

Behind the Shield: Piercing the Corporate Veil

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So you finally have a great case against Big Corporation. You file your complaint and send in discovery requests. Somehow you learn that Big Corporation may not actually have the resources you thought it would – either employees are hearing rumors about shutting down or layoffs, or you receive balance sheets in discovery showing a bleak bottom line. Is it still worth pursuing the case? That remains to be seen, but there may be other places to look for money.

Although the corporate structure normally protects individual owners or related entities from liability, courts will look beyond the corporation if the corporation appears to be a farce. As the North Carolina Supreme Court noted more than a century ago:

Some [corporations] are afflicted with what may be called congenital insolvency. They are born insolvent, capitalized into insolvency at the moment of their creation, and eke out a precarious existence in an apparent effort to solve the old paradox of living on the interest of their debts. Such corporations are not only intrinsically dangerous, but lay the foundation for an unjust suspicion of all other corporate bodies.

Commonwealth Mutual Fire Insurance Co. v. Edwards, 124 N.C. 116, 32 S.E.2d 404 (1899). Since then, the courts have tried to develop a strategy for balancing the rights of corporations, their owners and related entities and the rights of plaintiffs who are wronged by those corporations. In the right circumstances, the court will disregard the corporate entity or “pierce the corporate veil.” See Glenn

v. Wagner, 176 N.C.App. 247, 625 S.E.2d 800 (1985) (corporate veil may be pierced to “prevent fraud or to achieve equity.”)

Who Is The Veil Protecting?

The quintessential scenario for piercing the corporate veil, or disregarding the corporate entity, is an individual owner who undercapitalizes the corporation or a parent company that dominates a subsidiary. Look for any entity: (1) that might be holding money that should belong to the corporation or (2) that has more money than the corporation and is somehow connected to the corporation.

For example:

- Parent corporations
- Subsidiaries
- Individual owners
- Other related corporations

In Strategic Outsourcing, Inc. v. Stacks, 176 N.C.App. 247, 625 S.E.2d 800 (2006), the Court of Appeals considered whether “reverse piercing” was appropriate where the plaintiff contended that the court should hold the corporation liable for the owner’s actions (as opposed to the owner liable for the corporation’s obligations) and held:

Generally, under the alter ego, or instrumentality, theory, a corporate entity may be disregarded where there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist.

We conclude that here, where one entity is the alter ego, or mere instrumentality, of another entity, shareholder, or officer, the corporate veil may be pierced to treat the two entities as one and the same, so that one cannot hide behind the other to avoid liability.

The Factors

The ultimate question, then, is whether the corporation is operated as a “mere instrumentality” or “alter ego” of another entity. Glenn, 313 N.C. at 454, 329 S.E.2d at 330; East Market Square v. TyCorp. Pizza, Inc., 175 N.C. App. 628, 625 S.E.2d 191 (2006). The inquiry is highly fact-based. DeWitt Truck Brokers, Inc., v. W. Ray Flemming Fruit Company, 540 F.2d 681, 684 (4th Cir. 1976); Glenn, 313 N.C. at 458-59, 329 S.E.2d at 332-333; Hammond v. Williams, 215 N.C. 657, 659, 3 S.E.2d 437, 438 (1939), and the North Carolina courts have set forth three broad considerations for determining whether the veil should be pierced:

- (1) Control – not just majority control but domination - over finances, policy and business practice so that the corporate entity “had no mind, will or existence of its own;” Glenn, 313 N.C. at 455, 329 S.E.2d at 330; East Market Street Square v. TyCorp. Pizza, 175 N.C.App. 628, 633, 625 S.E.2d 191 (2006);
- (2) The control must have been used to commit a fraud or wrong “to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff’s legal rights; Id”; and
- (3) Control and breach of duty must be a proximate cause of the injury. Id.

Control

Courts have further refined the control inquiry into several common factors:

- (1) inadequate capitalization of the corporation;
- (2) non-compliance with corporate formalities. See Hammond, 215 N.C. 657, 3 S.E.2d 437. (Corporation had been established but business still being run through partnership); Henderson v. Security Mortgage and Finance Co., 273 N.C. 253, 260, 160 S.E.2d 39, 44 (1968) (individual defendant made no effort or pretense of keeping his interest and activities separate from the corporation. “The corporation was a mere devise or puppet in [defendant’s] hands.”);
- (3) “Complete domination or control of the corporation so that it has no independent identity;” and
- (4) Excessive fragmentation of a single enterprise into separate corporations.

The purpose of piercing the veil is to “place the burden of law upon the party who should be responsible.” Glenn 313 N.C. at 458, 329 S.E.2d at 332. To that end, “courts have recognized numerous other factors which may be considered inherent in the instrumentality rule. These include: non-payment of dividends, insolvency of the debtor corporation, siphoning of funds by the dominant shareholder, non-functioning of other officers or directors, absence of corporate record.” Id. at 458-59 (it “would be unconscionable to allow the owner of a valuable apartment/room rental property to escape liability because it turned the property over to an inadequately capitalized operating company which is simply itself in another form.”)

In East Market Street Square v. TyCorp. Pizza, 175 N.C.App. 628, 625 S.E.2d 191 (2006), the Court easily found that the defendant owner operated his companies as mere instrumentalities: defendant was sole shareholder and had total autonomy and control of the defendant corporation and its affiliated corporations. Defendant completely controlled and dominated the companies so that they had no independent identity and no separate mind, will or existence or their own; he exerted control over policies, finances and business practices; defendant made all the decisions for all the corporations; there were no boards of directors to oversee defendant's decisions; defendant was the only person to answer to in all business transactions; defendant company had no assets to speak of; and earnings of the parent corporation and each subsidiary went into a single pot. Of course not all of these factors must be present, but the case supplies a helpful laundry list of facts to search out.

Control used to commit fraud or wrong

This requirement is fairly broad. "When the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." Henderson v. Security Mortgage, 273 N.C. 253, 260-61, 160 S.E.2d 39, 44-45 (1968).

In Fountain v. West Lumbar Company, 161 N.C. 35, 76 S.E. 533 (1912), the plaintiff had a contract with C.R. Johnson and C.R. Johnson Lumbar Company to perform work. It turned out that the land and timber on which plaintiff was performing the work belonged to West Lumbar Company, and also that C.R. Johnson and his company lacked the funds to pay the plaintiff for his work.

When C.R. Johnson Lumber went into bankruptcy, West Lumbar Company claimed all of the assets but left the debts with Johnson.

Upholding plaintiff's jury verdict against West, the Court held that "if, notwithstanding the evidence relied on by the defendant..., the jury found that in fact the devise of separate corporations was used in order to evade responsibility on the part of [West], Johnson being president and practically owner of all the stock in both companies, then the issue should be found in favor of the plaintiff."

More recently, in East Market Street, 175 N.C.App. at 638, 625 S.E.2d at 199, the defendant corporation breached its lease contract with the plaintiff and had insufficient assets to satisfy a judgment. Plaintiff then went after the individual owner and the corporation's parent company. The defendant argued that a "mere breach of a contractual obligation does not constitute an unjust act" sufficient for disregarding the corporate entity. The court disagreed, saying, "we consider performance under a contract to be a positive legal duty, the violation of which constitutes a clear wrong done to plaintiffs." Id. The bottom line is that if a corporation fails to meet its legal obligations and the corporation is being run as an instrumentality of another entity, it cannot hide behind its corporate structure to avoid those obligations.

Proximate Cause

The wrong done by the corporation does not necessarily have to arise out of the same behavior that leads a court to find domination and control (ie., undercapitalization, fragmentation). "Domination sufficient to pierce the corporate veil need not be limited to the particular transaction attacked." Glenn, 313 N.C. 450, 329 S.E.2d 326 (1985). "Where an affiliated corporation is without

a separate and distinct corporate identity and is operated as a mere shell,...we do not believe an analysis of domination need be narrowly limited to control over the particular transaction attacked.”

Again, the court will focus upon equity and “placing the burden of loss” on the party responsible...” East Market, 175 N.C.App. at 640, 625 S.E.2d at 202. If the corporation fails to meet its legal obligations and plaintiff is injured by the corporation’s behavior, then a court may find proximate cause to exist.

The Nitty Gritty

If you have information before you file your complaint that the company is undercapitalized and you know where the money is going, by all means, make the allegation in your complaint. If you find out later, you may move to amend pursuant to Rule 15 of the North Carolina Rules of Civil Procedure.

There are different schools of thought about how to make the allegation. Some attorneys draft a separate claim for relief. Others, including this attorney, simply make the appropriate factual allegations, including one that “[Upon information and belief] John Smith owned, operated, managed and controlled Big Corporation as a mere instrumentality” or “Parent Company owned, operated, managed and controlled Big Corporation as a mere instrumentality.” You must then also name and serve John Smith and/or Parent Company. This method has withstood challenge by opposing counsel who thought it was necessary to make a discreet claim for Piercing the Corporate Veil.

Without initial concrete information that the corporation is being operated as an instrumentality, defense counsel will likely object to discovery requests seeking such evidence. Some information, however, can be found publicly in:

- Property Tax Appraisal Information (Most counties Register of Deeds records are searchable online);
 - Secretary of State searches for each entity (<http://www.secretary.state.nc.us/corporations/>) (you may find that they all have the same agent and address, or no board of directors);
 - Internet Searches for all of the entities;
 - Any promotional information for any of the entities;
 - 10-K and 10-Q reports, as well as other public information on publicly traded entities (available at Yahoo Finance or any similar site);
- and
- Speaking with attorneys or forensic accountants who may already have detailed knowledge of the defendant.
 - Any licensing information or other public reports that the entity is required to file.

Once you are able to litigate your claim, you will want to look for a paper trail showing that the corporations, or the corporation and individual, are not separate entities. For example, the following documents may be helpful:

- Payments for the rent/lease of real property
- Notices of meetings and the minutes of all shareholder meetings
- Minutes of all meetings and resolutions of the Board of Directors
- Documents on which defendant will rely to show that it observed corporate formalities and is adequately capitalized
- Copies of the Articles of Incorporation and By-Laws

- Shareholder ledger
- Dividend notices and/or payments
- Bank statements and copies of checks particularly from the one corporation to the other
- Transfers of funds between the corporations or corporation and individual
- Funds earned by the corporation that were not deposited into its bank account(s)
- Expenses/liabilities of one corporation paid by the other or the individual and vice versa
- Documentation showing ownership of assets, including but not limited to bills of sale, checks or invoices
- Security agreements, UCC financing statements, deeds of trust or any other evidence of secured interests in the corporation's assets
- Leases for any equipment or property
- Deeds or any other documentation of ownership of real property
- Documentation of transfers of assets
- Documentation of liability to the corporation, including but not limited to accounts receivable, promissory notes, contracts, invoices, statements of account or other memoranda
- General ledgers or balance sheets
- Credit applications, open account documentation or any other documentation requesting credit from any third party

- Capital contributions or monies paid from one corporation to the other (or between the individual and corporation and vice versa)
- Tax liens and settlement of any past due taxes owed
- Tax returns
- Contracts with other parties

As a third party, you are not likely to have all of the information regarding the business dealings of the subject corporation prior to filing the Complaint, so discovery is an extremely important tool to gather the required information to show inadequate capitalization, etc. Keep in mind, however, that it is often deficient documentation by the subject corporation (such as the lack of shareholder meeting minutes) that will establish the claim.

Conclusion

The corporate structure is often used as a shield to protect individuals from liability for acts that harm third parties. It is quite common for principals of the corporation to brandish the shield to protect from liability and ignore the entity when it is inconvenient. Piercing the corporate veil requires that the advocate conduct a thorough investigation of the business of the corporation and for that reason, warrants serious consideration before pursuing such claims.