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LESSONS FOR ENTREPRENEURS (AND THEIR ATTORNEYS)**

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Volume 2

2003

Number 1

The Minnesota Journal of Business Law and Entrepreneurship is published twice a year at the University of Minnesota Law School. Publication is online only in Internet format at <http://www.kommerstad.org/journal>. Hardcopy reprints are available for authors. Submission requirements are available at the Web site.

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THE LIMITATIONS OF LIMITED LIABILITY: LESSONS FOR ENTREPRENEURS (AND THEIR ATTORNEYS)

JOHN H. MATHESON *

An entrepreneur does not start a new business expecting it to fail. Yet, according to various statistics, most independent start-up businesses fail within the first year, while as many as 90% are no longer in business after three years. This is why the issue of personal liability for the owners of the business is critical.

Historically, the entrepreneur could protect personal assets by forming and operating the business as a corporation, recognized by state law as a legal entity separate from the owner of the business for purposes of imposing liability. Although operating a business as a corporation presumptively shields the personal assets of the owners from the claims of the business's creditors, a creditor may ask a court to ignore this liability shield when the corporation is unable to pay its debts and goes bankrupt. Disregarding or "piercing" the statutory limited-liability shield permits the business debts to be satisfied out of the owner's personal assets. Absent a judicial decision to "pierce the corporate veil" in this manner, the limited liability created by the applicable corporate statute stays intact and the creditor must shoulder the loss.

It is crucial that entrepreneurs and the attorneys advising them do everything possible to avoid potential "piercing." However, there are no clear guidelines for this task. Writing in a piercing case in 1926, one of the great judges of the common law, Benjamin Cardozo, wrote that "[t]he whole problem of the relation between [owners and their] corporations is one that is still enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."¹ Metaphors provide little guidance to entrepreneurs and their attorneys about what will result in a loss of limited liability.

Sixty years later Robert Clark, renowned corporate scholar and Harvard Law School Dean, commented: "Do you notice anything intellectually disturbing about this [standard piercing-the-veil] formulation? That's right; IT'S vague. It hardly gives you any concrete idea about which conduct does or does not trigger the doctrine--not enough of an idea, at least, to give you the ability to counsel clients in a meaningful way."²

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¹ Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

² Robert Charles Clark, Corporate Law 38 (1986).

Now that presumptive limited liability for business owners has become the norm through the proliferation of new forms of limited liability entities (LLEs) such as the limited liability partnership and the limited liability company, the stakes are more significant than ever. New forms of business organizations as well as corporations must address the issue of when limited liability might be lost.

The start-up business owner and the attorney counselor must prepare for the possibility that the business may fail. Creditors of the business may ask the court to ignore the separate legal existence of the LLEs and impose personal liability on the owner. It appears that the courts will follow the same general procedure for piercing the veil of the more modern LLEs based on the standards that have been historically applied to pierce the corporate veil of the corporation.³ The purpose of this article is to describe these standards and to distill some basic, practical lessons that entrepreneurs and their attorneys can follow to lessen the disastrous potentiality of piercing.

American law governing corporate limited liability has had a contentious history. In the 1800s, Thomas Cooper described limited liability as a "mode of swindling, quite common and honourable in these United States" and "a fraud on the honest and confiding part of the public."⁴ Early in the twentieth century, President Butler of Columbia University acclaimed limited liability as "the greatest single discovery of modern times" and that "even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it."⁵

Until the early to mid-1800s, legislation in both England and the United States imposed strict limits on an owner's ability to incorporate and to receive the benefits of limited liability. Incorporation required a special act of Parliament or a state legislature. State legislatures enacting general corporation statutes usually imposed substantial limitations on corporations, including minimum paid-in capital requirements, limited permissible purposes, and limited duration. As corporations began to dominate the economic

³ Colorado, Minnesota, and Texas Limited Liability Company statutes expressly allow "piercing" law developed for corporations to be applied to new LLE forms. Colo. Rev. Stat. Ann. § 7-80-107(1); Minn. Stat. Ann. § 322B.303 subd. 2; Tex. Rev. Civ. Stat. Ann. art. 1528n. For examples of cases applying corporate piercing tests to new forms of limited liability entities, see *Gallinger v. North Star Hosp. Mut. Assurance, Ltd.*, 64 F.3d 422, 427-28 (8th Cir. 1995); *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486, 491 (Colo. Ct. App. 1997); *Hollowell v. Orleans Reg'l Hosp.*, No. Civ. A. 95-4029, 1998 WL 283298 (E.D. La. May 29, 1998); *Abu-Nassar v. Elders Futures, Inc.*, No. 88 Civ. 7906 (PKL), 1991 WL 45062, at *10-14 (S.D.N.Y. Mar. 28, 1991).

⁴ Herbert Hovenkamp, *Enterprise and American Law 1836-1937*, at 50 (1991) (quoting Thomas Cooper, *Lectures on the Elements of Political Economy* 247, 250 (2d ed. 1830)) (footnote omitted).

⁵ Stephen B. Presser, *Piercing the Corporate Veil* §1.01, at 1-5 (1999) (citation omitted).

landscape, however, legislatures removed nearly all the original limitations on the ability of corporations to organize and operate.

Following the Industrial Revolution, capital-intensive businesses required substantial expenditures beyond the means of the typical entrepreneur, requiring outside investment. Granting limited liability to those who contributed capital encouraged investment because people could invest without risking their full personal net worth. Developing modern capital markets depended on limited liability. Although investors may be willing to risk their entire net worth in businesses they themselves operate, they are not willing--absent limited liability--to invest in businesses that they do not operate or closely oversee. Limited liability enabled venture capitalists and casual investors to invest in diverse enterprises without incurring the excessive costs necessary to monitor each enterprise closely.

Today these purposes have broadened. While corporate limited liability promoted passive investment, new LLE forms, such as the limited liability partnership and limited liability company, expect owner involvement in running the business. Legislatures' purposes have expanded from merely encouraging and protecting passive investors to simply and actively promoting business.

To provide guidance on when the owner of an LLE will lose the benefit of limited liability, the place to start should be with the courts' experiences over the years dealing with this issue in the corporate context. This is not as helpful as one might think -- the "tests" used by courts to determine whether to pierce the limited liability veil are universally recognized as unhelpful.⁶ The courts employ at least three conclusory "tests":

The Agency Test. Plaintiffs must show that the owner exercised a significant degree of control over the corporation's decision making;

The Alter Ego Test (founded in equity). The court will pierce the corporate veil to prevent fraud, illegality; or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability from a crime; and

⁶ See, e.g., Phillip I. Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* 8 (1983) (suggesting that court decisions are "irreconcilable and not entirely comprehensible"); Clark, *supra* note 2, at 72 ("[T]he courts usually forgo any sustained attempt at a remedial theory or even a coherent exposition of the basis of liability, although descriptive summaries are occasionally attempted."); Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* 54-55 (1984) ("[T]ests used by courts--whether a corporation has a 'separate mind of its own,' whether it is a 'mere instrumentality,' and so forth--are singularly unhelpful.").

The Instrumentality Test. Plaintiffs must show that the parent exercises extensive control over the acts of the subsidiary giving rise to the claim of wrongdoing.⁷

Application of these tests often consists largely of lists that the courts recite with little analysis or justification. Some courts list as many as nineteen factors.⁸ A sample list from one court recites “insufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, nonpayment of dividends, insolvency of debtor corporation at time of transaction in question, siphoning of funds by dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of corporation as merely a façade for individual dealings.” According to that court, an unspecified number of these factors, combined with an element of “injustice or fundamental unfairness,” would justify disregarding the corporation and holding the owners liable.⁹

At best, these “totality of the circumstances” analyses are a case-by-case assessment of the equities of each individual situation. At worst, they impose onerous burdens on an owner whose only culpability is the failure of the business. Nevertheless, a careful study of the cases provides an outline of principles that may provide guidance for the business owner. While no entrepreneur can prevent absolutely the ultimate imposition of personal liability by a court once the business fails, several steps should be standard operating procedure or standard advice by attorneys for the start-up business.

LESSON ONE: GET IT DONE

In an earlier issue of this Journal, I described and discussed the various alternative forms of limited liability entities available for use by today’s start-up business owner.¹⁰ While there are various benefits and drawbacks to each of these business organizational forms, they all have one thing in common. They exist only when a fee is paid to file signed documentation with a state agency - usually the secretary of state or department of commerce. If no filing occurs, no LLE exists, and the personal assets of the business owner are totally unprotected. Therefore, the first lesson for the entrepreneur in seeking to avoid personal financial ruin is to get the LLE of choice formed. GET IT DONE!

Entrepreneurs understandably focus on the business of getting the business going. This usually means designing and developing the product or service; assembling appropriate management, operational and sales personnel

⁷ Richard v. Bell Atlantic Corp., 946 F. Supp. 54, 61 (D.D.C. 1996).

⁸ Laya v. Erin Homes, Inc., 352 S.E.2d 93, 98-99 (W. Va. 1986) (listing 19 factors).

⁹ Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979).

¹⁰ John Matheson, Choice of Organizational Form for the Start-Up Business, Minn. J. Bus. Law & Entrep.

or teams; identifying and raising financial resources; and developing and implementing a marketing strategy. Too often, the demands of these important and necessary business activities take priority over “legal formalities,” and the legal formation of the LLE gets lost in the business demands of the moment. This is a big mistake. There is no protection for personal assets until legal formation of the LLE -- timing is everything.

If a business owner signs a contract for the business on Monday and forms the LLE later in the day, the business owner is personally liable on the contract. Similarly, if on Monday, an employee of the business drives carelessly while running a business errand, injuring a pedestrian, and the LLE is formed on Tuesday, the owner is personally liable for the employee’s negligence. Reverse the order of events in either of these scenarios, and the business owner’s personal assets are presumptively safe from appropriation for the business debts.

Intending to look into those “legal” issues, intending to meet with counsel, intending to sign the documents and return them, or intending to send the fee check and the papers to the state office, are to no avail. One can pave the road to ruin with good intentions.

As a practical matter, formation of the LLE is simple and involves minimal paperwork and fees. There is no excuse for not getting it done. There is even less excuse for the business’ legal counsel not getting it done.

Even if there are thorny ownership, allocation, or transfer issues to work out, the basic formation of the limited liability entity should be completed even before these issues are resolved. Courts have little sympathy for entrepreneurs who do not “get it done.”

Under the doctrines of “de facto incorporation” or “corporation by estoppel,” courts in some circumstances have come to the rescue of the entrepreneur by allowing for limited liability even where formation of a corporation was incomplete. This judicial solicitude cannot be relied upon. Whether and to what extent these theories will extend to other putative LLE formation situations is yet to be seen.

LESSON TWO: PLAY THE GAME

Once the courts have looked at the LLE formation, the issue of piercing becomes the focus. One of the most striking aspects of the lists of factors the courts employ to make a piercing determination is the emphasis on organizational formalities. To review the list set forth earlier: “insufficient capitalization for purposes of corporate undertaking, failure to observe corporate formalities, nonpayment of dividends, insolvency of debtor

corporation at time of transaction in question, siphoning of funds by dominant shareholder, nonfunctioning of other officers and directors, absence of corporate records, and existence of corporation as merely a façade for individual dealings.” Half of this list concerns following formal procedures or allowing participants in the LLE to play their roles. These are matters of form, not substance.

After formation of the LLE, laws require certain organizational steps. For the corporation, these steps include holding an organizational meeting of the incorporator to elect directors, adopt bylaws, elect officers, adopt banking resolutions, adopt a fiscal year, accept subscriptions for issuance of shares, hiring employees, make tax elections, and authorize or ratify the purchase, lease or other acquisition of suitable space, furnishings, equipment and supplies.

It may seem silly to the owner of a one-owner LLE to hold a meeting with him or herself as incorporator and then as the sole member of the company’s board of directors, and then another meeting to take actions as the sole shareholder. Yet this is what the courts expect because this is the appropriate manner in which the corporation -- as distinguished from the business owner -- is understood to operate.

Beyond the initial organizational activities, directors and shareholders should hold regular meetings, and officers or other employees should fill their roles and take actions within their designated authority. These steps will seem unnecessary to the business owner, but they will keep the courts from finding an easy way to criticize the entrepreneur for failing to follow corporate formalities. Why give the courts a wedge to begin the process of piercing the LLE veil?

Maybe it is easier to think of the limited liability granted by formation of an LLE as an insurance policy. As with any insurance, the policy does not go into effect until the policy is issued and the insured pays the first premium. In the LLE context, the entrepreneur buys the initial insurance of limited liability by forming the LLE. But as with all insurance policies, there are subsequent premiums to pay. The subsequent premiums in the LLE context are observing the requisite formalities of its operation—holding meetings, maintaining separate books and records for the entity, and having the LLE personnel function in their designated roles. Failure to follow these expected formalities, like failure to pay the premiums on any insurance policy, may cause the insurance to lapse. For a business owner this may mean piercing the LLE veil with the attendant imposition of personal liability for the business debts.

Following expected LLE formalities -- playing the game -- is a small price for the entrepreneur to pay to keep the insurance of limited liability in force. Observance of LLE formalities need not be burdensome. Many necessary LLE

actions can be accomplished without a meeting by way of written documentation distributed and signed by the appropriate LLE actors.

Here the entrepreneur's attorney can be extremely helpful. Legal counsel for the business should remind and assist the business owner to observe these formalities. Counsel knows what the courts expect and can help assure that the business observes the requisite formalities. It is important, then, for legal counsel to act and for the business owner to accept the acts of legal counsel as an important partner in protecting the owner's assets.

LESSON THREE: THERE IS ONLY "YOURS" AND "MINE" -- THERE IS NO "OURS"

It is not easy for anyone to keep one's personal financial life organized. Even in the everyday matters of bills and bank accounts and credit cards and other obligations, things can get lost or items mailed to the wrong party. For the start-up businessperson, adding the new LLE as a separate financial person to his or her life complicates these challenges.

The financial dealings of the LLE must be kept separate from the personal financial matters of the owners. Creating separate bank accounts, separate ordering and billing procedures, separate checks and invoice payment, and separate books of the LLE's financial affairs are a part of that process. This separateness must be maintained religiously. It is no excuse that a business owner does not have the LLE checkbook when called upon to write a check for a business obligation. A personal check or other personal payment is unacceptable. Similarly, LLE checks, LLE funds, or LLE cash or credit to pay or guarantee personal obligations is forbidden. In the law of piercing the LLE veil, there are the owner's assets and there are the business assets. There are no assets owned jointly by the business and its owner.

For the courts, commingling of assets or funds between the business and the owner is a red flag for potential piercing. Commingling shows that the owner does not recognize or operate the business as a separate legal person. In judicial terms, the LLE appears to be merely a façade for individual dealings.

Second, remember that the issue of piercing usually arises because the business has gone bankrupt. Commingling often signals the courts that there was inadequate capitalization for the business or that the owner has been siphoning off LLE funds. Courts are neither equipped nor interested in delving deeply into the financial transactions and records of the LLE when creditors seek to pierce the LLE veil. They may take even innocent commingling as indicia of more serious financial chicanery and use it as a convenient linchpin to hold the owner personally liable for the debts of the defunct business.

LESSON FOUR: TELL THE TRUTH

Entrepreneurs are optimistic salespeople by nature. The business will be a success. They look on the positive side and expect that things will be done. And what will get done is as good as done. You can count on it. What is not yet finished (or maybe not even started) in the formation or operation of the business is thought of as being “in process.”

In the law of piercing there is little room for matters “in process.” It operates in a polar way. The law deals in facts, not optimism or salesmanship. It is or isn’t. You did it or you didn’t. You own it or you don’t. There lies an important lesson in the operation of the start-up business.

Misrepresentation, even when innocent, can play a major role in the jurisprudence of piercing. What the entrepreneur might optimistically report as “good as done” looks like misrepresentation to a court when it is asked to pierce the LLE veil. Owner contributions in the LLE have been paid into the LLE bank account or they haven’t. The LLE owns certain assets or it doesn’t. The business signed that contract with an important distributor or it didn’t. The bank has approved and funded the business loan or it didn’t.

There is no room for sales talk in dealing with the reality of the LLE and its assets and obligations. Entrepreneurs that report matters in process as accomplished court (no pun intended) disaster when later the business fails. It is better in business to report the operational and financial and facts when dealing with creditors and other third parties than to put an optimistic spin on those facts. The alternative invites piercing and personal liability. The entrepreneur’s optimism and sales talk may look like fraud to a court when asked to pierce the LLE veil.

LESSON FIVE: GET BUSINESS INSURANCE

Despite the best business idea, the most committed of entrepreneurs with the greatest solicitude for recognizing the separate existence of the business, there may be a business failure. Too late, the entrepreneur realizes he or she should have purchased and maintained business liability insurance.

Business liability insurance may seem a needless expense to the entrepreneur. The business is strapped for cash as it is, and pouring money down this drain may be furthest from the wishes of the business owner. There are good reasons to overcome this reluctance.

The availability of business insurance to pay some of the claims of the defunct business lessens potential exposure of the entrepreneur. Whatever the

insurance covers is a debt paid, and no claims will be made against the business owner's personal assets based on paid debts.

As legal protection, business insurance serves valid purposes. First, it demonstrates that the owner recognized the LLE as a separate person with its own legal obligations and attendant insurance requirements. Second, it shows a court that not all claimants are left without recourse if the LLE veil remains intact. Those covered by the insurance are fully or partially compensated. Those not covered, often voluntary business trade creditors, financial institutions, or other transactional parties, may be left without recourse. These voluntary creditors chose to do business with the LLE with full knowledge of its nature as a start-up business. They could have chosen not to. They could have secured their obligations with a pledge of the assets of the business as security. They could have secured personal guarantees from the owners. They did not, and not having protected themselves from the potential of the business failing, they are not in a particularly appealing posture to call upon the equity of the courts to pierce the LLE veil.

Maintaining business insurance may have an important psychological effect on the court asked to pierce the LLE veil. The business owner was trying to do the right thing and recognized that people who might be harmed by the business should receive compensation. Absent piercing, the fact that voluntary creditors are left without recourse appears more palatable under these circumstances.

LESSON SIX: MAKE LEMONADE -- REVERSE PIERCING

According to a common saying, when life serves you lemons, make lemonade. A failed business is a large serving of lemons. The hopes, expectations, and most or all the assets of the entrepreneur are gone. Time to make lemonade.

In the piercing context, making lemonade may mean attempting to secure the best result from the bad situation of the business failure. Are there circumstances when the business owner will be better off if the LLE veil is pierced? This is what courts refer to as "reverse piercing." Although it will be rather rare for a business to ask a court to ignore the very entity he or she created, attempts to accomplish this result have occurred in various contexts with varying success.

Consider the situation where the start-up LLE business is a farm where the owners will live. The owners transfer the farm into the name of the LLE for various business and tax reasons. If the business goes bankrupt, is the farm available to satisfy creditor claims? Presumptively, yes. If the farm were held in the names of the owners themselves, it would be protected by a state

constitutional or statutory homestead exemption. In these circumstances, a court may be sympathetic to the plight of the owners, ignore the separate existence of the LLE, and allow the owners to claim the exemption.

Sometimes the reverse pierce theory can be used even if the business does not go bankrupt. Consider a one-owner business where title to six motor vehicles is held in the name of an LLE and are the only vehicles driven by the business owner. If the business owner dies, survivors' benefits under the vehicles' no-fault policies cannot be paid to family members, because the LLE and not the individual was the "insured," and LLEs do not have survivors. A court may reverse pierce and allow the survivors' benefits despite the existence of the LLE.

Even though no entrepreneur goes into business with the thought of reverse piercing in mind, situations may develop and the possibilities should not be overlooked. Lemonade tastes better than lemons.

It is not possible to guarantee the success of any business. Entrepreneurs and their counsel can do much to lessen the potential for piercing the LLE veil. The lessons are easy to implement and the cost is negligible. Careful planning and care in operating the business can avoid making a bad situation of a business failure a worse situation of personal bankruptcy for the business owner.

