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EROSION OF CORPORATE LIABILITY PROTECTIONS

June 23, 2009

One of the principle advantages to incorporating[1] your business is liability protection. The purpose of this article is to make business owners aware of certain limitations to that protection. Specifically, the focus here is on business law in Florida, though the concepts apply to businesses in all U.S. states and territories.

In the aftermath of recent scandals (*e.g.* Enron, Anderson Consulting, Madoff), the law has shifted somewhat in the direction of weakening corporate liability protection by making it easier to "pierce the corporate veil." Thisconcept, also known as "disregarding the corporate fiction," refers to the situation where the court allows a plaintiff to reach the personal assets of the company owner(s) rather than limiting the plaintiff to recourse against the company assets. Under the same principle, it may also be possible for plaintiffs to reach the assets of other companies belonging to the defendant owner.

Florida courts require a showing of three factors in order to pierce the corporate veil: [1]

1) The corporation was dominated and controlled by its shareholder(s) in such as way that it was merely an "alter ego" used for the shareholders' benefit,[2]

2) Some sort of improper conduct in either the formation or the use of the corporate form,[3] and

3) The improper conduct imposed an injury on the claimant.

Most courts tend to focus the analysis on the second element: "A critical issue in determination of whether the corporate veil will be pierced for imposition of personal liability is whether corporate entity was organized or operated for an improper or fraudulent purpose."[4]

The central issue then becomes identification ofthe degree and types of misconduct that results in personal exposure. In that regard, misconduct may be found where the corporate identity is used __

1) to defraud creditors,

2) to evade existing obligations,[5]

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1 The same protection entails under certain other business forms as well, (i.e. limited liability company).

[1] 8 Fla. Jur 2d Business Relationships §13 (2006); *Mullin v. Dzikowski,* 257 BR 356 (SD Fla. 2000); *Dania Jai-Alai Palace, Inc. v. Sykes,* 450 So. 2d 1114 (Fla. 1984); *Seminole Boatyard, inc. v. Christoph,* 715 So. 2d 987 (1998).

[2] For example, where the owner commingles his money with the corporation's money, or the owner uses corporate property for private purposes. Basically, any evidence that the owner does not respect the corporation as a separate entity could be used to meet the "alter ego" element.

[3] *Dania Jai-Alai Palace,* 450 So. 2d 1114; *Hilton Oil Transp. v. Oil Transp. Co., S.A.,* 659 So. 2d 1141, 1151 (Fla. 3d DCA 1995); *Ally v. Naim,* 581 So. 2d 961, 962 (Fla. 3d DCA 1991).

[4] *Kanov v. Bitz,* 660 So. 2d 1165 (3d DCA 1995)

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3) to achieve a perpetual monopoly, or

4) to protect knavery or crime[6]

5) where the owner commits an illegal act as an individual rather than by formal corporate action,[7] *or*

6) where property is used interchangeably without regard to corporate identity.[8]

While this standard provides some guidance, it remains purposefully broad. In other words, the language is ambiguous enough that courts have wide discretion in determining whether or not to pierce the corporate veil. Notwithstanding, owners can take certain precautions to minimize their exposure.

One overarching concern legislators and judges have is that business owners may attempt to use the corporate protection to avoid paying creditors. Many banks, merchants and service providers take their own measures to mitigate this risk, such as requiring owners to provide a personal guarantee for payment. Where the creditor is less sophisticated, however, the court may more readily assume the role of protector and allow recourse against the owner personally. So, owners can limit the risk of personal liability by making good-faith attempts to pay the company's creditors. This is not to say that owners must necessarily pay company bills from their own pockets in order to avoid having a judge pierce the corporate veil. Rather, the emphasis is on "good faith." If there is no misconduct, then the company's inability to pay its creditor's should not obviate the corporate protection.

Second, owners will be exposed where there is criminal conduct. In today's climate of corporate scandals, courts are alert to attempts by owners and officers to fill their personal pockets through unscrupulous means while allowing the company to bear the repercussions. There is a lot of pressure on courts and politicians to punish such activity, and piercing the corporate veil the vehicle for doing so.

The final guideline is less obvious. Many small business owners are less careful about separating their personal assets and liabilities from those of their company(s) than perhaps they should be. For example, it is fairly common for owners to pay personal expenses with the company credit card, utilize personal equipment for company business and vice-versa, especially when there is just one owner or the owners are a couple. While common, however, this kind of disregard for the corporate entity is potentially dangerous and can lead to exposure. The rationale here is that the owner who commingles resources really uses the company as an alter-ego, so the company is in substance a sole proprietorship—which does not afford corporate protection—rather than an autonomous entity capable of assuming its own liabilities. In this

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[5] Undercapitalization of the business and/or failing to maintain liability insurance to cover damages resulting from the company's negligence or intentional wrongdoing are traditionally looked at to determine these first two elements.
[6] Examples come from Wormser's "Disregard of the Corporate Fiction," which the Court quotes approvingly.
[7] 459 So. 2d at 1119.
[8] 459 So. 2d at 1118.

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scenario, there is a danger of undercapitalization whereby the company might be unable to pay its liabilities because the owner improperly spends company funds for personal use. That would be unfair to the plaintiff whose cause of action is technically against the company and not the owner personally. This is one concern. However, perhaps an even more compelling reason for this criterion is that the alter-ego scenario is just too messy. If the court cannot determine where the company's assets/liabilities end and the owner's begin, it is much more likely to claim substance over form and simply hold both accountable.

In conclusion, while the principles outlined herein have universal application, there are differences from state to state. Specifically, some states, such as Florida and Delaware, are conservative with respect to traditional protections and remain reluctant to pierce the corporate veil. By contrast, more liberal states—notably, California and Massachusetts, put greater emphasis on equity and readily set aside corporate protections where there is evidence that the company is formed or used for some illegal, fraudulent, or unjust purpose[9] and/or the company is merely the alter-ego of its owner(s).

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[9] 8 Fla. Jur 2d Business Relationships §13 (2006); *Dania Jai-Alai Palace,* 450 So. 2d 1114.