

WHAT ENTREPRENEURSHIP EDUCATORS NEED TO KNOW ABOUT THE LIMITATIONS OF CORPORATE FORMS AND THE “NITTY-GRITTY” OF VEIL PIERCING

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ABSTRACT

While incorporating offers many advantages, including affording some protections from personal liability, many small businesses and entrepreneurs are unaware of their vulnerabilities as plaintiffs may attempt to “pierce the corporate veil” in order to extend their reach to the personal assets of the business owner. Entrepreneurship textbooks are devoid of some of the more complex legal analysis that would lead would-be business founders to a more informed understanding of the limitations of corporate forms. Moreover, textbooks, the scholarly literature of small business and entrepreneurship, and the popular press often omit substantive discussions to fully explain that the corporate shield can only be effective if certain conditions are met. These conditions vary somewhat from state to state, and courts have interpreted cases based on what typically entails an extensive examination of whether or not veil piercing is a justifiable remedy. This paper provides an overview of issues that merit consideration on the topic of the corporate veil and veil piercing, and includes a discussion of implications for entrepreneurship teaching, research, and practice.

INTRODUCTION

The need for this present paper became evident after a series of searches in the scholarly entrepreneurship literature revealed a dearth of research on the subject of the corporate veil and veil piercing. We also reviewed textbooks, and found that they may typically lack sufficient emphasis about some of the vulnerabilities of corporate forms. Indeed, these texts may have contributed to what amounts to a myth in causing entrepreneurs to believe that they are personally separate and invulnerable, so long as they have taken the step to incorporate, as compared to operating as an individual under a sole proprietorship.

The authors of this paper have quoted the term “myth,” because practicing corporate attorneys and the plaintiffs they represent, the courts, and legal scholars are keenly aware of ongoing efforts to devise strategies and methods to pierce the corporate veil; of course, defendants also do become aware of their vulnerabilities (but perhaps too late). Despite such a legal landscape, our review of contemporary entrepreneurship textbooks and the scholarly literature of entrepreneurship undergirding these texts demonstrated a failure to convey that increasingly, there is greater risk for those who may be less familiar with the “nitty-gritty” of corporate forms and veil piercing. Hence, the topic this paper addresses should inspire lively discourse about the implications for entrepreneurship teaching, research, and practice.

“Most savvy business people are aware that corporations offer some protection to officers, directors and shareholders from personal liability. What many people may not know is that the corporate shield from personal liability is not infallible” (Hughes, 2004). Generally, piercing is a remedy to hold individuals accountable for abuses of the corporate form, including hiding behind a corporate entity in order to defraud creditors, investors or other claimants (Bainbridge, 2001; Caudill, 2003; Mirchandani, 1998; Russell, 2004; Wagoner, 1996).

However, veil piercing can become even more tumultuous, and “the risk is much greater than most people realize” (Graham, 2002). The corporate veil will not protect a business when acts or omissions will result in unfairness to the injured party: “The determination of whether the doctrine applies centers on whether there is an element of injustice..., fundamental unfairness, or inequity” (“State ex rel. Christensen v. Nugget Coal Co.” (1944). Unfairness!!! To this we exclaim “holy cow,” as the inclusion of this descriptive term in the court’s finding is very far reaching, as most *any* plaintiff can assert unfairness.

REVIEW OF EXISTING LITERATURE ON “PIERCING THE CORPORATE VEIL” WITHIN THE SCHOLARLY LITERATURE OF ENTREPRENEURSHIP

Vanderbilt University Professor of Law Robert Thompson (Thompson, 1995) is regarded to have provided an “exceptional study” of veil piercing (Morrissey, 2007; Rapp, 2006). “Veil piercing issues can also arise with regard to limited partnerships (‘LPs’) and limited liability partnerships (‘LLPs’). Like LLCs, LPs and LLPs are unincorporated business entities” (Bendremer, 2005). However, the need for this present paper became evident after a series of searches in the scholarly entrepreneurship literature revealed a dearth of research on the subject of the corporate veil and veil piercing. Search attempts conducted on databases used by *ProQuest* demonstrated that veil piercing was only covered within the literature from within scholarly and professional legal and accountancy contexts, typically associated with legal, finance or accounting oriented journals.

With parameters for our searches set to identify only articles with full-text availability and results in the citation and abstract, we identified 155 articles in *ProQuest* databases originating from sources that were not associated with the scholarly entrepreneurship literature. Upon attempting to combine the term “corporate veil” with others such as “corporate veil” AND “entrepreneurship” we found only one result (from an Australian journal published in 1992).

The popular business press produced some results in our *ProQuest* searches (but upon examination, some of these were erroneous and associated with other topics). Finally, we also examined several leading entrepreneurship textbooks and found that forms themselves were typically well covered, but emphasis on possible pitfalls and vulnerabilities was not. We presume that the paucity of results in the entrepreneurship scholarly literature may partially or largely explain the scant coverage of issues and consequences associated with veil piercing in contemporary entrepreneurship texts. Many misconceptions (Mauldin & Wilder, 1997) appear to exist.

Besides the general lack of coverage in entrepreneurship texts and the scholarly entrepreneurship literature which undergirds those texts, veil piercing is an evolutionary (Bendremer, 2005) topic within the legal community. It has also “been one of the most hotly debated concepts in business law” (Rapp, 2006), with “a long, if controversial, history in the law of business” (Morrissey, 2007). However, both the would-be and established entrepreneur may

typically fall under the false impression that the corporate form provides a bullet-proof shield (Graham, 2002) of protection against personal liability claims.

METHODS BY WHICH VEIL PIERCING MAY OCCUR

The applied test for corporate veil-piercing is *Van Dorn Co. v. Future Chemical and Oil Corp.*, 753 F.2d 565 (7th Cir.1985). ("*Van Dorn Co. v. Future Chemical and Oil Co.*" 1985). A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met: "(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." "Corporate veil piercing most often applies in cases of (i) fraud; (ii) inadequate capitalization; (iii) failure to adhere to corporate formalities; and (iv) abuse of the corporate entity that results in complete dominance by the shareholder or shareholders" (Bendremer, 2005).

Smaller firms are more likely to make mistakes or otherwise commit acts that lead to the use of the veil piercing remedy on the part of plaintiffs. In some instances, incorporations may occur in an effort to avoid preexisting personal liability issues. Those in favor of piercing the corporate veil are often (at least from their own point of view) justified in their efforts. They also may be formidable in their wherewithal (e.g., banks attempting to collect) and commitment to doing so. Veil piercing efforts are driven not only by the outcome of a single case, but also by the precedents that may be established, which will influence future litigation.

PREVENTING VEIL PIERCING

"Using a corporate form ordinarily will insulate the owners from direct liability for the company's obligations, because the corporation is considered to be a separate legal identity, independent of its owners"(Peckinpough, 2000). In other words, "although using a corporate form for doing business can provide many advantages, investors who use this approach must be careful to follow the rules to maintain those advantages" (Peckinpough, 2000).

Certain common principles tend to apply to the concept of veil piercing, regardless of venue (i.e., the place where cases are decided). For example, "one of the oldest ways to 'pierce the corporate veil' is to show that a corporation was created for an illegal purpose" (Jackson, 2001). "Tort law in the United States has the same common law foundations as tort law in most other nations" (Rolle, 2003) and fraudulent behavior or negligence associated with illegal acts is certainly suggestive of both litigation as well as what would likely become a successful petition for relief through the veil piercing doctrine.

Hence, one should also "avoid committing any torts. Examples of tort claims are negligence and fraud, in contrast to contracts" (Hughes, 2004). "The right to a law of redress has deep roots in Anglo-American law" (Goldberg, 2005).

"The corporate shield hinges upon the legal fiction that a corporation is a legal entity separate and apart from its owners, officers and directors. To maintain this legal fiction, you must treat the corporation like it is a separate entity" (Hughes, 2004). As a matter of practical implications, small business owners are probably particularly susceptible to mixing personal funds with corporate funds (and both they and their small corporations may easily become intertwined). It is imperative to maintain this separation, because once evidence shows that for

all intents and purposes a small business owner is basically identifiable in transactions as one in the same as his or her corporation, or vice versa, the protection of the shield is lost.

Another common way to create problems for a business is to fail to acknowledge the corporate status both in terms of disclosure, but also with respect to other formalities such as entering contracts. Formalities also include “‘corporate governance’ rules [which] cover things such as board of directors meetings, capitalization requirements and reporting requirements” (Peckinpaugh, 2000). Relative to subsidiary structures, “conducting a similar business in a similar location or having interlocking sets of officers, directors, and ownership can create problems” (Hughes, 2004).

CONCLUSION AND IMPLICATIONS FOR ENTREPRENEURSHIP TEACHING, RESEARCH, AND PRACTICE

The authors of this paper have sought to add an important and needed contribution to the evolving discipline of entrepreneurship. Changes in the environment foreshadow the likelihood of an even greater risk that future entrepreneurs (presently students) may encounter an even more complex morass of legal implications associated with their choice(s) of corporate form.

Entrepreneurship educators who may be laypersons in the area of law (as compared to practicing attorneys and legal scholars) may unwittingly contribute to creating a false sense of security about protections afforded under corporate forms in the course of providing instruction. This of course suggests content that is not only presently inadequate, but will be increasingly so in the future.

For the scholarly researcher in small business and entrepreneurship disciplines, as we have found, this paper will represent one of the first contributions of its kind to the literature. This suggests several opportunities for future research. First, is the obvious task of making further connections with the preexisting body of knowledge associated with well established legal scholars and their research. Second, we would suppose that small businesses and entrepreneurial firms may suffer from unique challenges in lacking sufficient access to corporate counsel, being more susceptible to mistakes and subsequent litigation, and more likely to forego formalities that are precisely those that will get them into real trouble. We expect this, but further research and empirical testing would aid in both defining the situation as it now exists (and subsequently addressing matters with practitioners and students who are would-be entrepreneurs).

Finally, as we have indicated, veil piercing is an evolving area and dynamic. Keeping up with changes and then correlating those changes with the concurrently evolving discipline of entrepreneurship is also a recommended course of action for any student, entrepreneurship educator, researcher, or practitioner.

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