

“PIERCING THE CORPORATE VEIL”

What It Means and How You Can Protect Your Small Business

By The Neighborhood Entrepreneur Law Project | August 2022

Forming a corporation or limited liability company (LLC) carries many benefits and most notably, provides business owners with limited liability protection from the debts or liabilities of the business. If a business corporation is found liable for a wrongdoing or incurs debt, the owner is typically safe from having their personal assets seized. While courts do not generally hold individual owners of these types of entities personally responsible, in some cases, they may be held personally liable under the concept of “piercing the corporate veil.”

What does it mean to pierce the corporate veil?

The concept of **piercing the corporate veil** primarily applies to corporations, but it can also relate to other entity forms including LLCs and limited partnerships. Piercing the corporate veil refers to instances when the courts put aside the limited liability of the shareholders (or members in the case of an LLC) and hold them personally responsible for the corporation’s actions or debts. This most often happens with close corporations, which are not publicly traded and have a small number of shareholders. While courts may hesitate to do this, they will do so in cases of grievous misconduct by the shareholders. If a court decides to pierce the corporate veil, shareholders will find their personal assets such as bank accounts or property (including homes and cars) at risk in the event of a lawsuit or a corporation’s insolvency.

It is uncommon for a court to pierce the corporate veil for a single transaction or action. However, courts will pierce the corporate veil when shareholders use a corporation in an attempt to defraud creditors. Courts also consider additional factors such as whether the corporation is **undercapitalized** (when a company does not have enough money to operate and cover its expenses) and whether shareholders maintained **corporate formalities** (steps to ensure that the entity remains legally separate from its owners).

How can you avoid having the corporate veil pierced?

Below are a few best practices you can follow to help keep your personal assets safe and minimize the possibility of having your company’s limited liability protection disregarded.

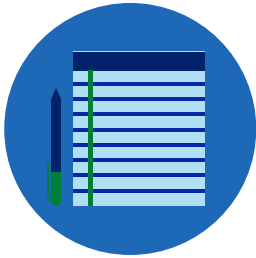
1. Keep personal and corporate assets separate



A business owner of a corporation or LLC should keep personal and corporate assets separate and not “commingle” funds. While this may feel burdensome, especially during the start-up phase of your business when resources are limited, it is an important step. Examples of commingling funds that you should avoid are: (a) having a single bank account for both your business and personal banking needs; (b) depositing a business check into your personal account; (c) transferring money between your business and personal account with no documentation; (d) paying for personal goods using your business account.

While these actions may seem harmless and like something you can sort out later with your accountant, this is one of the most common ways that small business owners can get into trouble.

2. Make sure to follow corporate rules in decision making



While LLCs have less formalities, corporations have many. If you have a corporation with a small number of “core” people that wear many hats, or you are the only shareholder and carry all of the responsibility of managing the corporation, it can be easy to overlook the importance of some basic formalities such as recording and tracking meetings held, topics discussed, and decisions made. First and foremost, shareholders should elect a board of directors, which includes a President, Treasurer, and Secretary and follow guidelines as set out in the by-laws. Directors of the corporation should make sure to hold annual meetings and keep a record of meeting notes. In a single-person corporation, where the shareholder is the Director and also holds all three required officer positions, it is still important to follow corporate formalities. For example, in a Board of Directors meeting where you are the only person present, you should document that you hold all three officer positions and that you are in attendance. Likewise, when it comes to voting, even if you are the only company shareholder, you should document your vote.

3. Maintain records of corporate decisions and transfers



Business owners should make sure all contracts are memorialized and authorized in writing by the corporation. Further, only individuals authorized to enter and sign contracts should do so. For example, if you hold all officer positions in a corporation and need to enter into a contract with a lending institution, you need to sign your name as well as include the position that authorized your ability to enter into the contract in the first place. In this example, you should indicate that you are the treasurer of the company.

Corporations and LLCs should also make sure to maintain accurate financial records. For example, loans, capital contributions, dividends, and salaries should be documented and should not be arbitrarily given.

While the suggestions provided above are not an exhaustive list of actions you can take to maintain corporate formalities, they are a good starting point. Remember to consult your accountant and attorney with any specific concerns.

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