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PIERCING THE CORPORATE VEIL

One of the biggest advantages to forming a legal entity is that it separates personal liabilities and assets from business liabilities and assets. However, corporate protection can be lost in certain instances. This is something that happens all the time to small companies, so please pay careful attention to the following paragraphs.

The term for ignoring an entity and going straight after the assets of the individual owners is called "piercing the corporate veil." This ordinarily happens in civil litigation, where the entity is believed to have inadequate assets to cover its liabilities, and the plaintiff alleges that the entity is actually a sham—that is, the entity is not really a distinct individual, but is merely an extension or "alter ego" of its owners, being used to advance their private interests or to perpetrate a fraud.

The precise circumstances which can result in a piercing of the corporate veil will vary depending upon current state law, and the particular facts in the case. Generally, when evaluating if a corporation is in fact legitimate, or if the corporate veil should be pierced, courts look at the following factors:

1. Commingling Funds
Did the business mix the personal funds of the business with the funds of one or more of its owners? Were separate bank accounts maintained, etc.?

2. Corporate Formalities
Did the business follow proper procedure, for example i) were bylaws drafted (or an operating agreement drafted for an LLC), ii) were officers and directors properly elected, iii) were shares issued, iv) were annual meetings of the shareholders and directors held, iv) did the company file its annual reports with the secretary of state, v) were adequate corporate records maintained, etc.?

3. Fraud
A court may also pierce the corporate veil to prevent a fraud, where the corporation is found to be a "sham" meant to facilitate fraud against others. If the corporation was set up, for example, to shield its owners from liability over a fraudulent real estate deal, and the owners siphon out the corporate assets such that the corporation is unable to compensate the victims of the fraud, a court is likely to set aside the corporation and allow the victims to recover from the personal assets of the owners. Remember, only filing your articles of incorporation with the Secretary of State will not protect you.

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