Chapter 3
Piercing the Corporate Shield

The reason most business owners choose to incorporate or set up a Limited Liability Company (LLC) to run their company is to create a legal barrier between them personally and their business. Some are also drawn to the tax advantages such as taking a part of the profit as a salary and part as a corporate distribution. Having security in knowing you won't be held liable personally for business debts and having tax advantages too sounds pretty good to most.

However, in certain circumstances a Court will hold that the owner of a corporation or an LLC is liable for the business debts and for lawsuits against the entity. This is called "piercing the corporate veil."

Generally, corporations and LLCs afford their owners a limited personal liability shield for the company's debts – unlike partnerships and sole proprietorships. This means you will not be responsible for the debts of the business; but sometimes the courts ignore this limited liability status. Closely held corporations and LLCs are more at risk than larger companies.

So what happens if the Court pierce's the company's corporate shield or "veil?" The creditors can move to liquidate the owner's home, bank accounts, investments, and other assets to satisfy the judgment. But a Court is only going to pierce where there are wrongful or fraudulent actions by the owners or where the owner didn't "respect the entity."

What does it mean to "respect the entity?" Well rather it might be easier to explain what disrespecting the entity means. An owner is disrespecting the corporate or LLC entity when there is no real separation between the company and its owners. A formal separation between the business owner and the finances of the company is a common form of this. If the Court finds that the business owner is commingling personal and business funds, they could rule that the business entity simply doesn't exist for purposes of the liability shield.

To provide an example, consider Tom who runs an IT company. Tom incorporated and is the sole owner of an S-Corporation. Tom sometimes paid personal bills from his corporate checking account. Last fall, Tom was served with a legal complaint from a customer who claimed they lost all their company data on their hard drive after Tom had repaired their Company server. The plaintiff asked the Court to award them $50,000 in damages. Because Tom was commingling his personal and business finances, the Court found he disrespected his corporation and the Court pierced the Corporate Shield. Tom's personal assets became subject to the $50,000 judgment against Tom's company.

Another way a Court could pierce the Corporate Shield is when a business owner fails to record important corporate decisions in annual meeting minutes (Board of Directors Annual Meeting Minutes and Shareholders Annual Meeting Minutes).

A Court could also pierce if it found the Company's actions were wrongful or fraudulent. Examples of this are engaging in business deals with the knowledge that the Company could not pay, or recklessly borrowing and losing money.

Next, let's examine the factors that the Court looks at when deciding whether to pierce the corporate veil:

1. Did the company engage in any fraudulent activities?
2. Were there only a small number of closely rated people or one person in control of the company?
3. Did the company owners fail to follow a corporate formality?
4. Did the owners of the company commingle personal and business finances or assets?
5. Was the company inadequately capitalized?

Because of the above factors, smaller corporations and LLCs are at greater risk of piercing than larger or publicly traded companies. So, what can you do to reduce or eliminate the risk of a future piercing of your corporation or LLC?

1. Adopt Company Bylaws or an LLC Operating Agreement and abide by those agreements.
2. Issue stock certificates or LLC membership certificates.
3. Keep your personal purchases separate from your company and don't use corporate accounts to pay personal expenses.
4. Keep accurate and detailed records of major decisions each year that you'll report in your corporate annual meeting minutes.
5. Timely pay your annual State Franchise Tax Board fee.
6. Keep your taxes for the business current and up to date.
7. File your annual Statement of Information with the Secretary of State.
8. Make prudent investments and purchases that are "viable" for the business.
9. If it's a professional corporation or LLC, make sure you conform with the requirements of your Professional Board.

In the end, following these simple rules will help shortcut an action in Court later on down the road when Plaintiff's counsel tries to pierce your company's corporate veil and reach your personal assets.

About the Author

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Mrs. Geiger's practice is located in Carlsbad, California. Her firm focuses on Business Planning, Asset Protection, Estate Planning, Trust Administration, and Elder Law. She obtained her law degree from the University of San Diego School of Law where she served as an Editor on the board of the San Diego International Law Journal.

She is also involved in a variety of professional and community organizations. She serves as an editor for the North County San Diego Bar Association Magazine (The North County Lawyer). She is also an active member of the North County Estate Planning Council, WealthCounsel, LLC and ElderCounsel, LLC. Mrs. Geiger is a frequent speaker for many local organizations and the North County San Diego Bar Association.

Additionally, she is the author of an estate planning book and an elder law planning book. The book on estate planning is titled "Safeguarding the Nest, Third Edition" (2013) and her book on elder law planning is titled “How to Avoid the Catastrophic Costs and Effects of Long Term Care: A California Elder Law Guide” (2013). She also authored the law journal article “Authorization to Kill Terrorist Leaders and Those Who Harbor Them: An International Analysis of Defensive Assassination, San Diego International Law Journal, 4 San Diego Int'l L.J. 491, Spring 2003”, and has published several articles.

Mrs. Geiger is admitted to practice before the United States Federal Court for the Ninth District and California State Courts and is an accredited V.A. Planning Attorney. On a more personal note, Brenda is married to Len, the CEO of a San Diego based company and has two young children. She loves running, travel and spending time with her family.

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