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“Piercing the Corporate Veil” - Best Practices for Avoiding Individual Liability for your Company's Debts

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Many business owners form a corporation or limited liability company to shield themselves from personal liability for their business debts. In fact, most business owners probably agree this was the single-most important reason they incorporated their business in the first place. However, a legal doctrine known as “piercing the corporate veil” allows certain creditors and other injured parties to "pierce" this limited liability veil, obligating business owners, individually, to pay the business’s debts.

When properly formed and maintained, an incorporated business entity (like a corporation or an LLC) will shield you and your family from the company's obligations - this protection is known as the "corporate veil." Frequently overlooked, however, is the fact that this immunity is not absolute and can be challenged. Importantly, your conduct as a business owner, including how you manage corporate operations, can greatly affect whether personal liability can be imposed. Too often, a small business owner forms its business and never looks back - forgetting (or not knowing) that corporate minutes and other corporate details are important to maintain the owner's limited liability.

Although a plaintiff must prove entitlement to pierce the veil of a corporation, the consequences to business owners can be severe. Pennsylvania courts have established several factors to determine when a business's veil should be pierced. Generally, the most important factors are whether the company is undercapitalized, ignored organizational formalities, commingled assets, or perpetrated a fraud. The facts and circumstances of each case are often considered together against these standards - so one or all of the piercing factors could be critical.

Gross Undercapitalization

In evaluating whether the corporate veil should be pierced, a court may consider whether the company had adequate financial resources at the time of its formation or at the time it incurred the debt. Certainly a company can mark-up losses and take on new liabilities in the ordinary course of business without subjecting the owners to liability. However, if the company knowingly incurs a debt that it had no ability or intention to pay - personal liability can attach. Similarly, a company that signs a contract for a job it had no ability to complete could also create personal liability. Generally, you should keep sufficient capital to meet obligations, maintain adequate insurance to cover insurable liabilities and resist the temptation to commit to a project that your company has no ability to accomplish.

Organizational Formalities

All corporations and limited liability companies must not only comply with the state's organizational filing requirements to be created, but should also maintain sufficient corporate documents, like minutes and shareholder agreements throughout the company's duration. For example, every corporation and limited liability company must have certain officers and should memorialize each change in command with written documents. Additionally, the business should keep written records or minutes of monthly or annual meetings where important decisions are made, even if it seems that nothing major happened in the previous year. Each business should also have formal voting requirements written into either a Shareholder Agreement (for corporations) or an Operating Agreement (for limited liability companies). When organizations take actions without using the proper procedure, or fail to keep annual minutes, a court may consider this as additional evidence in favor of piercing the veil.

Intermingling of Assets

Business owners, especially in small, closely-held businesses, need to be careful not to spend freely on personal bills from the business account, even if the owner's salary is paid in such a manner. An owner should be formally paid a salary from the company and, once the salary is paid, personal bills can be paid from the owner's personal account. We often hear business owners attempt to justify such personal spending by stating that since the company is owned by them, they can spend its money. However, paying personal expenses from a business account or using business funds or property for personal use can also provide evidence in support of piercing the corporate veil.

Perpetrate Fraud

The primary purpose of permitting a creditor to pierce the corporate veil is to prevent business owners from using the corporate shield to perpetrate fraud on creditors. Therefore, Pennsylvania courts allow this catchall basis for piercing the corporate veil whenever it can be proven that use of the corporate form was used to perpetrate fraud. Fraud can have a very broad meaning, and, as such, personal liability can be imposed even if there was no evidence to support piercing based on the other factors.

Even though a plaintiff asserting individual liability on a business owner must first prove their case, defending yourself can be costly and stressful. Therefore, avoiding the potential for such allegations is preferred, which requires you to be proactive and knowledgeable about what corporate practices are necessary and beneficial. You should also seek the advice of your attorney regarding what best practices you can implement to avoid personal liability. For more information about corporate law and the construction industry please contact Shumaker Williams, P.C. by visiting our website or by calling Evan C. Pappas, Esquire at 717.763.1121.
