. ACT § 14.30(a)(1)(ii) (1984).

<sup>117</sup> *But cf.* Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298 (Conn. App. Ct. 2002).

<sup>118</sup> *See, e.g.*, Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 100 (1989).

<sup>119</sup> *See generally* BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE, AND OPERATION* 31–41 (1997) (summarizing nexus of contracts theory); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1996); Henry Hansmann & Reinier Kraakman, *The End of History in Corporate Law*, 89 GEO. L.J. 439 (2001); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

<sup>120</sup> Bainbridge, *supra* note 15, at 485–507.

ty have distributed entity assets to themselves, leaving the entity unable to pay its obligations to creditors. The entity statutes, as well as other provisions of federal and state law, discussed below, deal directly with this situation.<sup>121</sup> Taken together, these provisions provide a legislative solution to the most common problem addressed in veil-piercing cases.

The idea, however, that state courts act without jurisdiction, or at least unadvisedly, when grafting equitable remedies onto a state statute is not widely accepted.<sup>122</sup> While federal courts are limited in their ability to create common law,<sup>123</sup> the conventional wisdom is that state courts are not.<sup>124</sup> This Article challenges this conventional wisdom, at least in the context of business association statutes. The statutes are crafted to balance the interests of the various constituencies of the entity—owners, managers, and third parties dealing with the entity—regarding the rights and obligations of the owners and managers. A business association statute serves no other purpose, and it arguably pre-empts the field on the issues it resolves. Judicial decisions that alter this balance by allowing a creditor to pierce the veil of an entity and hold an owner liable result in legislative push-backs,<sup>125</sup> add transaction costs as parties seek to contract around the judicial incursion,<sup>126</sup> or create uncertainty and additional litigation.<sup>127</sup> This is un-

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<sup>121</sup> See discussion *infra* Part III.

<sup>122</sup> See Zechariah Chafee Jr., *Coming into Equity with Clean Hands*, 47 MICH. L. REV. 1065, 1092 (1949); Mary Siegel, *The Dangers of Equitable Remedies*, 15 STAN. J.L. BUS. & FIN. 86, 88 (2009).

<sup>123</sup> See *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938). See generally Note, *Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 HARV. L. REV. 853 (1982) (discussing state alter ego laws and the inability of federal common law to disregard the corporate entity).

<sup>124</sup> See *Erie*, 304 U.S. at 79.

<sup>125</sup> In response to *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), a case in which the Texas Supreme Court announced a broad test for veil piercing, the Texas legislature amended its corporate code to drastically limit the doctrine. The court in *Castleberry* held that to pierce the corporate veil, a claimant need only show constructive fraud, which the court defined as “the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate a confidence, or to injure public interests.” *Id.* at 273. The legislative response is in section 21.223(b) of the Texas Business Organizations Code, which provides that a claimant must prove that a shareholder “caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the [claimant] primarily for the direct personal benefit of the [shareholder].” TEX. BUS. ORGS. CODE ANN. § 21.223(b) (2009). See generally Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 407–11 (2009) (discussing the statute).

<sup>126</sup> Bainbridge, *supra* note 15, at 481.

<sup>127</sup> *Id.*

fortunate, as one of the main goals of corporate law is, or at least ought to be, to provide predictability so that entrepreneurs can confidently invest.<sup>128</sup>

It is in this context that this Article considers the wisdom of veil piercing to hold non-owners liable. Before reaching that question, the next Part considers the liability of entity managers aside from veil-piercing claims. In effect, Part III provides the alternative to veil piercing and implicitly asks the question as to whether an additional veil-piercing cause of action is needed.

### III. HOLDING MANAGERS LIABLE

#### A. *Managerial Liability in the Absence of Veil Piercing*

The appropriateness of veil piercing should be considered in light of other doctrines that hold entity managers liable for what might be characterized as entity obligations. This Part demonstrates that there are several theories on which personal liability attaches and raises the obvious question as to whether an additional one—veil piercing—serves as critical a function as the courts and supporters of the doctrine assume. Interestingly, in the recent Colorado veil-piercing cases discussed below, it appears that such a cause of action existed; that is, the Colorado courts had ample reasons to hold the managers liable without resorting to veil piercing.<sup>129</sup>

##### 1. Tort Actions

In tort actions, the most important basis for holding managers liable is for their own wrongful conduct, an exception to non-liability carved out in corporate and LLC statutes.<sup>130</sup> For instance, in *Weber v. U.S. Sterling Securities, Inc.*, a Delaware LLC sent a business solicitation via fax to the plaintiff in violation of a federal statute that prohibited such solicitations.<sup>131</sup> Two individuals who owned and operated the

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<sup>128</sup> See *id.* at 514 n.166 (“It is obviously important that the Delaware corporate law have stability and predictability.”) (quoting *Harff v. Kerkorian*, 324 A.2d 215, 220 (Del. Ch. 1974)).

<sup>129</sup> See *infra* Part III.B.

<sup>130</sup> See, e.g., MODEL BUS. CORP. ACT § 8.31(a)(2) (1984); UNIF. LTD. LIAB. CO. ACT § 303 cmt. 2 (1996). See generally 2 LARRY RIBSTEIN & ROBERT KEATINGE, RIBSTEIN AND KEATINGE ON LLCs §§ 12:1–12.4 (2d ed. 2005) (noting that all LLC acts expressly provide that members and managers are not liable for the debts, obligations, or other liabilities of the LLC, but that this limitation “does not protect the members or managers from direct individual liability for their own wrongs, such as torts and professional malpractice”).

<sup>131</sup> 924 A.2d 816, 819–20 (Conn. 2007).



LLC were named as defendants and prevailed on summary judgment; the trial court concluded that they could not be personally liable.<sup>132</sup> The Connecticut Supreme Court reversed, holding that claims under the statute “generally are viewed as sounding in tort” and that the individual defendants, although they purported to act on behalf of the LLC, may themselves have violated the statute.<sup>133</sup>

In some ways, *Weber* is an easy case—the individual defendants were alleged to have actually committed the wrongful act. A bit more attenuated than *Weber* is the case *Estate of Countryman v. Farmer’s Cooperative Association*, in which the defendant’s wrongful act was more in the nature of nonfeasance than misfeasance.<sup>134</sup> The case arose out of a residential natural gas explosion resulting in death.<sup>135</sup> One of the defendants, the manager of the LLC that supplied the propane, was alleged to be at least partially at fault for failing to properly warn the propane users about the attendant dangers.<sup>136</sup> This negligence was enough, in the court’s view, to hold the manager directly liable to the injured parties.<sup>137</sup>

The *Estate of Countryman* decision pushes the boundaries of direct liability for managers of a limited liability entity because the defendant, at least arguably, did not have a direct duty to the plaintiffs or their decedents. The manager owed a duty to the LLC that employed him, and many courts have ruled that an agent is not liable for damages to a third party for a breach of the duty that the agent owes to the principal.<sup>138</sup> That is, many courts have drawn a distinction between misfeasance and nonfeasance, with the former a basis for liability but not the latter.<sup>139</sup> The principal in the *Estate of Countryman*—the

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<sup>132</sup> *Id.*

<sup>133</sup> *Id.* at 825.

<sup>134</sup> See 679 N.W.2d 598, 599–601 (Iowa 2004).

<sup>135</sup> *Id.* at 599.

<sup>136</sup> *Id.* at 599–600.

<sup>137</sup> *Id.* at 605.

<sup>138</sup> See, e.g., *Coker v. Dollar*, 846 F.2d 1302, 1304 (11th Cir. 1988).

<sup>139</sup> *Peguero v. 601 Realty Corp.*, 873 N.Y.S.2d 17, 21 (App. Div. 2009) (“The ‘commission of a tort’ doctrine permits personal liability to be imposed on a corporate officer for misfeasance or malfeasance, i.e., an affirmative tortious act; personal liability cannot be imposed on a corporate officer for nonfeasance, i.e., a failure to act.”) (citing *Michaels v. Lispenard Holding Corp.*, 201 N.Y.S.2d 611, 614 (App. Div. 1960); see also *MLM LLC v. Karamouzis*, 767 N.Y.S.2d 620 (App. Div. 2003)). See generally 3A WILLIAM FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1161, n.5 (collecting cases). But see *id.* at n.9 (collecting contrary cases). Even in New York, however, where the courts have embraced a misfeasance / nonfeasance distinction, the potential liability of corporate and LLC managers is far from clear. In *Haire v. Bonelli*, 870 N.Y.S.2d 591, 594 (App. Div. 2008), for in-

supplier of the propane—presumably owed a duty to warn and would be liable if it failed to discharge that duty,<sup>140</sup> but its agents, arguably, did not owe such a duty. By contrast, if the agent had negligently damaged the plaintiff's premises while installing a heater, the agent's liability is clearer; the agent owed a duty to both its principal and to the customer to exercise due care while on the customer's premises.<sup>141</sup> Nevertheless, the trend of the law seems to be in the direction of eliminating the distinction between misfeasance and nonfeasance in determining the liability of an agent,<sup>142</sup> and the court in *Estate of Countryman* did not even discuss the issue.

## 2. Contract Actions

Corporate codes, LLC acts, and statutes that regulate "fraudulent transfers" all provide direct statutory claims against managers of limited liability entities and also often provide a remedy otherwise sought in a veil-piercing case.<sup>143</sup> For instance, corporate codes and LLC acts prohibit the distribution of entity assets to owners if the entity is insolvent or would be rendered insolvent by the distribution,<sup>144</sup> and a director or manager who authorizes a distribution in violation of these sections is liable to the entity for the amount of the distribution in excess of what the statute allows.<sup>145</sup> There are procedural barriers in these sorts of provisions, such as the MBCA, which requires a

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stance, which arose out of a shooting at a shopping mall, the court refused to dismiss a claim against individual defendants who were officers or members of the defendant corporations or LLCs. The plaintiff had alleged that these individual defendants "participated in the commission of a tort in furtherance of company business or to benefit the business, namely reducing or eliminating mall security to maximize profits." *Id.* This allegation is fairly close to an allegation of nonfeasance and points out the difficulty of distinguishing between the two. *Haire* might also be explained as peculiar to the law of property. See also *Gray (ex rel. Rudd) v. Beverly Enterprises-Mississippi, Inc.*, 390 F.3d 400, 410 (5th Cir. 2004) ("Plaintiffs cannot demonstrate hands-on contact by the defendants, but such activity does not seem required to impose personal liability under Mississippi law. One may easily be a direct participant in tortious conduct by merely authorizing or negligently failing to remedy misconduct by one's subordinates.").

<sup>140</sup> RESTATEMENT (SECOND) OF TORTS § 388 (1965) (There is a duty to warn end users of products "known to be dangerous for intended use.").

<sup>141</sup> See *id.* § 284; see also RESTATEMENT (SECOND) OF AGENCY §§ 13, 343, 350, 352 (1958).

<sup>142</sup> RESTATEMENT (THIRD) OF AGENCY § 7.01 cmt. a (2006) (An "agent's tort liability extends to negligent acts and omissions as well as intentional conduct.").

<sup>143</sup> ROBERT C. CLARK, CORPORATE LAW § 2.4, at 71-74 (1986).

<sup>144</sup> See, e.g., MODEL BUS. CORP. ACT § 6.40(c) (1984); UNIF. LTD. LIAB. CO. ACT § 405(a) (1996).

<sup>145</sup> See, e.g., MODEL BUS. CORP. ACT § 8.33 (1984); UNIF. LTD. LIAB. CO. ACT § 406 (1996).

plaintiff to prove that the director failed to comply with the standard of conduct for directors set forth in section 8.30 of the MBCA.<sup>146</sup> But these barriers reflect a legislative judgment on the circumstances under which an actor in a limited liability entity ought to be liable for his or her conduct, a judgment that may be undercut by a judicial veil-piercing decision.

Similarly, the Uniform Fraudulent Transfer Act (UFTA), adopted by forty-four states,<sup>147</sup> gives creditors a remedy when a debtor has transferred assets with the intent to hinder, delay, or defraud creditors or has made a transfer of assets or incurred an obligation without adequate consideration (termed a “constructively fraudulent” transfer under the UFTA), if certain conditions are present.<sup>148</sup> As in the case of recoveries under the entity statutes for improper distributions, discussed above, there are certain hurdles for a creditor-plaintiff to clear under the UFTA.<sup>149</sup> For instance, as the introductory note to the UFTA indicates, a transfer that is

constructively fraudulent because insolvency concurs with or follows failure to receive adequate consideration is voidable only by a creditor in existence at the time the transfer occurs or the obligation is incurred. Either an existing or subsequent creditor may avoid a transfer or obligation for inadequate consideration when

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<sup>146</sup> To succeed on a claim that a director or directors made an “unlawful distribution,” the action must be commenced within two years after the distribution and the plaintiff must show that the offending director(s) failed to act in good faith and did not reasonably believe the action was in the best interests of the corporation. *See* MODEL BUS. CORP. ACT § 8.30 (1984) (“(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.”); MODEL BUS. CORP. ACT § 8.33 (1984) (“(1) the liability of a director . . . is barred unless it is commenced within two years after the date.”). This language in section 8.30 codifies in part the “business judgment rule.” Application of the business judgment rule presents a heavy burden of proof for a plaintiff to overcome and adversely affects a plaintiff’s chance for success.

<sup>147</sup> GRANT W. NEWTON, BANKRUPTCY AND INSOLVENCY ACCOUNTING: PRACTICE AND PROCEDURE 250 (2009) (“At least 44 states and the District of Columbia have adopted the UFTA.”).

<sup>148</sup> UNIF. FRAUDULENT TRANSFER ACT (UFTA) § 4 (1984). If any of the following conditions is present, the transfer is deemed to be constructively fraudulent and subject to recovery by the creditor:

- (1) the debtor was left by the transfer or obligation with unreasonably small assets for a transaction or the business in which he was engaged;
- (2) the debtor intended to incur, or believed that he would incur, more debts than he would be able to pay; or
- (3) the debtor was insolvent at the time or as a result of the transfer or obligation.

UFTA, Prefatory Note at 3, *available at* <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.pdf>.

<sup>149</sup> *See supra* notes 143–48 and accompanying text.

accompanied by the financial condition specified in § 4(a)(2)(i) or the mental state specified in § 4(a)(2)(ii)

of the UFTA.<sup>150</sup> Again, these and other limitations in the UFTA may reflect a considered legislative judgment as to when a creditor can void a transfer by an entity. While beyond the scope of this Article, it is worth noting that the “preferential transfer” provisions of federal bankruptcy law also provide a remedy in certain cases.<sup>151</sup>

A final doctrine is worth considering here: the corporate trust doctrine.<sup>152</sup> This is a judicially created doctrine that imposes liability on directors and managers of insolvent entities who favor their own interests or claims over the claims of other creditors.<sup>153</sup> Obviously, such transfers may (and likely do) run afoul of the creditor protections noted above and, to that extent, this doctrine is similar to veil piercing. Like veil piercing, and unlike the statutory doctrines considered here, the corporate trust doctrine could render a director or manager liable to creditors without regard to the amount of the offending distribution.<sup>154</sup> The doctrine operates in an almost punitive manner; an improper distribution renders the director or manager liable to the creditor for the amount of the creditor’s claim, even if it exceeds the amount of the improper distribution.<sup>155</sup> For this and perhaps other reasons,<sup>156</sup> creditors may prefer a cause of action based on this doctrine over more limited statutory remedies.

The remedies discussed in this section are not frequently invoked. That is especially true with respect to creditor remedies set forth in corporate codes and LLC acts. Given the availability of the much more liberal remedy provided by veil piercing, this is not surprising.

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<sup>150</sup> UFTA, *supra* note 148, Prefatory Note at 3.

<sup>151</sup> See 11 U.S.C. § 502 (2006).

<sup>152</sup> *Alexander v. Anstine*, 152 P.3d 497, 502 (Colo. 2007); *New Crawford Valley, Ltd. v. Benedict*, 877 P.2d 1363, 1369 (Colo. App. 1993); James R. Ellis & Charles L. Sayer, *Trust Fund Doctrine Revisited*, 24 WASH. L. REV. & ST. B.J. 134 (1949); FLETCHER, *supra* note 139, §§ 7369, 5422.

<sup>153</sup> See, e.g., *In re Mortgage America Corp.*, 714 F.2d 1266, 1268–70 (5th Cir. 1983); *Bank of America v. Musselman*, 222 F. Supp. 2d 792, 798 (E.D. Va. 2002).

<sup>154</sup> See, e.g., *Colborne Corp. v. Weinstein*, No. 09CA0724, 2010 Colo. App. LEXIS 58 (Jan. 21, 2010), *cert. granted*, 2010 Colo. LEXIS 606 (Aug. 16, 2010) (No. 10SC143).

<sup>155</sup> See *Collie v. Becknell*, 762 P.2d 727, 729 (Colo. App. 1988).

<sup>156</sup> Statutory remedies often include a statute of limitations. See MODEL BUS. CORP. ACT § 8.33 (1984).

*B. Managerial Liability under Veil Piercing*

Veil piercing against non-owners has not been universally accepted by the courts; a number of courts have considered, and rejected, a veil-piercing theory to impose liability on non-owners. An early example of a court apparently requiring that a defendant have an ownership interest in order to pierce the corporate veil is *Riddle v. Leuschner*, which involved two corporations that were formed by the Leuschner family in 1949.<sup>157</sup> The plaintiff, Riddle, was a creditor of one of the corporations and sought to hold the defendants (husband, wife, and son) liable, alleging that they were the alter egos of the corporation.<sup>158</sup> Although the husband was the president of one of the corporations and involved in the management of the other corporation, he did not own any shares in either corporation.<sup>159</sup> The court held that because the husband did not have an ownership interest in the corporations or share in their profits, “there was not such unity of ‘interest and ownership’ between . . . [the husband] and the corporations” to demonstrate that he was the alter ego of the corporations, a necessary finding to pierce the corporate veil.<sup>160</sup> The court went on to hold that the wife’s ownership of one share in one of the corporations was “sufficient to permit holding her personally liable to creditors of that corporation provided that the alter ego doctrine [was] otherwise applicable.”<sup>161</sup> This small amount of ownership also allowed her to be held liable for the other corporation’s debts because the corporations were “controlled, dominated, managed, and operated by” the family so “that there was no separateness between them and the corporations.”<sup>162</sup>

Because the wife was also liable for the debt of the corporation in which she did not hold an ownership interest, it was not entirely clear whether an ownership interest is required in California. Two subsequent Ninth Circuit decisions applying California law have held that *Riddle* does require a defendant to hold an ownership interest to pierce the corporate veil.<sup>163</sup> In addition, courts in Ohio<sup>164</sup> and Louisiana<sup>165</sup> have also indicated that ownership is a prerequisite to piercing.

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<sup>157</sup> 335 P.2d 107, 108 (Cal. 1959).

<sup>158</sup> *Id.*

<sup>159</sup> *Id.* at 108–09.

<sup>160</sup> *Id.* at 111.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *SEC v. Hickey*, 322 F.3d 1123, 1128–30 (9th Cir. 2003) (holding that no matter how much control the defendant had over the brokerage, under *Riddle*, the first requirement of an alter ego relationship did not exist because the defendant did not

In contrast to the courts that seem to require an equity ownership interest as a prerequisite to piercing, a number—perhaps a growing number—of courts will pierce through the entity's veil to an "equitable owner."<sup>166</sup> *Fontana v. TLD Builders, Inc.*, a 2005 Illinois Court of Appeals decision, exemplifies piercing to reach an "equitable owner."<sup>167</sup> Theresa DiCosola was the sole shareholder of TLD, but her husband Nicola was the "governing and dominating personality" of the corporation.<sup>168</sup> This control gave rise to the conclusion that Nicola was TLD's equitable owner, which, in turn, was sufficient

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hold an ownership interest in the brokerage); *Firstmark Capital Corp. v. Hempel Fin. Corp.*, 859 F.2d 92, 94–95 (9th Cir. 1988) (holding that *Riddle* requires an ownership interest be established before a corporation's obligations may be imposed on the individual). But see *Logix Dev. Corp. v. Faherty*, No. B178872, 2007 WL 1113255, at \*6–11 (Cal. Ct. App. Apr. 13, 2007), where the court held that *Riddle* relied primarily on the amount of control an individual had and that ownership was simply a factor.

<sup>164</sup> In *Minno v. Pro-Fab, Inc.*, 905 N.E.2d 613 (Ohio 2009), for instance, the plaintiff tried to pierce the corporate veil to hold one corporation liable for another corporation's debts. *Id.* at 615. The two corporations, Pro-Fab and See-Ann, were owned by common shareholders, but neither corporation owned an interest in the other corporation. *Id.* The plaintiff alleged that he was injured at work because of See-Ann's actions and that Pro-Fab controlled the work site and was the *alter ego* of See-Ann. *Id.* The Ohio Supreme Court rejected this argument because Pro-Fab did not hold an ownership interest in See-Ann, and therefore, it was unable to control the sister corporation. *Id.* at 617. Thus, the lower court erred in holding a genuine issue of material fact remained over whether the plaintiff could pierce the veil of See-Ann and hold Pro-Fab liable. *Id.* at 615.

<sup>165</sup> *Riggins v. Dixie Shoring Co.*, 577 So. 2d 1060 (La. Ct. App. 1991), *rev'd on other grounds*, 590 So. 2d 1164 (La. 1991). In *Riggins*, the plaintiffs alleged that the defendants negligently leveled their house and sought to hold both the corporation's owner and an officer personally liable. *Id.* at 1061. The court reversed the trial court's decision to hold the officer liable because he did not hold an ownership interest in the corporation. *Id.* at 1065. The court reasoned that the purpose behind piercing "is to protect a creditor in his dealings with a shareholder who fails to distinguish, in transactions, between the corporation and his identity as a shareholder." *Id.* On that basis, a piercing claim is "not applicable to employees and/or officers who are not also shareholders in the corporation." *Id.* But see *Withers v. Timber Prods.*, 574 So. 2d 1291 (La. Ct. App. 1991). Timber Products was pierced and co-defendant Mr. Maker was held personally liable for its debts. *Id.* at 1295. At the time of Timber Products' incorporation, Maker was the sole shareholder and officer; however, he subsequently transferred 100% of his stock to Mr. Johnson, who was a judgment-proof convicted felon that had no knowledge or active role in Timber Products after the swap. *Id.* Looking at the "totality of the circumstances," the court found that the trial court had not clearly erred in finding Maker the *alter ego* of Timber Products despite his apparent lack of ownership. *Id.* But it is important to note that the record contained no evidence of the transfer, so precedential value of the case is weak.

<sup>166</sup> See, e.g., *Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc.*, 447 A.2d 406, 412 (Conn. 1982).

<sup>167</sup> 840 N.E.2d 767, 771 (Ill. App. Ct. 2005).

<sup>168</sup> *Id.* at 775.

to “satisfy the ‘unity of interest and ownership’ element of piercing the corporate veil.”<sup>169</sup> The court reasoned that:

[S]tock ownership, while important, is not a prerequisite to piercing the corporate veil but is merely one factor to be considered in evaluating the entire situation. . . . [T]he key factor in any decision to disregard the separate corporate entity is the element of control or influence exercised by the individual sought to be held liable over corporate affairs.<sup>170</sup>

Colorado has embraced this line of reasoning, first in a 1984 corporate case, *LaFond v. Basham*,<sup>171</sup> more recently in a case involving an LLC, *Sheffield Services Co. v. Trowbridge*,<sup>172</sup> and in another involving a corporation, *McCallum Family L.L.C. v. Winger*.<sup>173</sup> A close analysis of these Colorado cases demonstrates both the weakness of the “equitable ownership” doctrine and the likelihood that an alternative basis for finding liability was present in the cases.

*LaFond* appears to be the first Colorado case holding a non-shareholder liable for a corporate debt on a piercing theory.<sup>174</sup> It in-

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<sup>169</sup> *Id.* at 777 (citing *Freeman v. Complex Computing Co.*, 119 F.3d 1044, 1051 (2d Cir. 1997); *In re MacDonald*, 114 B.R. 326, 332–33 (D. Mass. 1990); *Angelo Tomasso, Inc.*, 447 A.2d at 412; *Establishment Tomis v. Shearson Hayden Stone, Inc.*, 459 F. Supp. 1355, 1366 n.13 (S.D.N.Y. 1978); *Lally v. Catskill Airways, Inc.*, 603 N.Y.S.2d 619, 621 (N.Y. App. Div. 1993)).

<sup>170</sup> *Angelo Tomasso, Inc.*, 447 A.2d at 412. New York is another jurisdiction that has embraced the notion of equitable ownership. In *Freeman*, the plaintiff sought to hold defendant Mr. Glazier liable for the obligations of Complex Computing Company (“C3”) despite Glazier not being a C3 employee, officer, director, or shareholder. *Freeman*, 119 F.3d at 1046. C3 was incorporated after Columbia University refused to license the computer software that Glazier co-developed to a corporation in which Glazier had an ownership interest. *Id.* To get around this, Glazier arranged for a friend to be C3’s sole shareholder and initial director, while Glazier was hired by C3 as an independent contractor. *Id.* The district court found that, for all intents and purposes, Glazier dominated and controlled C3 and held the only valuable interest in C3. *Id.* at 1048. The appellate court rejected Glazier’s argument that because he was “not a shareholder, officer, director, or employee of C3,” the plaintiff could not pierce the corporate veil and hold Glazier liable. *Id.* at 1051. The court reasoned that New York courts recognize the doctrine of equitable owner, and “to regard [Glazier] as anything but the sole stockholder and controlling person of C3 would be to exalt form over substance.” *Id.* at 1052 (internal quotes omitted). But, while the C3’s veil could be pierced and Glazier held liable, the court remanded the case to determine whether Glazier used his control “to commit a fraud or other wrong that resulted in unjust loss or injury to Freeman.” *Id.* at 1053.

<sup>171</sup> 683 P.2d 367, 369–70 (Colo. App. 1984).

<sup>172</sup> 211 P.3d 714 (Colo. App. 2009).

<sup>173</sup> 221 P.3d 69 (Colo. App. 2009).

<sup>174</sup> The court in *LaFond* cited only *Rosebud Corp. v. Boggio*, 561 P.2d 367 (Colo. App. 1977) as precedent for its holding, see *LaFond*, 683 P.2d at 369, but the defendant in *Rosebud* was a shareholder, see *Rosebud*, 561 P.2d at 369.

volved a garden-variety problem; homeowners were aggrieved when their home remodelers (two Colorado corporations) breached their agreement.<sup>175</sup> Finding the corporation without assets, the homeowners sued the individual who “ran” the corporations, Basham, although he was not a shareholder (instead, his wife and son were).<sup>176</sup> *LaFond* announced a new and rather broad rule of law:

A corporate entity may be disregarded and corporate directors may be held personally liable if equity so requires. . . . If adherence to the corporate fiction would promote injustice, protect fraud, *defeat a legitimate claim*, or defend crime, the invocation of equitable principles for the imposition of personal liability may occur.<sup>177</sup>

Read literally, if a creditor’s claim is unpaid, equity requires that directors be held personally liable.<sup>178</sup> Such a rule, however, would practically eliminate the concept of limited liability. Moreover, until the recent cases of *Sheffield* and *McCallum*, *LaFond* has had no influence on the development of the law.

*LaFond* could have been litigated on the narrower grounds discussed above—fraudulent transfer and unauthorized distribution.<sup>179</sup> The court noted in the opinion that “[w]hen the corporations arrived at virtual insolvency status, [Basham] demanded, to the detriment of other creditors, payment upon his notes, which allegedly were due him at the time, and he took over corporate assets to the detriment of other creditors, including the LaFonds.”<sup>180</sup> These findings suggest a strong case against Basham on statutory grounds and under the corporate trust doctrine. Yet the judgment was solely on veil-piercing grounds, and Basham was liable for the breach of contract damages suffered by the plaintiffs, with no indication of the amount of improper distributions to him.<sup>181</sup>

The court in *McCallum* employed the reasoning in *LaFond* to hold corporate manager, Marc Winger, liable.<sup>182</sup> The plaintiff had

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<sup>175</sup> *LaFond*, 683 P.2d at 368.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at 369 (emphasis added).

<sup>178</sup> The federal district court, in one of the few cases to cite to *LaFond*, recognized this problem: “The court agrees that any equitable doctrine must be narrowly applied, else the time-honored presumption against imposing personal liability on officers and directors be eroded.” *Marriner v. Nation-Wide Horse Transp., Inc.*, No. Civ.03-808-MO, 2004 WL 2203297, at \*4 (D. Or. Sept. 29, 2004).

<sup>179</sup> See discussion *supra* Part III.A.2.

<sup>180</sup> *LaFond*, 683 P.2d at 369.

<sup>181</sup> See *id.* at 369.

<sup>182</sup> *McCallum Family LLC v. Winger*, 221 P.3d 69, 69 (Colo. App. 2009).



leased property to the corporation, Manitoba, and, although all lease payments were made, the corporation failed to pay property taxes as required under the lease.<sup>183</sup> The lessor paid the taxes and obtained a judgment against the corporation for the payment.<sup>184</sup> When the judgment against the corporation went unsatisfied, the plaintiff sought to recover from Winger on a piercing theory.<sup>185</sup> Winger managed the corporation, but he was not an officer, director, or shareholder.<sup>186</sup> His wife and mother-in-law, however, each owned fifty percent of the outstanding stock and were the corporation's sole officers and directors.<sup>187</sup> Winger ran the corporation with apparently no oversight from his wife or mother-in-law, had used corporate funds to pay personal expenses, and otherwise "abused" the corporate form.<sup>188</sup>

While the trial court concluded that veil piercing was inappropriate, the court of appeals, after marching dutifully through the three-prong test applied in Colorado,<sup>189</sup> concluded that plaintiff had established a prima facie case for veil piercing and remanded the case to the trial court for further proceedings.<sup>190</sup> The appellate court concluded that Winger was an equitable owner of the corporation and its alter ego and that because he diverted corporate funds for his own purposes, failing to pierce the corporate veil would defeat plaintiff's "rightful claim."<sup>191</sup> These facts were sufficient to satisfy the first two veil-piercing tests, and the case was remanded to allow the trial court

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<sup>183</sup> *Id.* at 72.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> *McCallum*, 221 P.3d at 72.

<sup>189</sup> *Id.* at 74.

To determine whether it is appropriate to pierce the corporate veil, a court must make a three-part inquiry. First, the court must determine whether the corporate entity is the "alter ego" of the person or entity in issue. . . . Second, the court must determine whether justice requires recognizing the substance of the relationship between the person or entity sought to be held liable and the corporation over the form because the corporate fiction was "used to perpetrate a fraud or defeat a rightful claim." . . . Third, the court must consider whether an equitable result will be achieved by disregarding the corporate form and holding a shareholder or other insider personally liable for the acts of the business entity. . . . All three prongs of the analysis must be satisfied. The paramount goal of piercing the corporate veil is to achieve an equitable result.

*Id.* (citations omitted).

<sup>190</sup> *Id.* at 74, 80.

<sup>191</sup> *Id.* at 79.

to exercise its equitable discretion to determine whether to pierce the corporate veil.<sup>192</sup>

This conclusion of the appellate court was rather remarkable in light of the findings of the lower court, which the appellate court summarized:

Here, the trial court noted that Marc Winger did not sign the lease; no evidence was presented that he conspired with his father or anyone else to mismanage Manitoba or divert its assets to avoid its liability under the lease; there was no evidence that McCallum [the creditor] had investigated Manitoba's financial circumstances before renting to it; and 'Manitoba apparently lived up to its obligations under the lease (except for paying . . . property taxes) for four or five years.'<sup>193</sup>

It seems that Winger withdrew money from the corporation for personal purposes, but these withdrawals could be characterized as compensation. The informality with which the business was run should not be the basis for holding its manager personally liable, but that was essentially what the appellate court was suggesting. Because the corporation was insolvent, the creditor had the option of filing a claim against the corporation's directors for breach of their fiduciary duty to the corporation.<sup>194</sup> Any recovery would go to the corporation to be available to all of the corporation's creditors.<sup>195</sup> If a defendant unlawfully diverted corporate resources to himself, that claim may be pursued by the creditors in the same action under the rubric of fraudulent transfers or breach of fiduciary duty.<sup>196</sup> But these actions limit the exposure of entity managers to the amounts wrongfully paid, not to all liabilities of the entity.<sup>197</sup> These causes of action are more closely designed to address the loss suffered and better suited to the facts of *McCallum*.

*LaFond* was also the basis for extending veil-piercing liability to managers of an LLC in *Sheffield*<sup>198</sup> and, as in *LaFond* and *McCallum*, the extension of liability appears to be unwarranted. *Sheffield* involved an LLC that had a "subdivision agreement" with the City of Broomfield under which it was obligated to improve lots it owned as a condition

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<sup>192</sup> *Id.*

<sup>193</sup> *Id.* at 78.

<sup>194</sup> See *McCallum*, 221 P.3d at 80 (noting that plaintiffs could file such a claim under prior precedent but holding that the district court did not err in dismissing the claim).

<sup>195</sup> See *supra* notes 152–56 and accompanying text.

<sup>196</sup> See *McCallum*, 221 P.3d at 80.

<sup>197</sup> See *In re Amdura Corp.*, 75 F.3d 1447, 1452 (10th Cir. 1996).

<sup>198</sup> See *Sheffield Servs. Co. v. Trowbridge*, 211 P.3d 714, 718 (Colo. App. 2009).

to obtaining a building permit.<sup>199</sup> Prior to completing these improvements, the LLC agreed to sell the subject lots to the plaintiff and represented in the sales agreement that the improvements had been made.<sup>200</sup> After the closing, the plaintiff sued for breach and sought to hold the LLC manager personally liable for the damages arising from the breach of contract.<sup>201</sup> The trial court held in favor of the defendant-manager, reasoning that only LLC members can be held liable on a piercing theory.<sup>202</sup>

The Colorado Court of Appeals reversed this holding in a strange opinion.<sup>203</sup> Colorado, like many other jurisdictions, has a provision in its LLC statute that permits veil-piercing claims against “members.”<sup>204</sup> The Colorado court ruled, however, that this statutory claim did not preclude a common-law claim for veil piercing and, under the common law of Colorado (citing only *LaFond*), a manager of an LLC may be held liable for the obligations of the company if the veil-piercing criteria are present.<sup>205</sup> As the lower court dismissed the veil-piercing claim, the case was remanded for a determination of whether these criteria were in fact present.<sup>206</sup> The appellate court, however, clearly suggested that veil piercing was appropriate, noting how the defendant acted to “frustrate the . . . creditors” and enrich himself.<sup>207</sup>

*Sheffield* is a good example of why veil piercing is a troubling doctrine. The plaintiff’s claim was one for damages for breach of representation, and the plaintiff, by his own admission, was a sophisticated real estate developer who should have known of the misrepresentation.<sup>208</sup> Indeed, plaintiff had sued the defendant on an individual claim for negligent misrepresentation but failed because the court concluded that plaintiff’s reliance on the misrepresentation was not reasonable; he should have made inquiry of the city before closing on

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<sup>199</sup> *Id.* at 717.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.* at 718.

<sup>202</sup> *Id.* at 718–19.

<sup>203</sup> *See id.* at 721.

<sup>204</sup> COLO. REV. STAT. § 7-80-107(1) (2010) (“In any case in which a party seeks to hold the members of a[n LLC] personally responsible for the alleged improper actions of the [LLC], the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.”).

<sup>205</sup> *Sheffield*, 211 P.3d at 721–22.

<sup>206</sup> *Id.* at 722.

<sup>207</sup> *Id.* at 719.

<sup>208</sup> *See id.* at 718.

the transaction.<sup>209</sup> Thus, plaintiff's claim is against an individual manager for breach of representation by an entity when the facts indicate that the plaintiff unreasonably relied on that representation (if he relied on it at all). Put differently, the court remakes the contract by suggesting that the defendant might be personally liable on the LLC's misrepresentation, thereby giving the plaintiff far more than he bargained for.

To the extent that the defendant made improper distributions from the LLC, there are, as in other veil-piercing cases, ample doctrines to address the conduct. There are strong suggestions in the opinion that the defendant's actions constituted fraudulent transfers and, if so, the Uniform Fraudulent Transfer Act provides a remedy.<sup>210</sup> Moreover, as in *LaFond*, the statutory provision for unlawful distributions and the corporate trust fund doctrine provided plaintiff with remedies.<sup>211</sup> Indeed, the *Sheffield* court held that the corporate trust fund doctrine may be applied to impose personal liability on the manager of an LLC who favors his own claims when distributing LLC assets, if the company was insolvent or rendered insolvent when the distribution was made.<sup>212</sup>

These doctrines came together in another recent Colorado case, *Colborne Corp. v. Weinstein*, where a creditor brought a claim against the members and managers of a Colorado LLC.<sup>213</sup> The claim against the members alleged that they received a distribution from the LLC that rendered the company insolvent and the distribution, therefore, was recoverable by the creditor under a provision of Colorado's LLC act.<sup>214</sup> Against the managers, the creditor claimed that those distributions favored managers and were, therefore, in violation of the trust doctrine.<sup>215</sup> The appellate court ruled in favor of the plaintiff on both claims.<sup>216</sup> As to the first claim, the court noted that the Colorado LLC act provides that the unlawful distribution is recoverable by the LLC.<sup>217</sup> Nevertheless, the court held that the creditor had standing to maintain this claim, consistent with precedents that allowed corporate creditors to maintain claims against corporate shareholders un-

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<sup>209</sup> *Id.* at 725.

<sup>210</sup> *See id.* at 721–22.

<sup>211</sup> *See Sheffield*, 211 P.3d at 721–22.

<sup>212</sup> *Id.* at 723.

<sup>213</sup> No. 09CA0724, 2010 WL 185416, at \*1 (Colo. App. Jan. 21, 2010).

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> *Id.*

<sup>217</sup> *Id.* at \*2–4.

der a similar statute because the managers of the LLC had no incentive to maintain a claim against themselves.<sup>218</sup>

On the corporate trust doctrine claim, the appellate court relied on *Sheffield*.<sup>219</sup> Interestingly, no piercing claim was brought against the members or managers in *Colborne*, although the facts suggest that one might have succeeded.<sup>220</sup> Whether there were other facts that undermined such a claim, or the lawyers overlooked the claim, it is noteworthy that the creditor got full relief without it.<sup>221</sup>

In short, then, statutory provisions and a common-law doctrine all protect entity creditors from the risk that those who control the entity will favor their own claims against the entity or otherwise enrich the entity's owners to the detriment of creditors. Veil piercing is an overlay on these doctrines that potentially expands this liability and does so in an unpredictable and haphazard manner.

#### IV. CONCLUSION

*LaFond*, *Sheffield*, and *McCallum* each demonstrate the ad hoc quality of veil piercing and the lack of an underlying rationale to justify the doctrine. The doctrine of veil piercing is grounded on a notion that the state has granted the owners of a business the privilege of operating the business with the assurance of limited liability in exchange for which those owners must operate that business as a separate entity. If owners fail to adhere to that bargain, thereby "abusing" the privilege, they risk the loss of that limited liability. When non-owners are held liable for the entity's debts, it cannot be said that they abused any privilege, as they were never granted one. Moreover, these cases sharply demonstrate the absence of causation in veil piercing. Plaintiff's loss in *Sheffield* was, at best, caused by a misrepresentation, and in *LaFond* and *McCallum* the plaintiffs' losses were the result of illegal distributions.<sup>222</sup> In no case was the plaintiff's loss caused by defendant's failure to recognize the separate existence of the entity.

The effect of extending liability to non-owners is to increase the risk of personal liability to employees and other actors in an entity and to continue the erosion of the limited liability concept. All this comes at a cost: employees will require a risk premium and promo-

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<sup>218</sup> *Id.* at \*4.

<sup>219</sup> *Colborne Corp.*, 2010 WL 185416, at \*5.

<sup>220</sup> *See id.*

<sup>221</sup> *See id.* at \*5–6.

<sup>222</sup> *See* discussion of cases *supra* Part III.B.

ters of limited liability entities face greater uncertainty. More importantly, carefully crafted legislative solutions are mooted and replaced by fuzzy judicially created doctrines. The tendency of courts—and, in a few cases, legislatures<sup>223</sup>—to extend the veil-piercing doctrine to LLCs only compounds these problems. The questions of whether and when owners and managers of limited liability entities should be liable for the entity's debts is one that calls for a legislative, not judicial, resolution. Arguably, state legislatures have addressed this question in multiple ways. Nevertheless, the tendency of state courts to modify business entity statutes continues and, in the area of veil piercing, profoundly so.

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<sup>223</sup> See CAL. CORP. CODE § 17101(b) (West 2011); COLO. REV. STAT. § 7-80-107 (2010).