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ALERTS

Behind the Veil and the Blurred Distinctions of Entity Liability

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Charleston Bankruptcy Member Robert Kerr, Litigation Member Chris Ogiba and Corporate Associate Trey Robinson were published in the Association of Corporate Counsel South Carolina Chapter's Summer 2014 newsletter. Their article, "Behind the Veil and the Blurred Distinctions of Entity Liability," discusses lesser-known theories in South Carolina jurisprudence that could negate standard liability protections if certain measures are not taken when forming or acting through corporate entities. The article can be seen in its entirety below.

Behind the Veil and the Blurred Distinctions of Entity Liability

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As corporate counsel, you are well aware that the practice of creating, expanding, or reorganizing corporate entities and their subsidiaries is fraught with legal peril, both for your client and its officers and directors. However, this practice is necessary for a multitude of business reasons, including expanding your organization, creating special purpose entities for financing, mergers and acquisitions, or restructuring for taxation purposes. These new entities may take the form of limited liability companies or corporations. One of the main benefits you will appreciate when creating such an entity is the liability shield afforded to your client and its officers and directors. In most modern corporate structures, the parent company operates, in whole or in part, through its subsidiaries or holds assets in separate entities. You may consider the parent company and its directors safe from liability for actions and activities engaged in by these subsidiaries and separate entities. While most attorneys are aware that an entity's veil may be pierced, there are lesser-known theories that have developed in South Carolina jurisprudence that may also negate standard liability protections if certain measures are not taken when forming or acting through corporate entities. Ignoring these potential pitfalls can lead to devastating results for not only the individual directors or members of an entity but also for other entities within a business's corporate structure.

Traditional Veil Piercing

As mentioned above, one of the primary benefits of setting up a corporation or LLC is the protection that it provides investors and/or the owners of the entity from personal liability for the debts and liabilities of the entity. However, a South Carolina court may "pierce the corporate veil," thus removing the liability shield and

subjecting the shareholders of a corporation or the members of a LLC[ii], as the case may be, to personal liability for the entity's obligations.

The seminal South Carolina veil piercing case is Sturkie v. Sifly.[iii] The court set forth a two-prong test to determine whether it is appropriate to pierce the corporate veil. The first prong of the test is "an eight factor analysis, [which] looks to observance of the corporate formalities by the dominant shareholders."[iv] No single factor is sufficient to satisfy the test and a plaintiff does not need to prove all of the factors, but case law seems to give more importance to the undercapitalization of the entity and the commingling of funds.[v] The second prong of the Sturkie test is whether the evidence shows that the party seeking the pierce the veil will "suffer injustice or fundamental unfairness" if the corporate identity is allowed to stand.[vi]South Carolina courts will not pierce the corporate veil without "substantial reflection."[vii] However, post-Sturkie case law provides additional criterion that may lead to veil piercing.

The Alter-Ego Theory

The alter-ego theory is a procedural weapon that, if applicable, will result in the piercing of the corporate veil.[viii] The alter-ego theory, also called the instrumentality theory, is implicated where one entity acts through another without maintaining proper separation. Under this theory, a parent entity can be held accountable for the acts or liabilities of its subsidiary entity. In Colleton County Taxpayers Association v. School District[ix], the court held that the "alter-ego theory requires a showing of total domination and control of one entity by another and inequitable consequences caused thereby."[x] The South Carolina Supreme Court went on to state that "control may be shown where the subservient entity manifests no separate interest of its own and functions solely to achieve the goals of the dominant entity."[xi] The court does narrow the analysis by adding that there must be inequity or misuse of control which results in injustice, fraud or a contravention of public policy for the alter-ego theory to apply.[xii] In its dismissal of the plaintiffs' claim, the court pointed out that the corporation, alleged to be an instrument of the school district, appointed its own directors, approved its own by-laws and oversaw its own operations. As is clear from the analysis in Colleton County, South Carolina courts will consider the factors from Sturkie in determining whether a parent entity is exercising total domination and control over a subservient entity.[xiii]

Increased Potential for Veil Piercing in Insolvency Situations

The inequity prong of the veil piercing test is more difficult to satisfy than the eight-factor test prong. When a corporation is insolvent, certain acts by a corporation's director(s) may satisfy the latter prong, even though those same acts would not satisfy the Sturkie test if the corporation were solvent.[xiv] Generally, the directors of a corporation have a duty to act in the best interests of the corporation and the shareholders of the corporation.[xv] This responsibility is commonly referred to in terms of a director's duty of care and duty of loyalty.[xvi] However, "when the corporation becomes insolvent, the fiduciary duty of the director shifts from the stockholders to the creditors."[xvii] In Federal Deposit Insurance Corporation v. Sea Pines Company, the Fourth Circuit Court of Appeals "set aside the corporate cloak" of a subsidiary and held the parent entity liable because the directors of the insolvent subsidiary acted in the best interest of its parent and to the detriment of subsidiary's creditors.[xviii] As a result of the subsidiary's "unjust and fundamentally unfair" actions and "interlocking directorships and undercapitalization," the court treated the subsidiary as an

extension of the parent corporation rather than as a separate legal entity.[xix]

Strengthening the Veil

The case law cited above provides insight as to measures corporate counsel can take in setting up new corporate entities to prevent veil piercing. First and foremost, any new entity should be properly capitalized with sufficient funds to engage in whatever business purpose it will serve; the mere filing of paperwork with the South Carolina Secretary of State is not enough to properly form and maintain a corporate entity. For a corporation, director(s) should be elected and officer(s) appointed. If possible, an entity should have more than one officer and director, and the officers and directors should be actively involved in the operation of the entity. Separateness should also be maintained among parent and subsidiary entities, such as special purpose vehicles, to avoid an alter-ego claim. This can be accomplished by avoiding overlapping directors or officers, maintaining separate bank accounts, and ensuring that each entity has its own governing documents. While a subsidiary will always be controlled to some degree by the principals of the parent company, it is important that the control not reach the point where there is no semblance of the existence of a separate entity.

Corporate entities must adhere to statutory mandates related to record keeping and meetings. When forming a small corporation, special consideration should be given to the statutory close corporation option, which is immune from veil piercing claims for failing to follow corporate formalities.[xx] More important than corporate formalities under the case law is maintaining separation between the assets and activities of the corporate entity and those of its shareholders or members and properly capitalizing new entities, as South Carolina courts are chiefly concerned with ensuring that a corporate entity is not simply a legal shell used to inequitably protect its owners. However, veil piercing will not be applied unless injustice, fraud, or contravention of public policy has resulted. As long as the entity is used for common business purposes, a plaintiff will have difficulty asserting the alter-ego theory because it will be difficult to satisfy the second prong of the test.[xxi]

However, as is shown in Sea Pines, director actions may be found to contravene public policy.[xxii] Directors of a corporation in insolvency or in a failing condition must meet their fiduciary duties and must understand that those duties flow to the corporation's creditors. Furthermore, a director's breach of his or her fiduciary duties may result in that director being held personally liable for the breach.[xxiii] Safeguards that can be implemented to minimize this risk include: holding extensive director meetings with active discussions on corporate actions that are well documented and relying on experts (e.g. lawyers and accountants) in making corporate decisions, especially when those decisions implicate financing and restructuring.[xxiv] However, these safeguards will be of no use in a clear-cut situation such as Sea Pines where the directors violated their fiduciary duties for the benefit of the corporation's parent at the expense of the corporation's creditors.

Amalgamation

While the veil piercing theories discussed above result in vertical liability (i.e. the owners of an entity are held liable for the actions, debts and liabilities of the entity itself), the amalgamation theory found in South Carolina case law results in horizontal liability (i.e. related entities (sister companies) are held liable for the actions, debts and liabilities of each other).

Amalgamation will exist when there is "an amalgamation of corporate interests, entities and activities so as to blur the legal distinction between the corporations and their activities."[xxv] In Kincaid, using the amalgamation theory, the court upheld a ruling against a property management company for a breach of warranty claim even though it asserted that it was solely the marketing and sales company for the development company.[xxvi] The key factors considered in Kincaid included: (1) the corporations shared officers and shareholders, (2) the corporations shared an office, (3) the description of the corporation on its letterhead was inconsistent with its assertions, and (4) the property management company undertook functions inconsistent with its claimed purpose.[xxvii] In Magnolia North Property Owners' Association v. Heritage Communities, Inc.,[xxviii] the court relied on similar indicia of amalgamation, and also the fact that the corporations shared office space and a phone number and distributed a warranty manual with a title containing the name of the developer corporation.[xxix]

While amalgamation will not result in liability by individual owners of an entity, it can result in unintended corporate liability. Several precautions that corporate counsel should take when setting up affiliates include: having different officers and directors, maintaining separate phone numbers and letterhead, and avoiding operation of the related entities out of a central location. In our rapidly evolving technological world, it is prudent to maintain separateness in entities' online and electronic personas.[xxx]

A less obvious and arguably more important common factor in amalgamation case law is a corporate entity taking action or making representations inconsistent with its asserted purpose and function. While South Carolina courts do not explicitly refer to an inequitable result as being a requirement for amalgamation, courts appear to apply an analysis similar to estoppel, based on the principle that a company should not be able to avoid liability merely because it calls itself a distinct entity with a particular function when it has acted outside of the scope of that function. In organizing and supervising affiliated entities, you should ensure they stay within the bounds of their intended purposes. Where interaction with third parties is necessary, management and employees should make clear the identity of the entity on whose behalf they are acting, especially if the same individual is an officer or principal of multiple related entities. Failure to maintain adequate separateness could result in crippling liability, especially where the assets of the primary entity are significantly greater than those of the related entity that was intended to be a liability buffer.

Veil piercing and amalgamation can result in unanticipated exposure for not only multiple entities within your organization but for individuals as well. For large corporations, the likelihood of a shareholder being held personally liable is minute, but counsel should still consider the risks of veil piercing and amalgamation, as most modern corporate structures involve a multitude of entities that are intended to provide liability protection from the different operations, businesses and/or functions within the organization. Additionally, under certain circumstances, such as insolvency, there is an increased risk of unintended liability. While the South Carolina Corporate Code sets forth the basic procedural requirements needed to form a corporate entity, the theories discussed above stress substance over form. The case law related to these theories set forth additional requirements that must be followed in order for an entity to enjoy the liability protections provided by South Carolina law.