PIERCING THE CORPORATE VEIL

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A. The General Rule

1. “Unless otherwise provided in the articles of incorporation a shareholder of a corporation is not personally liable for the acts or debts of a corporation . . .” Revised Model Business Corporation Act, Section 6.22
   a. The origins of the rule date to the 19th Century
   b. The limited liability rule encourages capital formation, innovation and entrepreneurship

2. The problem with the general rule is that it may unfairly prevent creditors of a corporation from collecting on valid claims because the corporate debtor does not have sufficient assets
B. The Veil Piercing Exception to the General Rule

1. At times, courts allow the “veil” of the corporate debtor to be “pierced” so as to allow a creditor of corporation to collect from the assets of the corporate debtor’s shareholders

2. The exception is designed to mitigate the consequences of the limited liability rule in cases of fraud, injustice or other wrongdoing
C. Veil Piercing is an Equitable Doctrine Governed by State Law

1. There are numerous formulations of the doctrine

2. Generally, there are two common factors
   a. There is a unity of interest between the corporation and shareholder so that separate identities do not exist
   b. If the separate identity of the corporation is recognized, an inequitable result would follow

3. Many courts say the doctrine is limited and will only be applied in exceptional cases
C. Veil Piercing is an Equitable Doctrine Governed by State Law

4. Many factors considered
   a. Some jurisdictions require plaintiffs to plead and prove fraud
   b. Others do not

5. Factors are not weighted

6. Highly fact specific

7. Very flexible concept – no hard and fast rules

8. The doctrine can be applied differently from jurisdiction to jurisdiction and within jurisdictions

D. Veil Piercing Issues

E. Remember that corporate officials acting for the corporation are nonetheless responsible for their own acts, including torts
II. The Context In Which Veil Piercing Claims Arise

A. The Assertion of Independent Claims for Veil Piercing

B. The Assertion of Veil Piercing as a Remedy to Shift Responsibility for Claims Asserted Against a Corporation

C. The Assertion of Veil Piercing in a Judgment Enforcement Context

D. The Assertion of Veil Piercing as a Means to Obtain Personal Jurisdiction Over a Non-U.S. Parent
III. Pleading Requirements

A. Higher level of factual detail generally required

B. Greater specificity required in jurisdictions where fraud is required
   1. Federal Rule of Civil Procedure 9(b)
      a. “In alleging fraud . . . a party must state with particularity the circumstances constituting fraud . . .”
III. Pleading Requirements

C. Greater specificity generally required in federal court
   1. Fed.R.Civ. Pro. 8(a)(2) requires a “short and plain statement of the claim showing that the pleader is entitled to relief.”
   2. Historically, *Conley v. Gibson* required dismissal only if there was no set of facts on which a plaintiff would be entitled to relief.
   3. This changed with *Iqbal* and *Twombly*
      a. To survive a motion to dismiss, a complaint must contain sufficient facts so that a claim is plausible on its face. *Ashcroft v. Iqbal*
      b. Factual allegations must be enough to raise a right to relief above the speculative level. *Bell Atlantic v. Twombley*
         i. Take care when briefing cases decided under the *Conley v. Gibson* standard
IV. Bases for Piercing the Corporate Veil

A. The Alter Ego Theory

1. The theory is that:

   a. The corporation is so dominated by the shareholder that it is being used for the shareholder’s personal purposes rather than for corporate purposes

   b. If the corporation is dominated and abused by the shareholder for personal purposes, each may be deemed the alter ego of the other

   c. If abuse of the corporate form is used to commit a wrong against a third party, the corporate form should be disregarded

   d. Shareholder will be held personally liable for corporate obligations
A. The Alter Ego Theory

2. The burdens of pleading and proof are heavy

   a. Difficult to convince a court to use equitable power to pierce corporate veil
A. The Alter Ego Theory

3. Factors – No one factor is dispositive
   a. Was the corporation adequately capitalized?
   b. Was the corporation solvent?
   c. Did the shareholder finance the corporation?
   d. Did the shareholder pay the corporation’s expenses?
   e. Were the corporate formalities observed?
   f. Did the shareholder use corporate assets for personal purposes?
   g. Did the corporation generally function as a façade for the shareholder?
A. The Alter Ego Theory

3. Factors – No one factor is dispositive
   h. Were funds commingled?
   i. Did the corporation and shareholder have common office space, mailing address, telephone numbers?
   j. Did the corporation and the shareholder use the same name?
   k. Did the corporation and the shareholder have overlapping officers and directors?
   l. Was harm caused to a third party?
   m. Was fraud committed?

4. For a plaintiff, the more factors pled and proven with specificity, the better
IV. Bases for Piercing the Corporate Veil

B. The Agency Theory

1. This is not strictly speaking a piercing theory

2. Plaintiff attempts to prove that the subsidiary was acting as an agent of the parent, causing the imputation of the subsidiary’s actions to the parent

3. Generally, to prevail a plaintiff must plead and prove the elements of a principal agent relationship under controlling law:
   a. The parent intended for the subsidiary to act on the parent’s behalf
      i. The authority may be actual or apparent
      ii. Apparent authority exists when the parent gives a third party the impression through words or conduct that the subsidiary had the authority to act
IV. Bases for Piercing the Corporate Veil

b. The subsidiary agreed to act as the parent’s agent

c. The parent controlled the subsidiary’s actions
   i. Ordinary control exercised by a majority shareholder is generally insufficient
   ii. A plaintiff must prove:
      a. active participation in and control over the subsidiary
      b. direction of the subsidiary to act with respect to the plaintiff in the circumstances at issue

4. The parent’s mere ownership of all the equity of the subsidiary is insufficient
V. Contract Claims v. Tort Claims

A. Courts may react differently to a plaintiff with a contract claim who is attempting to pierce than a plaintiff with a tort claim

B. Some courts have held that claims for breach of contract present insufficient circumstances to pierce the corporate veil
   1. The reasoning is that a plaintiff with a contract claim voluntarily entered a relationship with the defendant
   2. Plaintiff can mitigate credit risk by contract

C. Courts may not be as reticent to consider piercing in tort cases because the plaintiff did not enter a relationship with the defendant voluntarily
   1. Plaintiff has no means to mitigate credit risk
VI. Reverse Piercing Doctrine

A. Creditors usually ask the Court to pierce the corporate veil to hold shareholder personally liable for corporate debts.

B. Under the Reverse Piercing Doctrine, the corporation will be held liable for the debts of the shareholder, and corporate assets may be used to satisfy a creditor’s judgment against the shareholder.
VII. Limited Liability Companies

A. Case law is not entirely consistent and it is developing
   1. Several jurisdictions have held that members of an LLC can be held liable for an LLC’s debts under an alter ego veil piercing theory

B. Concepts as applied to LLCs are generally parallel to those applied to corporations

C. Two general exceptions:
   1. Less emphasis is placed on whether the LLC observed corporate formalities because fewer formalities required for an LLC relative to a corporation
   2. Less emphasis on domination and control because LLCs may be managed by members
VIII. Jurisdictional Issues

A. A plaintiff with a claim against a US subsidiary of a foreign parent may attempt to pierce the veil of the subsidiary so as to:

1. Subject the foreign parent to the personal jurisdiction of a US court
2. Force the foreign parent to appear and defend itself in the underlying action
3. Subject the assets of the parent to the payment of a US judgment against the US subsidiary
B. The theory is that if the subsidiary is the alter ego or instrumentality of the foreign parent, the acts of the subsidiary are the acts of the parent, rendering the parent subject to personal jurisdiction


C. A foreign parent’s ownership of stock in a US subsidiary is generally insufficient to subject the foreign parent to the personal jurisdiction of a US court

D. If the only issue is jurisdiction as a precursor to litigation of the merits, courts may be more inclined to pierce the veil

1. Some courts may require a lesser showing of fraud, injustice or improper conduct in the jurisdictional context
E. Delaware has rejected the extension of personal jurisdiction under an alter ego theory absent fraud

1. Delaware courts by statute may exercise personal jurisdiction over officers and directors of Delaware companies. Del. Code tit. 10, Section 3104(c)

2. However, with respect to shareholders, Delaware courts “will ignore the sanctuary of the corporate form to assert jurisdiction over a non-resident . . . under the alter ego theory only in the exceptional case where the complainant can show fraud, injustice or inequity in the use of the corporate form.” Fitzgerald v. Cantor, 1998 WL 842316 (Del Ch. Ove. 10, 1998)
IX. Best Practices

A. Provide adequate capital and insurance for subsidiaries
   1. Plaintiffs may not pierce if they believe the defendant has adequate resources to satisfy the claim
   2. Undercapitalization is a commonly alleged basis for piercing

B. Separate boards of directors for parents and subsidiaries

C. Observe corporate formalities
   1. Articles
   2. By-laws
   3. Regular elections of directors
   4. Regular meetings of directors
IX. Best Practices

D. Require a subsidiary’s management to run the operations of the subsidiary as independently as possible of the parent

1. Subsidiary should hire and fire its own employees
   a. Employees of a subsidiary should report to management of the subsidiary, not to management of the parent

2. Maintain separate bank accounts
   a. Don’t commingle funds

3. File separate tax returns

4. Maintain separate facilities

5. Subsidiary should hold itself out as a separate company using its own name

6. Maintain books and records for subsidiaries independent of other companies in a corporate family

7. Intercompany transactions should be arms-length and well-documented
Steven S. Scholes is a partner in the law firm of McDermott Will & Emery LLP based in the Firm’s Chicago office. He has served as the partner in charge of the Chicago Trial Department and the Firm's SEC Defense Group. Steve concentrates his trial practice in all varieties of securities and other complex commercial litigation. He has tried civil, criminal and administrative cases in federal and state courts, and he regularly represents clients before the Securities and Exchange Commission, state securities regulators and self-regulatory organizations, such as the Financial Industry Regulatory Authority, the Public Company Accounting Oversight Board and numerous stock, options and futures exchanges.

Steve has substantial experience in securities class actions, including cases alleging accounting irregularities, illegal trading, and breaches of fiduciary duty, among other things. Steve regularly represents public companies and their officers and directors in merger and acquisition litigation, including both class and derivative actions, across the country. He also has substantial experience in conducting internal investigations and in representing individuals who are subjects of internal investigations.

A former attorney in the Securities and Exchange Commission’s Division of Enforcement, Steve has been appointed by three different federal judges in Chicago to serve as receiver in SEC civil enforcement proceedings. His work as receiver included conducting fraud investigations, prosecuting fraudulent conveyance claims, enforcing judgments, marshalling and liquidating assets, and developing and implementing plans of distribution. Stemming from his work as a receiver, Steve has substantial experience in both prosecuting and defending a wide variety of fraudulent conveyance claims.

Steve frequently speaks on securities litigation and enforcement topics. He has appeared numerous times in the press and has authored various materials concerning the federal securities laws. Steve has served as co-chairman of the Practising Law Institute's national program on internal investigations for several years. Steve is a former member of the Securities Law360 Editorial Board and he has served as a faculty member for the National Institute of Trial Advocacy. He has also served on the Business Conduct Committee of the Chicago Mercantile Exchange as well as on the Board of Visitors of the University of Illinois College of Law. Since 2008, Steve has been nationally ranked in Benchmark Litigation as a leader in securities litigation and as a lawyer most consistently recommended as a “bet the company” counsel. He received an “AV” Peer Rating, the highest rating available, from Martindale-Hubbell, and was selected as a Super Lawyer by Law & Politics, which names the top five percent of lawyers in each state as chosen by their peers and through the independent research of Law & Politics.

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