

The Legal Strategist

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This quarter's Feature Topic explores situations in which your personal assets may be in jeopardy due to your business liability. One of the primary reasons you formed a legal entity was to protect your personal assets behind a "corporate veil." However, the corporate veil is not absolute. In certain situations, the corporate veil can be pierced.

Although courts will generally not hold a business owner, shareholder, officer or director liable for actions that are legally the responsibility of the entity, even if the entity has a single shareholder, it will do so if the entity has not followed well established practices or the owner, shareholder, officer or director's actions were clearly designed to attempt to pass personal liability off to the entity.

The Feature Topic is a cursory review. If you would like more information on this, or any other topic previously covered in our newsletter (which can be viewed on [The Legal Strategist](#) tab of our web site), please contact our office to set up a consultation.

Scott Barrett

TEXAS ESOTERIC FACTS

- ◆ 70% of the population of Texas lives within 200 miles of Austin.
- ◆ Texas' most populous county and third most populous in the United States is Harris county in southeast Texas with 3.4 million residents. The least populated county in Texas and the United States is Loving county with only 67 residents.
- ◆ Texas includes 267,339 square miles, or 7.4% of the nation's total area

FEATURE TOPIC:

PIERCING THE CORPORATE VEIL



A properly formed and operated corporation, limited partnership or limited liability company (these three are the most common entities in Texas) offers its owners limited liability for the debts of the business, so that their losses are limited to their investment in the business. This separation of personal liability from entity liability is deemed the "corporate veil." In some cases, however, courts hold the owners liable for the debts of the entity, including for judgments resulting from lawsuits. This is called "piercing the corporate veil."

To prevent the piercing the of the corporate veil, you must do more than merely form a business entity and register it with the state. There are a host of ongoing governance requirements and formalities for business owners. If challenged in a lawsuit, IRS audit, or other action, you must be able to prove that you have a bona fide business entity.

Courts normally pierce the corporate veil in situations where one owner or a small group of owners dominate the management and operation of the entity. Without more, the combination of ownership and management is not a problem, as some entities are, by design, designated to be managed in such a manner. Business owners, officers, directors and controlling shareholders have a general fiduciary duty of loyalty and care which should govern all their conduct in regards to their respective entity. Unless they breach that duty by gross negligence or acts in bad faith, they usually will have no personal liability to third parties.

The Texas Supreme Court actually listed six basis (plus one in dicta) to disregard the corporate fiction in one of the more notable veil piercing cases, *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986). In *Castleberry*, the Court listed seven determining factors:

- (1) when the fiction is used as a means of perpetrating fraud (i.e. as a sham to perpetrate a fraud);
- (2) when a corporation is organized and operated as a mere tool or conduit of another (i.e., alter ego);
- (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;
- (4) where the corporate fiction is used to achieve or perpetrate monopoly;
- (5) where the corporate fiction is used to circumvent a statute;
- (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong; and
- (7) where the entity has inadequate capitalization.

Of these, the alter ego and sham to perpetrate a fraud theories appear to be the most commonly asserted veil piercing hypothesis in Texas. The alter ego situation is especially troublesome for small businesses who disregard the statutorily mandated governance rules, co-mingle funds and operate the business as "themselves" and not a legal entity.

Increased awareness of the personal liability concept in the entity context may deter the business owners from committing inappropriate actions and thus can benefit an entity, and its officers, shareholders, members, partners and employees alike. The obvious lesson for the business owners is to adequately capitalize the entity at inception, maintain governance formalities, fully disclose the entities principal's identity in conjunction with all business transactions, and recognize that the "corporate veil" will not insulate the business owners from liability for everything they do.

If you would like more information on how to protect your personal assets from the obligations of your business, please contact [Scott Barrett](#) to set up a consultation.