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An Ounce of Prevention - The Importance of Periodic Corporate Audits

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Most, if not all, long term care providers operate their business in an entity form, such as a corporation or limited liability company. Many use multiple entities – for example, one entity to own the real estate (or a separate entity to own each parcel of real estate) and another to operate the business.

Although the type of entity (or entities) used in your business was likely selected based on an evaluation of the benefits and drawbacks of each type of entity (including tax considerations and management structure), one of the principal benefits of both a corporation and a limited liability company (LLC) is limited liability, which is often referred to as the “corporate veil” or “corporate shield.” The corporate veil refers to the concept that the owners of the corporation or LLC are generally not liable for the debts and obligations of the entity. Rather, the “corporate veil” protects the owners from that personal liability and places responsibility for the entity’s debts and obligations on the entity.

As we all know, for every rule, there are exceptions, and that holds true with respect to the corporate shield. Some of these exceptions are created by statutes and others by case law. For example, under federal statutes, employees who are responsible for the entity’s payroll or financial affairs may be personally liable (and also subject to penalties) for willfully failing to collect and remit required federal withholding or employment taxes. Similarly, under certain federal environmental laws, corporate officers who have authority and control over the disposal of hazardous wastes can be held personally liable for the corporation's failure to comply with certain environmental laws.

In the category of case law type exceptions, generally an individual will always be liable for his own wrongdoing. For example, if I get frustrated at work and punch my partner in the nose, the corporate shield will not protect me from liability to my partner! We all understand (and can't legitimately complain about) those types of exceptions to the corporate shield. But there is also a broader set of case law that creates additional exceptions that allow plaintiffs to "pierce the corporate veil." Under this concept, a judge may decide that the facts of a particular case warrant piercing the corporate veil and, thereby, holding the owners of the entity personally liable for the matter being litigated. Generally, the courts examine a laundry list of factors, including, most importantly whether the facts suggest that a refusal to pierce the corporate veil would result in fraud or similar injustice.

Generally, to succeed in a veil piercing case, the plaintiffs would have to prove, among other items, that the owners of the entity so dominated its finances, policy and business that the entity had no separate mind, will or existence of its own. In determining whether that level of control exists, a court looks to several factors (none of which are typically decisive in and of themselves). These factors include (i) inadequate capitalization of the entity, (ii) noncompliance with corporate formalities, (iii) excessive fragmentation of a single enterprise into multiple entities, (iv) absence of company records, and (v) siphoning of funds from the company by the dominant owner.

Although the case law rules for veil piercing vary somewhat from state to state, the good news is that courts are typically very reluctant to pierce the corporate veil. The perhaps better news is that there are steps you can take to make it less likely that the veil of your entity will be pierced. So what can you do to lessen the risk of a successful veil piercing claim? For one, be sure your entity complies with appropriate corporate formalities and maintains appropriate corporate records. For example, if your entity is a corporation, each year the corporation should hold a shareholders' meeting to elect its Board of Directors and the directors should appoint the officers. All major corporate actions should be approved by the Board of Directors and records of those approvals should be maintained. If money is distributed to the owners or there are multiple entities and money flows between the entities, all of this should be approved in writing by the directors and properly documented. Generally, these types of records are kept in the entity's minute book. If the last entry in your minute book dates from 1982, your entity is not keeping proper records!

As a service to our clients, we often conduct legal reviews of a client's corporate/LLC records, including, as applicable, minute books, shareholders' or operating agreements, articles of incorporation/articles of organization, bylaws, annual reports, stock transfer ledgers, foreign qualifications, good standing certificates, tax clearance certificates, etc., to ensure the records are up to date, reflect the current operations of the company, comply with current law, and generally reflect compliance with the governing documents and formalities applicable to the company. To the extent we find deficiencies, we propose a course of action and help our clients implement corrections. This is an easy and inexpensive way for you to eliminate one of the factors associated with piercing the corporate veil and help protect owners from personal liability.

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