Rendigs
ATTORNEYS AT LAW

Business Briefs
Legal Update

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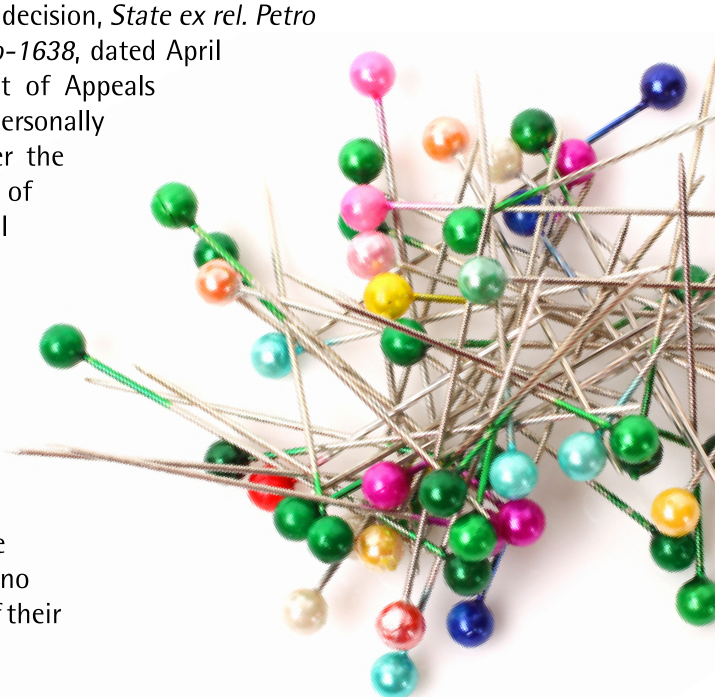
If they can't pay, sue everyone!

This month we're revisiting an important subject that no one seems to like to discuss - but you should. We're talking about actions requesting the court to pierce the corporate veil, which relief occurs when a court decides to ignore the limited liability status of a corporation or LLC and hold its officers, directors, and shareholders or members personally liable for company debts.

One of the main reasons business owners form an LLC or incorporate is to shield themselves from personal liability for company debts. To justify the notion of limited liability for owners, corporations and limited liability companies have long been considered fictitious legal entities that are separate and apart from their owners. However, if a litigious claimant convinces a court that the owner is merely the alter ego of the company, the owner of a corporation or LLC can be held personally liable for company debts. While personal liability is the exception instead of the rule, one survey estimates that more corporate litigation involves piercing the corporate veil than any other area of corporate law. According to another more recent study the corporate veil is successfully pierced around 30 – 40% of the time regardless of the size of the debtor company. These statistics make sense to us lawyers and it should to you too. If an insolvent company owes you money, you'd want to sue everyone, right? As a result Rendigs' attorneys often find ourselves defending claims in Ohio, Kentucky and Indiana where litigants frequently include alter ego allegations in their pleadings, sometimes as a matter of course, in an attempt to expand the number of potentially liable individuals or entities.

Could this happen to me?

Lawsuits requesting the courts to pierce the corporate veil happen all the time and we can only imagine that the liable shareholders wish they could turn back the clock and do things a little differently. In one recent decision, *State ex rel. Petro v. Pure Tech Sys., Inc., 2015-Ohio-1638*, dated April 30, 2015, the 8th District Court of Appeals in Ohio found Robert Kattula personally responsible for $6.1 million after the State of Ohio sued him and two of his companies for environmental violations in connection with hazardous waste operations. Kattula was the sole shareholder of one company and the other was his family's business. Despite his contentions that "there is not a shred of evidence" against him, the court found that Kattula controlled the corporations "such that they had no separate mind, will, or existence of their



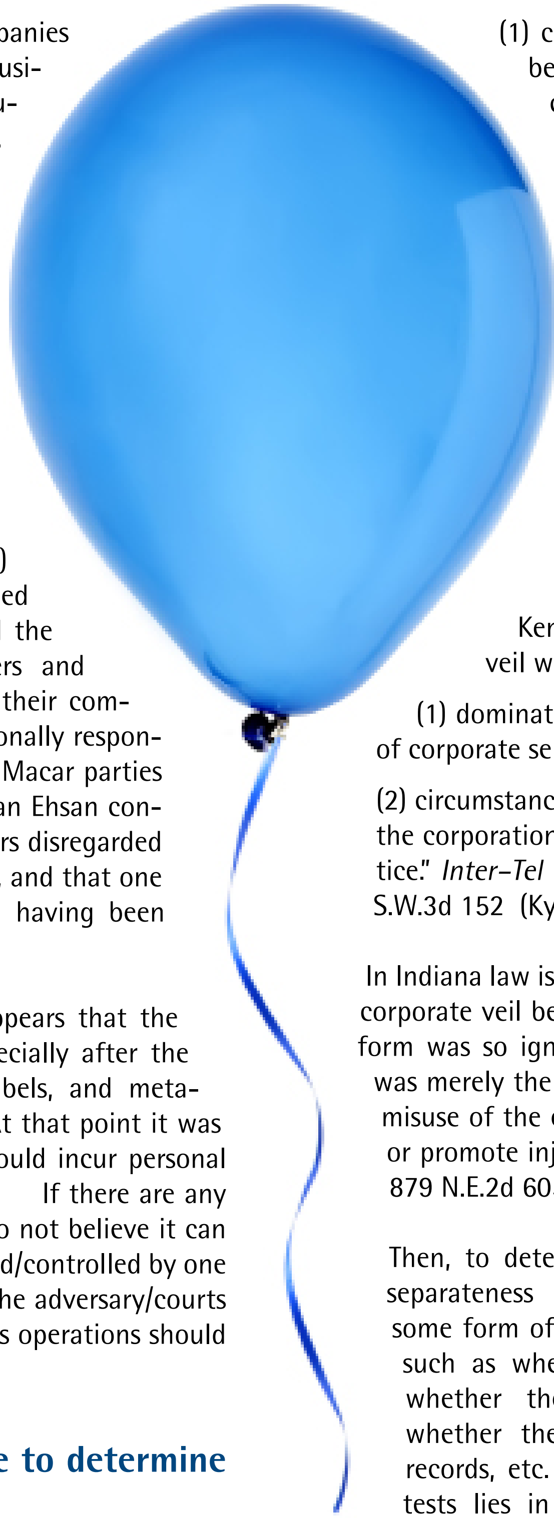
own" because he did business for the companies on his personal stationery, conducted business without complete corporate resolutions, and co-mingled corporate assets.

In another recent decision, *Kentucky Petroleum Operating Ltd. v. Golden*, Civ. No. 12-164-ART, 2015 WL 927358 (E.D. Ky. March 4, 2015, two LLCs ("the Macar parties") arbitrated a contractual dispute against two other companies ("the KPO debtors") following a dispute about oil and gas leases. After the arbitration hearing, but before the arbitrator's award issued, the KPO debtors mortgaged/pledged their assets to another (related) company. After the Macar parties prevailed in the arbitration, they sought to unwind the mortgages/pledges as fraudulent transfers and sought to hold the related company and their common, sole shareholder, Mehran Ehsan, personally responsible for the half million dollar debt. The Macar parties prevailed after the court found that Mehran Ehsan controlled the defendants, that the KPO debtors disregarded corporate formalities and comingled funds, and that one of the KPO debtors was undercapitalized having been initially funded with only $10.00.

In reading these decisions, it certainly appears that the Courts reached the correct decisions, especially after the courts started using characterizations, labels, and metaphors such as "alter egos" and "shams." At that point it was a foregone conclusion that the owners would incur personal liability in the name of equity and justice. If there are any lessons from these cases for people who do not believe it can happen to them, any company that is owned/controlled by one or two people are particularly at risk and the adversary/courts will scrutinize every aspect of your business operations should you face such a claim.

What is the test that Courts use to determine whether to pierce the veil?

All courts use a fairly similar test to determine whether to pierce the corporate veil. In Ohio, the corporate form may be disregarded and individual shareholders held liable for wrongs committed by the corporation when



(1) control over the corporation by those to be held liable was so complete that the corporation has no separate mind, will, or existence of its own,

(2) control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act (or "a similarly unlawful act") against the person seeking to disregard the corporate entity, and

(3) injury or unjust loss resulted to the plaintiff from such control and wrong." *Dombrowski v. Wellpoint, Inc.*, (2008) 119 Ohio St. 3d 506.

Kentucky courts will pierce the corporate veil where they finds:

(1) domination of the corporation resulting in a loss of corporate separateness and

(2) circumstances under which continued recognition of the corporation would sanction fraud or promote injustice." *Inter-Tel Tech., Inc. v. Linn Station Prop., LLC*, 360 S.W.3d 152 (Ky. 2012).

In Indiana law is similar. "The party seeking to pierce the corporate veil bears the burden of proving the corporate form was so ignored, controlled or manipulated that it was merely the instrumentality of another and that the misuse of the corporate form would constitute a fraud or promote injustice." *Massey v. Conseco Services, LLC*, 879 N.E.2d 605 (Ind. Ct. App. 2008).

Then, to determine whether a company has lost its separateness from its ownership, most courts use some form of a multi-factor test that looks at things such as whether the company is undercapitalized, whether the company/owner co-mingled assets, whether the company kept corporate books and records, etc. The problem with these multi-factor tests lies in their uncertainty and varied application. While in the cases discussed above, the owners failed to follow corporate formalities and co-mingled assets but one never really knows how much weight any particular court will assign to any particular factor and/or how many factors are required before the court will find liability.

So how do you protect yourself?

There is nothing certain about litigation except that it is expensive, time consuming, and risky. In our experience, too many business owners do not worry enough about taking preventative action such as adhering to corporate formalities, especially when they believe they have sufficient insurance to cover any liability claim. However, most general liability insurance policies exclude coverage for the company's own breach of contract and damages intentionally caused by the company / faulty workmanship. While your company should also have Directors & Officers (D&O) Insurance policies that can cover the officer's personal liability, such policies are only effective if the officer acted honestly, in good faith, and in the corporation's best interests. D&O insurance also contains various exclusion clauses as well as defined terms that should be reviewed carefully with legal counsel.

While you cannot necessarily prevent a creditor from making a claim against you, here are some things you should do to protect yourself from personal liability.

1. **Never sign your own name to a contract or make any personal promises during negotiations.** If you fail to disclose that you are acting for your company, agency law can make you personally liable without any need to pierce the corporate veil. Take care to hold yourself and your other companies out to the public as separate entities.

2. **Be careful not to co-mingle personal obligations and company obligations**. Do not co-mingle business transactions, property, employees, bank accounts, or corporate records. Of course, you never use company money to pay personal debts but you also cannot use corporate assets as your own. If you have multiple companies with common officers and directors, for example, then you should hold separate and distinct meetings to conduct business for each entity. If you must make a loan to the company, and most of you do at some point, the loan must be well documented and payments should be made in accordance with the loan agreement.

3. **Follow corporate formalities.** Keep your company registrations current with the Secretary of State and follow the procedures set forth in your by laws or code of regulations. Most problems with corporate formalities occur when a small company is controlled by a single member or shareholder. In these situations, it is especially important to document your corporate meetings and maintain proper corporate books and records. In addition, the records and policies of the corporation should indicate that all actions by the company are primarily done for the best interests of the company, and not any individual or other corporation.

4. **Maintain corporate financial records.** Keep all account records, tax records, balance sheets, and profit and loss statements for each year. Any company that fails to maintain its financial records is asking for trouble.

5. **The corporation should be adequately financed** from the point of view of being able to meet its normal obligations that are foreseeable in a business of its size and character. A frequent argument we see is that if the corporation was never funded at start up, there is little legal basis for having a corporation as a separate entity. Just as importantly, do not siphon off too much earnings so that the company cannot act without financial dependency.

6. **Use common sense.** You can legitimately form a company to absorb liability for a risky venture but you should not create a corporation to perpetrate fraud. Likewise, while there are legal ways to hinder creditors, you cannot make fraudulent transfers or concoct a scheme to squirrel away assets into liability-free corporations while heaping liabilities upon an asset-free corporation.

7. **Your company should issue stock if applicable.** The failure to issue stock is the failure to perform one of the basic requirements of a corporation and this defect shows up in many reported legal decisions.

8. **Where any debt arises out of a claim for breach of contract, you can shield yourself from liability,** in the absence of fraud, if your contracts simply state that the other party shall only look to the corporation, and not to the shareholders, managers or members, to perform the contract. This language limits the other parties' remedies and they should not be able to pierce the corporate veil. Frankly, we are not sure why everyone doesn't do this. However, if you start doing this, this article was worth your time.

Mike Chapman *divides his time between civil litigation and regulatory compliance/transactional matters throughout Indiana, Kentucky, and Ohio. Mike strives to provide the highest quality defense that is cost-effective and result-oriented. His over-arching goal of each matter is to collaborate with the client to identify and achieve the best, cost-effective solution for their particular circumstance – even if this means going to trial.*

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