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LIMITED LIABILITY POLICY AND VEIL PIERCING

*Harvey Gelb**

I. INTRODUCTION

The evolution of the common law is marvelous to behold, especially when it adheres to its tradition of thoughtful, measured adjudication. Judges should take special care in considering the espousal or adoption of broad principles based on the generalizations of commentators or even other judges, rather than through the more trustworthy development of rulings based on specific factual situations. This is not to depreciate the value of the work of commentators, one of whom is the author of this article. Hopefully scholarly efforts contribute to the resolution of cases presented by concrete factual situations as part of a healthy adversarial process that considers all relevant arguments. But a serious danger to the rational legal process occurs when able commentators too effectively advocate the adoption of persuasive sounding generalizations that, though offered in good faith, ill serve the policies underlying the rulings through which legal principles evolve. Both commentators and judges may cease to reexamine the principles they have embraced, and those principles will prematurely gain the status of settled law.

One such generalization has been creeping into the law of corporate veil piercing. It calls for contract creditors to be treated less kindly than tort creditors. Indeed, some argue that a contract creditor should succeed in piercing the corporate veil in only the most exceptional situation. This article challenges that generalization as contrary to the essential public policies underlying the conferring

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of limited liability on business enterprises; reliance on such a generalization will prove unjust in many veil piercing cases. It should be understood from the outset that the veil piercing doctrine discussed throughout this article is confined to privately held businesses.¹

This article reviews some of the important elements of veil piercing and proposes an alternative approach to the tort versus contract distinction. It also discusses the implications of causation as an element in piercing claims.

II. THREE LIMITED LIABILITY SCENARIOS

Three scenarios illustrate public policy issues related to limited liability.

Scenario 1: Two brothers formed a corporation to go into business together, to work full time, to produce useful items, and to make money. They invested substantially in the business but did not want to risk all of their personal assets. While their goal was to achieve business success, they wanted the veil of limited liability to protect their homes and other assets not committed to their business in the event of failure. They formed and operated their business entity in a financially responsible manner, but their business failed. A rational public policy favoring responsible entrepreneurship could be materially enhanced by allowing such persons the privilege of limited liability.

Scenario 2: Two brothers used the corporate form not to achieve business success, but simply to obtain money from creditors and to ultimately ignore their liabilities. They were willing to become rich or at least derive some monetary benefit at the expense of contract and tort creditors while hiding behind the veil of limited liability.

While the first scenario encourages owners to invest money, talent and hard work into something that may benefit the society in which they live, the second scenario simply makes limited liability a vehicle for owners of a business to cheat others. It would be absurd to support a policy in which such persons would be given immunity from liability.

Scenario 3: Two brothers form a corporation to go into business together to produce useful items and make money but want to risk little or none of their assets to do it. Their goal is to try to develop a successful business but lose nothing or very little, leaving it to the creditors of the business to sustain any or all of its

¹ DOUGLAS M. BRANSON ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY 217 (2009). Although it is theoretically conceivable to pierce the corporate veil of publicly-held corporations, the doctrine has only been successfully invoked in the context of privately held corporations whose stock is owned by another business enterprise (which may be a publicly-held corporation) or whose stock is held by individual equity holders. *Id.*

losses. In other words, they undertake a business for a good purpose but with an outrageous degree of financial irresponsibility. This scenario would generally not serve the societal interest in authorizing limited liability. The word “generally” is used because it is conceivable that voluntary and properly informed creditors may choose in some circumstances to deal with such corporations and recognize the limited liability of their owners. In that unusual event, the burden should be on the debtor to make proper disclosure and to secure the consent of the creditor to the allowance of limited liability.

III. PIERCING THE VEIL: BACKGROUND AND TRENDS

It is a well established rule of law that when a corporation cannot pay its debts, its owners are not liable for them in the absence of special circumstances.² The corporation is considered an entity with the characteristic of limited liability. Of course, owners can contract away their immunity from corporate debts or may themselves be personally liable for the commission of certain torts or on the basis of other theories. This article, however, is concerned with the doctrine of piercing the corporate veil, a doctrine that enables creditors to collect from owners of a corporation in situations where the corporate characteristic of limited liability is not respected by the courts.

This article is written against the background of two major trends affecting issues of limited liability. The first is the emergence of two new business forms. It used to be that if owners wanted their business organization to have the limited liability characteristic, they would have been likely to form a corporation or a limited partnership. Those forms of doing business have been well established under state laws that require the filing of forms in particular governmental offices. In the corporate form, the limited liability characteristic is available to shield owners who are active participants in corporate affairs, as well as those who are passive owners. In the limited partnership form, historically a degree of passivity was required for those owners designated as limited partners to enjoy the limited liability shield. The other major business organizational form, the general partnership, was quite commonly used but did not provide its owners limited liability. More recently, state laws have been enacted that enable partners to limit their liability by complying with simple requirements and becoming limited liability partnerships (“LLP”s).³ Allowing general partners to limit their liability represents a dramatic change in business organization law because previously a

² *E.g.*, *Radaszewski v. Telecom Corp.*, 981 F.2d 305, 306 (8th Cir. 1992); *DeWitt Truck Brokers, Inc. v. W. Ray Fleming Fruit Co.*, 540 F.2d 681, 683 (4th Cir. 1976).

³ *E.g.*, S.D. CODIFIED LAWS § 48-7A-306 (2008); REV. UNIFORM PARTNERSHIP ACT § 306 (2001 ed.); ALAN R. BROMBERG & LARRY E. RIBSTEIN, LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT 12, 17–18, 31–33, 48–58 (Aspen Law & Business ed. 2009). All United States jurisdictions have adopted LLP provisions. California, Nevada, New York, and Oregon only permit professional firms to be LLPs. *Id.* at 16.

cardinal principle of partnership law held partners personally liable for the debts of the partnership. Now personal liability can be limited in most states, though the wording of each state statute may raise issues about the extent of liability avoidance.⁴ In addition, and even more significant at the moment because of its great popularity, is the relatively new business organization with the limited liability characteristic called the limited liability company (“LLC”).⁵

A question arises about the extent to which doctrines related to the piercing of the corporate veil may be applied to these new limited liability forms. In other words, how much, if at all, will courts be guided by traditional veil piercing doctrines in cases involving LLCs or LLPs? Case law suggests that corporate law piercing principles will be applied to LLCs⁶ and there is no reason to believe that LLPs will be treated differently.

A second major trend in business organizations law permits certain business entities with the limited liability characteristic to operate with a minimum of formality. As will be seen later, failure to observe formalities has often been a factor cited in corporate piercing analysis. Partnerships have been subject to relatively little restrictive state regulation regarding their governance mode, a characteristic unchanged by limited liability partnership statutes. Limited liability companies are also free of significant restrictive state regulation of their modes of governance.⁷ Laws governing both of these entities allow for considerable latitude in making arrangements as to governance. While corporations historically were subject to a great deal of state statutory regulation in governance matters, closely held corporations now have the ability under certain conditions to escape from the governance rules previously imposed on public and closely held companies. For example, states that have adopted Revised Model Business Corporation Act (“RMBCA”) § 7.32 allow a nonpublic corporation to be governed largely through an agreement signed by all of its shareholders.⁸ The statutory reduction

⁴ For example the language of the Wyoming Uniform Partnership Act § 17-21-306 allowing limited liability partnerships is not the same in limiting liability as that of § 306 referred to in the Revised Uniform Partnership Act, *supra* note 3.

⁵ See, e.g., WYO. STAT. ANN. §§ 17-15-101 to 17-15-147 (2008) (an LLC statute).

⁶ See, e.g., *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323, 329 (Wyo. 2002).

⁷ See, e.g., *Fisk Ventures, LLC v. Segal*, 2009 WL 73957 at *2 (Del. Ch. 2009); *Gottsacker v. Monnier*, 697 N.W.2d 436, 438 (Wis. 2005).

⁸ REVISED MODEL BUS. CORP. ACT § 7.32 (1984)

(a) An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it: (1) eliminates the board of directors or restricts the discretion or powers of the board of directors; (2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in section 6.40; (3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal; (4) governs, in general

of the necessity for the formalities of corporate structure or governance requires clarification of the meaning and significance of corporate formalities observance in the piercing analysis. Additionally, statutes may follow that provision of the RMBCA § 7.32, which provides:

The existence or performance of an agreement authorized by this section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.⁹

Furthermore, courts have referred to the issue of reduced significance of formalities observance for LLCs as compared to corporations,¹⁰ although to some extent, as pointed out above, the need for some corporations to observe governance formalities has already been lessened in some corporate statutes.

IV. LIMITED LIABILITY JUDICIAL APPROACH

How do courts decide to reject limited liability for certain corporate shareholders? Although courts may call a corporation a mere alter ego or instrumentality of its owners in deciding to pierce the corporate veil, the use of such terminology does little to explain the basis of a court's decision. Courts often cite general piercing tests or list factors to be taken into consideration in a piercing decision. Among the tests cited are the following:

or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies; (5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them; (6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders; (7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or (8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.

⁹ REVISED MODEL BUS. CORP. ACT § 7.32(f) (1984); *see, e.g.*, WYO. STAT. ANN. § 17-1-132(f) (2008).

¹⁰ *See, e.g., Kaycee Land & Livestock*, 46 P.3d at 328 (Wyo. 2002).

[F]irst, 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.¹¹

There is also an instrumentality test:

The instrumentality rule requires, in any case but an express agency, proof of three elements: (1) Control, 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; and (2) 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) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.¹²

Additionally, courts sometimes use epithets like “sham” or “dummy” or “shell” to describe corporations unfit for the privilege of limited liability.¹³ In a recent case, where the words sham and shell appear, a veil was pierced against an individual who was the sole owner and officer of the defendant corporation in a case involving breach of an asset purchase agreement. The court said:

The “corporate veil may be pierced under exceptional circumstances, for example, where the corporation is a mere shell.” . . . Factors which would support such a finding include: (1) the corporation is undercapitalized, (2) without separate books, (3) its finances are not kept separate from individual finances, individual obligations are paid by the corporation,

¹¹ Van Dorn Co. v. Future Chem. & Oil Corp., 753 F.2d 565, 569–70 (7th Cir. 1985). For similar statements of this test, see for example, Semmaterials, L.P. v. Alliance Asphalt, Inc., 2008 WL 161797 at *4 (D. Idaho 2008); Baize v. Eastridge Companies, 47 Cal. Rptr. 3d 763, 770 (Cal. Ct. App. 2 Dist. 2006).

¹² Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967); *accord* Pae v. Chul Yoon, 838 N.Y.S.2d 172, 173 (N.Y.App. Div. 2 Dept. 2007).

¹³ See, e.g., HARVEY GELB, PERSONAL CORPORATE LIABILITY: A GUIDE FOR PLANNERS, LITIGATORS, AND CREDITOR'S COUNSEL § 1.2 (1991); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 146, at 344–45 n.2 (3d ed. 1983) for a list of such words and phrases.

- (4) the corporation is used to promote fraud or illegality,
- (5) corporate formalities are not followed or (6) the corporation is merely a sham.¹⁴

In applying these factors the court said that the corporation involved was never funded with any assets, had no separate books, no established course of business, and was formed for the sole purpose of purchasing the radio station involved in the agreement.¹⁵ In *Ventresca Realty Corp. v. Houlihan*, a New York case, the court supported piercing where the evidence demonstrated a lessee corporation was a mere dummy or shell entity created solely to sign the lease.¹⁶ The court said, “[t]he corporation owned no assets, held no investments, conducted no business, had no employees, did not possess its own telephone line, and had no income other than the funds periodically contributed to it by the individual defendants so that its monthly rent obligation could be met.”¹⁷

The use by courts of pejoratives like sham, dummy, or shell may reflect at times a disgust and rejection of the use of corporate limited liability, not by the good faith entrepreneur, but by financially irresponsible parasites.

A lengthy list of factors in making piercing decisions appeared in a Wyoming case:

Among the possible factors pertinent to the trial court’s determination are: 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; the treatment by an individual of the assets of the corporation as his own; the failure to obtain authority to issue or subscribe to stock; the holding out by an individual that he is personally liable for the debts of the corporation; the failure to maintain minutes or adequate corporate records and the confusion of the records of the separate entities; the identical equitable ownership in the two entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management;

¹⁴ *Burke v. Cont’l. Broad. Inc.*, 746 N.W.2d 279 (Table), 2008 WL 141565 at *2 (Iowa Ct.App. 2008) (quoting *Briggs Transp. Co. v. Starr Sale Co.*, 262 N.W.2d 805, 810 (Iowa 1978)). In *Burke*, the trial court determined that because Local Continental was a “shell or sham entity” its corporate veil could be pierced. *Id.* The appellate court affirmed the decision. *Id.* at *3.

¹⁵ *Id.* at *2.

¹⁶ *Ventresca Realty Corp. v. Houlihan*, 41 A.D.3d 707, 709, 2007 N.Y. Slip Op. 05498 (N.Y.App.Div. 2 Dept. 2007).

¹⁷ *Id.*

the failure to adequately capitalize a corporation; the absence of corporate assets, and undercapitalization; 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; the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest or concealment of personal business activities; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services or merchandise for another person or entity; 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; the contracting with another with intent to avoid performance by use of a corporation as a subterfuge of illegal transactions; and the formation and use of a corporation to transfer to it the existing liability of another person or entity.¹⁸

Courts may insist that more than one factor exists before the veil may be pierced. Such an approach may be regarded as implicit or explicit in piercing tests with dual and triple prongs, such as those cited earlier. Furthermore, there are numerous cases that resolve the piercing issue by actually applying a multifactor analysis.¹⁹ Difficulties in utilizing and applying multifactor analyses may arise in ascertaining the meaning and weight of particular factors in the mix leading to a particular piercing decision. This is often the case because the piercing decision is so dependent on the court's equitable discretion as applied to varying fact patterns and multiple factors, which may indeed be frustrating to those seeking certitude or predictability.

V. FINANCIAL RESPONSIBILITY AND VEIL PIERCING

If at times the privilege of limited liability should be denied to certain owners who have run an entity that is not financially responsible, then it is logical to look at the entity from inception for evidence of responsibility or irresponsibility. Among other things, it is appropriate to determine if the owners have undersupplied or misused assets of the entity.

¹⁸ *Miles v. CEC Homes, Inc.*, 753 P.2d 1021, 1023–24 (Wyo. 1988) (quoting *Amfac Mechanical Supply Co. v. Federer*, 645 P.2d 73, 77–78 (Wyo. 1982) (quoting *Arnold v. Browne*, 27 Cal.App.3d 386, 394–95 (Cal.App. 1972))).

¹⁹ See, e.g., *Semmaterials*, 2008 WL 161797 at *4; *DeWitt Truck Brokers*, 540 F.2d at 686–87.

Undercapitalization is mentioned in the long list of piercing factors referred to above.²⁰ It is a relative concept. Some businesses need a great deal of capital, others very little, and of course there are the in-betweens. Courts may look to whether a corporation was grossly undercapitalized for the purposes of the corporate undertaking; it has been said that “an obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking, has frequently been an important factor in cases denying stockholders their defense of limited liability.”²¹ The importance of relativity is illustrated by the words of a California court that said: “[i]n the instant case the evidence is undisputed that there was no attempt to provide adequate capitalization. [The corporation] never had any substantial assets. . . . Its capital was ‘trifling compared with the business to be done and the risks of loss. . . .’”²² A leading commentator explained the undercapitalization issue as follows:

If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.²³

Some courts would limit the undercapitalization determination to the situation existing at the outset of the business,²⁴ but others may look at it as a continuing issue.²⁵ Because the issue of adequate capitalization is a relative concept, it should not be frozen at the outset of the enterprise, but must be

²⁰ See *supra* note 18 and accompanying text.

²¹ *DeWitt Truck Brokers*, 540 F.2d at 684 (citing *Anderson v. Abbott*, 321 U.S. 349, 362 (1944)).

²² *Minton v. Cavaney*, 364 P.2d 473 (Cal. 1961) (citing *Automotriz Del Golfo De California S. A. De C. V. v. Resnick*, 306 P.2d 1, 4 (Cal. 1957)); see also GELB, *supra* note 13, § 1.6.

²³ H. BALLANTINE, *BALLANTINE ON CORPORATIONS*, § 129, 302–03 (rev. ed. 1946).

²⁴ See, e.g., *Keams v. Tempe Technical Inst., Inc.*, 993 F. Supp. 714, 724 (D. Ariz. 1997); *Pierson v. Jones*, 625 P.2d 1085, 1087 (Idaho 1981).

²⁵ See, e.g., *Coughlin Const. Co. Inc. v. Nu-Tec Indus., Inc.*, 755 N.W.2d 867 (N.D. 2008); *United States v. Golden Acres, Inc.*, 702 F.Supp. 1097, 1105–1107 (D. Del.1988); *Bucyrus-Erie Co. v. Gen. Prods. Corp.*, 643 F.2d 413, 418 (6th Cir. 1981); see GELB, *supra* note 13, § 1.6[3].

looked at as the needs of the business change, as it expands and contracts, as it accumulates profits and prospers, or loses money and declines. In *Atlas Const. Co. v. Slater*²⁶ the court considered relevant changes in corporate needs and asset levels, in addition to initial capital or assets as well as the insurance carried by the corporation, and explained as follows:

Undercapitalization is often cited as a factor which will support piercing the corporate veil. . . . The problem of determining adequate capitalization in a particular case, however, may be a complicated one.

Courts cannot focus solely on initial corporate capital or assets, as some are prone to do, in deciding whether inadequacy of assets warrants a decision to pierce because subsequent changes, such as increased hazards or reduced assets, may render a determination as to initial inadequacy irrelevant.

Whatever the courts' requirements in terms of inadequacy of assets, courts must still consider many varying factors relevant to their deliberations. For example, where the inadequacy of capital and other assets is at issue the testimony of expert financial analysts and statisticians as to comparable businesses may be relevant. Perhaps this analysis might include evidence of the adequacy of insurance coverage, and involve testimony concerning the amounts of insurance carried by comparable businesses. Furthermore, in addition to consideration of the amount of capital provided, other factors such as shareholder loans and the amount of earnings retained by the corporation may be analyzed.²⁷

Undercapitalization is generally more reasonably considered in a context of financial responsibility along with the other assets that a corporation has available for creditors and in light of the nature and risks of the business at various points in its life.²⁸ In the *Atlas* case a purchaser of a new home brought action against a construction company, its subsidiary and individual shareholders for negligence and breach of the implied warranty of habitability. In analyzing the issue of piercing the corporate veil, the court indicated that initial corporate capital or assets could not be the sole focus. The court looked at the corporation's capitalization and retained earnings for a period of years subsequent to its initial capitalization. The

²⁶ 746 P.2d 352 (Wyo. 1987).

²⁷ *Id.* at 356 (quoting Harvey Gelb, *Piercing the Corporate Veil—The Undercapitalization Factor*, 59 CHI.-KENT L. REV. 1, 14–15 (1982)).

²⁸ GELB, *supra* note 13, §§ 1.6, 1.7.

court considered the events that allegedly caused the declining corporate assets, which had grown considerably over the years, pointing to an affidavit indicating that five houses had been sold at considerable loss attributable to a downturn in the market and that a flood caused further losses.²⁹ The court also said that the record suggested that the corporation purchased insurance to cover the type of liability that arose in this case, but during the litigation and at the time the judgment was entered the company was apparently involved in a dispute with its carrier over the coverage.³⁰ The result in this particular case was that a summary judgment favoring piercing of the veil was overruled and sent back to the lower court for further inquiry into the facts.³¹ Thus, while undercapitalization is recognized as a possible indicator of financial irresponsibility in terms of unfairness to creditors, the piercing issue really depends in a broader sense upon the level of assets available for potential claims. Clearly, when assets to pay claims turn out to be insufficient, reasons for their inadequacy are important in determining whether the corporation was operated in a financially responsible manner.

In certain types of cases, the nature of the debt owed may also be considered by some courts in determining the importance of inadequacy of capital. Indeed the relative importance of the amount of capital a corporation has at its outset or at any given point in time when it incurs an obligation can vary a great deal. To a tort victim, insurance available to cover her claim is often of central significance. In the *Radaszewski* case, a biker injured by a truck was frustrated in the collection of his claim by the failure of an insurance company.³² In that case insurance was carried in the amount of eleven million dollars, but only one million dollars was actually collectible. The court felt that undercapitalization was relevant because of the question of financial responsibility, and that a trucking company carrying eleven million dollars in liability insurance was financially responsible even though it was assumed that undercapitalization existed.³³ Important to the court was that the company did not appear to be intentionally or recklessly set up to evade responsibility to the tort creditor.³⁴

If there is a contract claim or a type of tort claim generally not covered by insurance, the existence of insurance covering other tort claims in the face of gross undercapitalization or lack of adequate assets almost seems irrelevant. Why “almost”? Because appropriate insurance should somehow be taken into account as part of an undercapitalization or adequacy of assets assessment, as it may be relevant to the issue of financial responsibility. It should, therefore, be part of

²⁹ *Atlas*, 746 P.2d at 357.

³⁰ *Id.*

³¹ *Id.* at 360.

³² *Radaszewski*, 981 F.2d at 306.

³³ *Id.* at 310.

³⁴ *Id.*

a determination of overall financial responsibility, and its availability may leave other corporate assets for potential creditors.

A. Financial Responsibility and Misuse of Assets

A number of factors in the list cited earlier³⁵ concern the “misuse of assets.” The drainage of funds from the corporation to its owners may unfairly leave creditors with a judgment-proof corporate debtor, or the controlling corporate owners may deplete the assets reasonably required for current or potential tort or contract liabilities, destroying the financial responsibility and even viability of the company. There are certain appropriate financial dealings between the corporation and its owners, such as where the corporation is receiving proper consideration for the funds it is disbursing. Transactions between the corporation and owners, such as property transfers, leases, salaries, loans and fringe benefits, may cost the corporation what it would have to pay in arm’s length deals, but the danger of favoritism to owners as part of an unbusiness-like reduction of corporate assets calls for a determination as to whether transactions with owners were fair to the corporate entity and just to its existing or prospective tort or contract creditors.³⁶ Injustice can be an important criterion in veil piercing cases.³⁷

B. Financial Responsibility and Limited Liability Public Policy

Shirts, Inc. manufactures and sells shirts to wholesalers and retailers. Its sales employees travel mostly by automobile to show company merchandise to customers and prospective customers. A, B and C are the only shareholders of Shirts, Inc., and all three of them have been active as directors and managerial employees and have been its only shareholders since it was incorporated. At the time of incorporation A, B and C each invested \$5,000 in the common stock of Shirts, Inc. and no additional funds have ever been invested by them. E, a sales employee of Shirts, Inc., negligently struck P, a pedestrian, who sustained severe injuries and was awarded \$2 million in damages against Shirts, Inc. and E. Both

³⁵ See *supra* note 18 and accompanying text.

³⁶ *Stockton v. Nenadic Invs., Ltd.*, 2006 WL 3775850 at *7 (Wash. Ct. App. 2006) (disregarding corporate entity when corporation intentionally removed funds to avoid liability); *Windsor v. Huron Mach., Inc.*, 2006 WL 1752137 at *6 (Mich. Ct. App. 2006) (piercing the veil where a transfer of corporate assets to avoid payment of a judgment). The court also pointed to defendant’s use of corporate funds for his own benefit and the benefit of his family without offering adequate business justifications for the expenses at issue. *Id.* at 5. In *Miles*, 753 P.2d at 1021 defendant’s procurement of labor and services of the corporation and diversion of corporate assets to other than corporate uses was cited *inter alia* as basis for veil piercing. For further discussion of misuse of assets see GELB, *supra* note 13, § 1.7.

³⁷ See, e.g., *Int’l. Fin. Servs. Corp. v. Chromas Tech. Can., Inc.*, 2005 WL 2304783 (D.N.D. Ill. 2005).

Shirts, Inc. and E are insolvent and P received only \$20,000, which represented the entire available insurance amount carried by Shirts, Inc. P, however, seeks to pierce the veil of Shirts, Inc. and collect from A, B and C, who are very wealthy persons. During the five-year life of Shirts, Inc. it has paid annual salaries of \$500,000 each plus certain fringe benefits to A, B and C. It has no retained earnings and its liabilities far exceed its assets.

Assuming that the amount of insurance carried by Shirts, Inc. is considered inadequate, and that it has been otherwise financially irresponsible, allowing the owners of Shirts, Inc. to escape liability to the injured pedestrian is unjust and poor public policy. The corporation that risks inflicting harm on others should reasonably provide for damages that may result to those others. It should also promote safety in its operations. Controlling owners should be encouraged to responsibly face the risks of business by the possibility of personal liability if they fail to do so. Moreover, the ownership of companies that are financially responsible and reasonably use resources to promote safety should not be disadvantaged in their competition with owners who are irresponsible.

In a recent North Dakota case where plaintiff's judgment against a corporation was based in part on a finding of fraud, the court stated:

In tort cases, particular significance is placed on whether a corporation is undercapitalized, which involves an added public policy consideration of whether individuals may transfer a risk of loss to the public in the name of a corporation that is marginally financed.³⁸

The court pointed to the importance of "carefree entrepreneuring" in a piercing case saying that "The essence of the requirement for fairness is that an individual cannot hide from the normal consequences of carefree entrepreneuring by doing so through a corporate shell."³⁹ Of course, it is the contention of this article that as a matter of policy carefree entrepreneuring is unworthy of protection against the veil piercing claims of contract creditors as well as tort creditors.

C. Formalities

As indicated earlier, in deciding whether or not to pierce the veil a court may refer to the observing or disregarding of corporate formalities as a factor. Corporations may be remiss in holding board or shareholder meetings, keeping

³⁸ Axtmann v. Chillami, 740 N.W.2d 838, 834–44 (N.D. 2007).

³⁹ *Id.* (citing Jablonsky v. Klemm, 377 N.W.2d 560, 567 (N.D. 1985) (quoting Labadie Coal Co. v. Black, 672 F.2d 92, 100 (D.C. Cir. 1982))).

minutes and other records, and even issuing stock. However, state law frequently authorizes corporations to proceed in some respects with great informality, such as unanimous written consents instead of board meetings.⁴⁰ Indeed, as explained earlier, statutory provisions modeled after § 7.32 of the RMBCA provide great latitude for the operation of nonpublic corporations where agreements are entered into by all shareholders.⁴¹ If despite such statutory authorization shareholders and directors operate informally but outside the scope of technical statutory compliance, say without meetings or written consents or without complying with statutory provisions like § 7.32, how much should a court weigh such behavior in the piercing decision? It is hard to see how creditors or the public are harmed if the only three shareholders who are also the only three directors of a closely held corporation sit in a common office area, talk over their problems and make decisions without formal meetings or passing resolutions. If there is no harm to creditors or to the public stemming from such informal conduct, why should shareholders be punished by such a drastic remedy as veil piercing? Certainly statutory trends shrinking formality requirements indicate little if any public interest in them. Some things, however, which may be thought of or labeled by some courts as formalities, may be worth weighing in piercing decisions. The lack of appropriate corporate records and minutes may in some cases mislead persons who are about to become creditors about the financial health of an enterprise or hinder them in tracing corporate assets available to them for the payment of debts.⁴² The commingling of funds and the misuse of assets, which may sometimes also be labeled in the category of lack of respect for formalities,⁴³ may reflect both corporate financial irresponsibility and chaos that will be confusing to creditors. Indeed the failure to issue stock and the lack of other formalities referred to above may raise a question as to whether the corporation was in fact functioning at all.⁴⁴ If judicial opinions are to offer meaningful guidance as precedent, the court should separate and articulate what items are actually considered by it to be of significance in the nonobservance of formalities category.

⁴⁰ *E.g.*, CONN. GEN. STAT. ANN. § 34-140 (2008); MASS. GEN. LAWS ANN. ch. 156D, §§ 7.32, 8.21 (West 1999).

⁴¹ *See supra* notes 8–9 and accompanying text.

⁴² *See* Conn. Light & Power Co. v. Westview Carlton Group, L.L.C., 2006 WL 3719484 at *3 (Conn. Super. Ct. 2006). Among the factors considered by the court in finding that the first prong of the instrumentality test had been proved by plaintiff in a case involving an LLC veil are the following: defendant was the sole owner, member, and manager of the company, certain state or federal tax returns were not filed, there was a failure to preserve financial records, and the defendant had total control concerning business practices, finances and policy. For further discussion of formalities issues see GELB, *supra* note 13, § 1.8.

⁴³ GELB, *supra* note 13, § 1.8.

⁴⁴ *Id.*

D. *Fraud*

Fraud is often cited as a factor in veil piercing cases.⁴⁵ If a debtor deceives a creditor by misrepresenting material facts about its financial condition before a creditor has extended a loan or at the collection stage, or if a debtor with a duty to disclose material information to a creditor fails to do so at either stage, piercing may be justified.⁴⁶ Fraud in the sense of deception may even be perpetrated by a corporation that could not rightly be called a financially irresponsible entity for piercing purposes, because a creditor should have the opportunity to decide how much interest to charge, or what security is needed to extend a loan to even a financially responsible entity. Fraud in making the borrower look financially better than it really is, may justify veil piercing.

Sometimes courts go beyond disclosure or nondisclosure situations and consider other factors relevant to a fraud determination in a veil piercing context. For example, a Nebraska case includes grossly inadequate capitalization, insolvency of a debtor at the time a debt is incurred, or improperly diverting corporate assets to shareholders.⁴⁷ In using these factors, the fraud determination reflects a condition of financial irresponsibility.

E. *Contract versus Tort*

Tort victims who are involuntary creditors do not have an opportunity to bargain for the personal guarantees of corporate shareholders or other protections as many contract creditors would be able to do. While banks or other big creditors extending loans to closely held corporations are generally in a position to demand personal guarantees from corporate owners, a person about to be hit by a car lacks that luxury. It is not surprising, therefore, that some judges and commentators have articulated the proposition that courts ought to be less willing to pierce the corporate veil in contract cases than in tort cases.⁴⁸ It has been argued that contract creditors should protect their own interests by demanding personal guarantees from controlling shareholders, and if they fail to protect themselves the

⁴⁵ See, e.g., *DeWitt Truck Brokers*, 540 F.2d at 686–87; *Bergh v. Mills*, 763 P.2d 214, 218 (Wyo. 1988); *Westmeyer v. Flynn*, 889 N.E.2d 671, 677 (Ill. App. Ct. 2008); GELB, *supra* note 13, § 1.9.

⁴⁶ GELB, *supra* note 13, § 1.9.

⁴⁷ See, e.g., *Carpenter Paper Co. of Neb. v. Lakin Meat Processors Inc.*, 435 N.W.2d 179, 183 (Neb. 1989) (quoting *J.L. Brock Bldrs., Inc. v. Dahlbec*, 391 N.W.2d 110, 115 (Neb. 1986)); GELB, *supra* note 13, § 1.9.

⁴⁸ See, e.g., *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406, 415–416 (7th Cir. 1988); *Perpetual Real Estate Servs., Inc. v. Michaelson Prop., Inc.*, 974 F.2d 545, 550 (4th Cir. 1992); *United States v. Jon-T Chem., Inc.*, 768 F.2d 686, 693 (5th Cir. 1985) STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 155 (Found. Press 2002).

law should not rescue them.⁴⁹ One commentator points to “a substantial number of courts [which have] correctly . . . accepted the proposition that they ought not to pierce on behalf of contract creditors in an absence of fraud or other unusual circumstances,”⁵⁰ but states that “although the contract/tort distinction makes so much sense as to seem unassailable, it has received a surprisingly mixed reception from the courts.”⁵¹ Indeed this commentator admits that in practice courts in fact tend to pierce more often in contract than in tort cases.⁵² A contemporary treatise refers to the tort vs. contract controversy stating, “[a]lthough commentators have sometimes argued that it should be more difficult to pierce the corporate veil in contract as opposed to tort cases, courts have not always discussed or applied these distinctions.”⁵³ The position that the perspective of courts in piercing the veil should be more hostile to contract creditors than tort creditors may be fashionable in some quarters and have a deceptively persuasive sound to it, but it is actually inappropriate. This article proposes an entirely different perspective for a number of reasons.

First, in the vast universe of contract piercing cases, there are probably relatively few where it would be practical or sensible for contract creditors to obtain personal guarantees or other contract protections. Those contract creditors who are in a position to do so, like banks, may obtain personal guarantees and/or security from privately held businesses as a matter of course. But the vast majority of contract creditors or potential contract creditors, such as wage earners, consumers, trade creditors and small suppliers, have probably been in no position competitively or economically to insist on guarantees or other protections or to incur the expenses of investigating whether they should be seeking such protections. These contract creditors should not lose the opportunity to pierce corporate veils or be disadvantaged in their efforts to do so simply because they are classified as contract creditors.

Furthermore, the costs and consequences of attempts at protection, such as demanding guarantees from many debtors, may be undesirable. Will the owners of innocent and financially responsible businesses end up with burdens because of the irresponsible? Will defaults by egregiously irresponsible debtor corporations lead to costs being passed on to responsible businesses or to the public? A claim for veil piercing should logically start with the premise that tort creditors and contract creditors are in the same position except to the extent that it can be shown that voluntary contract creditors have decided to accept the risk of dealing

⁴⁹ BAINBRIDGE, *supra* note 48, at 155.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.* at 155–156.

⁵³ EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES* § 20:6 (Thomson/West 2007).

with a pierce-worthy operation and given up the right to the equitable relief of veil piercing. It is hard to imagine why a court should generally start with a bias against contract creditors in most piercing cases.

Second, courts have been reluctant to pierce entity veils.⁵⁴ Usually those in control of the pierced entity have been financially irresponsible or done something seriously wrong before veil piercing is allowed. Protecting contract creditors against egregious behavior by withdrawing the limited liability shield for those responsible for such behavior should be the norm and not the exception.

Third, it is not good public policy to give limited liability to businesses so irresponsible as to ordinarily qualify for veil piercing, and it should not be assumed that any legislature intended to do so just because a contract creditor is the claimant. For example, a business that makes its money from taking advantage of creditors rather than from operating in some way beneficial or potentially beneficial to society does not deserve veil piercing immunity in contract cases except on rare occasions where a creditor has been shown to have thrown all caution to the wind and in effect waived her rights to equitable relief. For special reasons, for example, a landlord may accept a no assets corporation as a tenant. If so, that should preclude or at least weigh heavily against veil piercing in favor of that landlord, not because of a general rule against contract creditors, but because of the particular behavior of this one.

Fourth, there are many cases where courts pierce veils in favor of contract creditors.⁵⁵ Although some courts and commentators may have advocated a more hostile position to contract creditors, the existence of many case precedents favorable to contract creditors should not be ignored. Surely the collective wisdom of courts that have had to deal with piercing situations in the front lines of litigation is worth considerable weight.

Fifth, the general proposition that society and both contract and tort creditors should be able to rely on limited liability entities operating in good faith for profit and not simply to profit from taking advantage of creditors is completely reasonable. It is important to clarify that the position expressed in this article is not based on the notion that there is anything wrong with courts being reluctant to strip away the veil of limited liability entities, quite the contrary is true. Rather, the position of this article is that generally most contract creditors are as worthy plaintiffs in veil piercing cases as tort creditors, and the many cases in which contract creditors are allowed veil piercing relief reflect the proper approach.

⁵⁴ Nat'l Ass'n of Sys. Adm'rs., Inc. v. Avionics Solutions, Inc., 2008 WL 140773 at *6 (S.D.Ind. 2008); *DeWitt Truck Brokers*, 540 F.2d at 681.

⁵⁵ *Id.*; BRODSKY & ADAMSKI, *supra* note 53, § 20:6.

Veil piercing allows courts to make wrongdoers pay for corporate debts. When done with proper reluctance, it does not subvert limited liability policy. Moreover, the threat of veil piercing encourages knowledgeable attorneys to advise clients to follow proper business practices. When courts adequately explain their reasons for or against veil piercing in particular cases, lawyers are able to better advise clients about financial responsibility, appropriate behavior, and about what may be expected for a corporation to be seen as a legitimate business. Certainly owners who use the corporate form as a tool to transfer creditors' assets to themselves, rather than to profit from running a legitimate business, should not be able to hide behind the corporate limited liability characteristic. At least the piercing of the veil doctrine may prevent some egregiously bad behavior because of good, early, and continuing legal advice and it may rectify situations where such behavior has occurred. To force voluntary creditors to add to their contractual costs of doing business or to pass costs on to the public by letting scoundrels walk away from irresponsible pierce-worthy conduct would be bad public policy.

H. Piercing the Veil: Causation and Liability

Piercing the corporate veil, sometimes called "disregarding the corporate entity," does not mean that the protection of limited liability is necessarily stripped away from all shareholders or in favor of all judgment creditors of the particular corporation. For example, in a case where the corporation is carrying a lot of automobile insurance to protect tort victims from negligent employee drivers, a wage earner or trade creditor alleging undercapitalization and misuse of assets may fare better in a piercing case than a tort victim of a negligent employee driver when the insurance is inadequate because of the unusual severity of the injuries.

The question of who is to be liable when the veil is pierced may also be complicated. One well known case, *Minton v. Cavaney*, speaks of imposing liability on the equitable owners of a corporation who actively participate in the conduct of corporate affairs.⁵⁶ The instrumentality rule cited earlier⁵⁷ refers to control, not mere majority or complete stock control, but domination, and speaks of the defendant being liable who has used control to commit fraud or wrong or perpetrate other improper actions. It also indicates that the defendant's control and breach of duty must proximately cause the injury or unjust loss complained of. Significantly, the proximate cause requirement of the instrumentality rule is subject to more than one interpretation. For example, on the one hand, fraud by a controlling corporate officer may lead a creditor to enter a contract with the corporation and satisfy the proximate cause requirement of the instrumentality rule. On the other hand, unjust loss in the sense of inability to collect on

⁵⁶ 364 P.2d 473 (Cal. 1961).

⁵⁷ See *supra* note 12.

a judgment obtained by the plaintiff because of the improper diversion of corporate assets, may meet the proximate cause requirement.⁵⁸ Under either the *Minton* test of active participation, or the instrumentality approach, the passive shareholder would generally be an unlikely candidate for veil piercing liability. Neither approach, however, furnishes a universal bright line rule of exclusion. The instrumentality rule is replete with issues. It cannot or should not mean that the defendant will not be held liable if she is one of three equal stockholders on a board of directors consisting only of herself and the other two stockholders who have voted unanimously for what a court determines to be grossly inadequate capitalization, serious misuse of assets and other inappropriate behavior under veil piercing guidelines because her control exists only in conjunction with the support of the others. The test of active participation in the conduct of corporate affairs should protect the passive shareholder who is a mere investor and not engaged in corporate affairs beyond the traditional shareholder role, nor should the person who happens to own a share of stock and is a janitor for the company but does not really participate in the conduct of corporate affairs be personally liable. Still some may think it equitable in some piercing cases to hold liable an owner who does not vote or participate in corporate affairs, but knowingly benefits from improper activity.

On its face the instrumentality causation rule predicates liability on wrongdoing while the *Minton* rule looks only to activity. Because piercing cases involve multifactor findings, which courts weigh to decide if the piercing line is crossed, some shareholders may participate slightly in wrongful behavior or in a lesser wrongdoing compared to the magnitude of wrongful behavior by other shareholders in the piercing factors mix. For example, the corporation may have grossly inadequate capitalization, be underinsured, have commingled its assets with shareholders' assets and engaged in confusing recordkeeping, but a particular shareholder, either because of when she entered the picture as an owner or because she even opposed some of the wrongdoing, may argue for exculpation by trivializing her role and seeking equitable mercy. Additionally, a significant shareholder may, without any official role, contact active persons to give advice or occasionally speak favorably to outsiders on behalf of the corporation to promote its business or reputation. Could such behavior attain a level of activity under *Minton* or constitute the requisite level of wrongful control under the instrumentality rule to justify personal liability?

In addition to deciding who should be liable by virtue of causation or activity requirements, there is the question of whether an effort should be made by the court to quantify the particular loss caused by the improper conduct of a defendant or defendants, or whether once the veil is pierced there should be liability for the entire judgment that the plaintiff has obtained against the corporation.

⁵⁸ GELB, *supra* note 13, § 1.11.

In analyzing the quantification of damages issue, consider the following hypothetical: Since its inception the same five shareholders have each owned 20% of the shares of X Corporation and four of them, A, B, C and D, have been active participants in the governance of X Corporation and also its paid managerial employees. E, the other shareholder, has lived far away in body and mind from the corporate business and, other than voting for directors and on other shareholder matters, has been inactive and received only a yearly dividend equal to that received by each other 20% shareholder. Plaintiff was negligently hit by an X Corporation vehicle driven by Z, an employee of the corporation, and obtained a one million dollar judgment against X Corporation due to severe injuries.

Utilizing a multifactor test, a court has determined that X Corporation has been grossly undercapitalized and woefully underinsured, and that its shareholders other than E have received, without charge, significant services and property from X Corporation; the court further determined that it would be unjust to not pierce the corporate veil of an insolvent X Corporation so that Plaintiff can collect his judgment.

Out of the group should A, B, C, D and E all be liable, and of those who are liable should liability be for the entire amount of one million dollars? Should the court limit the amount of personal liability to less than one million dollars, based on the theory that all of the wrongdoing (for example, combined undercapitalization, underinsurance and misuse of assets) could be evaluated as depriving the corporation of \$500,000 of assets that should have been available for Plaintiff? That approach may be unwise. First, there may be difficulties and expenses in making such calculations. Second, society should not confer on an irresponsibly run corporation the gift of limited liability. Society through its legal system gives a great benefit to business people in bestowing limited liability, so as to encourage persons to try to succeed in business without the risk of losing everything they have. However, when people go so far as to operate financially irresponsible businesses that incur debts that cannot be paid, they should not be seen as the intended beneficiaries of the limited liability privilege. Indeed the granting of limited liability to such irresponsible persons who are often willing to cheat their creditors is opposed to the interests of society, the victims of their wrongdoing and to legitimate businesses with which they compete, because it shifts responsibility to pay for injuries and obligations to the wrong people. Finally, and perhaps of most importance, is that the damages caused to tort or contract creditors cannot simply be measured by adding up the amounts of asset misuse, undercapitalization, lack of insurance or other calculable improprieties. Rather, creditors and the public ought to be able to expect that businesses granted limited liability are being run in a way to achieve success and increase their value through properly combining and using assets and labor, and are not being created or operated to feast parasitically on creditors and avoid financial responsibilities. Thus, the lack of or misuse of assets and underinsurance may cause harm beyond

the dollar measurement of those items since a bona fide business would be seeking to generate greater value than its owners invest in it. Of course, there may be some situations where certain contract creditors agree to assume all risk and accept limited liability no matter what. But such an unusual assumption of risk should be clearly understood and articulated. For courts to simply presume that contract creditors should have obtained guarantees or other protections from corporate shareholders is to endorse corporate limited liability even for the financially irresponsible or those whose goals in entering or operating a business are not in the public interest.

In a recent appellate opinion focusing on the amount of damages to be awarded in a piercing case, the court affirmed a lower court award of damages of over \$1 million against a corporate seller of real estate based on an agreement requiring the seller to indemnify the purchaser for remediation costs if hazardous substances were found on the property.⁵⁹

The trial court had also found corporate officers personally liable for part but not all of the judgment against the corporate seller on the basis that piercing can occur only to the extent that the wrongful activities caused harm to the party seeking relief.⁶⁰

On appeal the court stated:

The corporate entity is disregarded and liability assessed against shareholders in the corporation when the corporation has been intentionally used to violate or evade a duty owed to another. This may occur either because the liability-causing activity did not occur only for the benefit of the corporation, and the corporation and its controllers are thus “alter egos”, or because the liable corporation has been “gutted” and left without funds by those controlling it in order to avoid actual or potential liability.⁶¹

The trial court found that two officers had abused the corporate form in both ways mentioned, i.e., under the “alter ego” and the “gutting principles”; that the “gutting” occurred when an officer transferred \$450,000 (all corporate funds) to his son to hide it from the plaintiff; that abuse occurred as the officers routinely failed to separate corporate affairs from their own, representing corporate assets

⁵⁹ *Stockton*, 2006 WL 3775850.

⁶⁰ *Id.* at *5 (citing *Morgan v. Burks*, 611 P.2d 751, 755 (Wash. 1980)).

⁶¹ *Id.* (citing *Morgan*, 611 P.2d at 755).

in financial statements supporting applications for personal loans. The lower court found that shareholders, directors and officers merged their personal and corporate interests and identities after the real estate agreement was signed and the corporation started generating cash income.⁶² Although the lower court pierced the veil against corporate officers, it limited their liability to the \$450,000 gutting amount on the ground that the alter ego use did not directly harm plaintiff.

The court of appeals affirmed, holding that there is a proximate cause requirement in veil piercing and plaintiff must prove not just abuse of the corporate form but that wrongful conduct actually harmed the party seeking relief. It was the court's position that the harm caused was \$450,000 and that there was no proof that additional corporate funds would have been available even if the officers scrupulously maintained the corporate identity separately from their own, though the court admitted that the corporation "was established solely to manage the property in question, and therefore had no assets other than cash received from [plaintiff]."⁶³

Thus, the court overlooked or gave no significance to the unavailability of assets and the issue of financial responsibility by simply limiting the recovery based on an ill-applied proximate causation theory.

One would hope and expect that the same court would have more clearly seen the need to give weight to the lack of assets, gutting, and lack of financial responsibility factors if the case involved an involuntary tort plaintiff. A fair reading of this opinion would show that the court really took comfort in its result (though reached through a proximate causation route) by pointing to the sophistication of both contracting parties and suggested that plaintiff could have protected himself by requiring a personal guarantee.⁶⁴ This argument requires a policy judgment that some contract creditors are the cause of their own problems if they do not secure personal guarantees or other protection.

As indicated above, the ability of some creditors to obtain protection should not sabotage piercing claims of tort creditors or contract creditors, because the privilege of limited liability should not bar piercing claims against owners of entities who have not operated in good faith. On rare occasions, informed contract creditors may accept debtors that lack an appropriate level of assets, and that is part of the deal. In those cases the intentions of the parties should be respected. As stated earlier, although there are cases unfavorable to contract creditors, there are many that allow piercing by contract creditors. Indeed why should contract creditors be precluded from piercing, a judicial remedy granted only with reluctance where equity requires it, because of notions that such

⁶² *Stockton*, 2006 WL 3775850.

⁶³ *Id.* at *7.

⁶⁴ *Id.*

creditors have the burden to enter into further protective transactions such as securing guarantees. Moreover, the beneficial impact of limited liability may be diluted to the extent that more and more contract creditors conclude that it is best as a matter of course to require personal guarantees from owners of privately held limited liability entities.

Society should be able to expect entities granted limited liability to be operated in a financially responsible manner and that the victims of irresponsible financial behavior should have the right to go behind the veil of limited liability and hold its perpetrators accountable.

VI. CONCLUSION

The conclusion of this article will come as no surprise. Commentators and courts should reject the argument to disadvantage contract creditors in veil piercing suits against financially irresponsible owners. Blaming contract creditors for not protecting themselves is frequently unrealistic and may save unworthy persons from personal liability.

Caveat: While veil piercing is a respectable, well-established remedy against the financially irresponsible, and the threat of it may help prevent some negative debtor behavior, it is reluctantly granted and may be costly to pursue. Creditors need to analyze carefully the best ways to protect themselves from the harm of debtor default. As a practical matter, creditors in some situations may be able to take more self protective steps in considering the extension of credit and its ultimate collection. But limited liability is a privilege, and if its disregard will help a creditor against persons undeserving of that privilege, then veil piercing, a venerable and equitable remedy, is appropriately invoked.

Furthermore, using strict or narrow causation concepts in piercing cases may often ignore the simple reality that it is financial irresponsibility as such that often leads to insolvency and is the real cause of creditor collection problems. The cause of insolvency may be traced to the lack of a good faith or appropriate effort to succeed as a business; those responsible for that lack should not be protected in piercing cases by the privilege of limited liability. Of course, in piercing cases where it is shown that a properly informed creditor has agreed not to hold owners of the limited liability entity liable, that agreement should be respected.

Otherwise owners of privately held businesses who operate limited liability entities in a financially irresponsible way should be deemed outside the scope of protection from personal liability in piercing cases. Case law and statutes relevant to veil piercing should not protect such owners. Our society has enough financial distress without endorsing through law a policy to protect the irresponsible from veil piercing.