<u>Piercing the Corporate Veil in South Carolina</u>

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The recent case of *Hunting v. Elders*, 359 S.C. 217, 597 S.E.2d 803 (Ct. App. 2004) (certiorari granted Aug. 12, 2005; motion to dismiss granted Oct. 5, 2005), has updated the court created doctrine of piercing the corporate veil in South Carolina. The *Hunting* case discusses the effect of a business electing (1) to be a statutory close corporation under state law and (2) a subchapter S corporation under tax law.

The doctrine of piercing the corporate veil varies from state to state. This article reviews the doctrine as applied in South Carolina and discusses the new principles brought about as a result of the *Hunting* decision. This article is written from the viewpoint of a business lawyer (as opposed to a trial lawyer). The aim of this article is twofold. First, to make the application of the doctrine more understandable. Second, to encourage business lawyers to provide their clients with guidance on how to avoid application of the doctrine to their case.

South Carolina provides by statute that a shareholder of a corporation is not personally liable for the acts or debts of the corporation. S.C. Code Ann. §33-6-220. For limited liability companies (LLCs), see S.C. Code Ann. §33-44-303. Note, however, that shareholders continue to be liable for their own negligent conduct and acts. “Piercing the corporate veil is a common law doctrine by which courts disregard the separate corporate entity in particular circumstances and impose liability on the participants behind the entity’s veil. It is the most litigated issue in corporate law.” Thompson, *Piercing The Veil Within Corporate Groups: Corporate Shareholders As Mere Investors*, 13 Conn.J.Int’l L. 379, 383 (Spring 1999).

"'Piercing' seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled. There is a consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law." Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U.CHI.L.REV. 89 (1985).

Development of the Doctrine in South Carolina

Piercing the corporate veil has been recognized in South Carolina for many years. See, for example, *Parker Peanut Company v. Felder*, 200 S.C. 203, 20 S.E.2d 716 (1942); *Nettles v. Sottile*, 184 S.C. 1, 191 S.E. 796 (1937); and *Jennings v. Automobile Sales Co.*, 107 S.C. 514, 93 S.E. 188 (1917).

State courts, as well as federal courts, in South Carolina use a **two-prong test** to determine whether a corporate entity should be disregarded. The test was first applied in *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976), a federal case involving South Carolina law. The test was approved by the South Carolina Court of Appeals in *Sturkie v. Sifly*, 280 S.C. 453, 313 S.E.2d 316 (Ct. App. 1984) (although the court forgot to include one factor in its decision) and later endorsed by the South Carolina Supreme Court in *Multimedia Publishing of S.C., Inc. v. Mullins*, 314 S.C. 551, 431 S.E.2d 569 (1993).

"'[P]iercing the corporate veil' is not a doctrine to be applied without substantial reflection." *Baker v. Equitable Leasing Corp.*, 275 S.C. 359, 367, 271 S.E.2d 596, 600 (1980). There is a "general reluctance of courts to disregard the integrity of the corporate entity." *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319. "In general, a corporation and a shareholder are separate and distinct, and the debts of the corporation are not the debts of the shareholder. However, when the corporate veil is pierced, the corporation and the individual become one and

the same. *See DeWitt*, 540 F.2d at 683. As they are identical, the liabilities of the corporation are the liabilities of the shareholder." *Hunting*, 359 S.C. at 230, 597 S.E.2d at 809-810.

General Description of the First Prong of the Test

"The first prong is an eight factor analysis of the shareholder's relationship to the corporation." *Multimedia Publishing of S.C., Inc.*, 314 S.C. at 553, 431 S.E.2d at 571. It is "designed to analyze the corporation's adherence to the corporate form." *University Medical Associates of Medical University of S.C. v. UnumProvident Corp.*, 335 F.Supp. 2d 702, 707 (D.S.C. 2004). It "looks to observance of the corporate formalities by the dominant shareholders." *Sturkie*, 280 S.C. at 457, 313 S.E.2d at 318. The eight factors analyzed in the **first prong** of the test are as follows:

(1) whether the corporation was grossly undercapitalized;

(2) failure to observe corporate formalities;

(3) non-payment of dividends;

(4) insolvency of the debtor corporation at the time;

(5) siphoning of funds of the corporation by the dominant stockholder;

(6) non-functioning of other officers or other directors;

(7) absence of corporate records; and,

(8) the fact the corporation was merely a facade for the operations of the dominant stockholder.

The conclusion to disregard the corporate entity must involve a number of the eight factors, but need not involve them all. *Dumas v. InfoSafe Corporation*, 320 S.C. 188, 192, 463 S.E.2d 641, 644 (Ct.App. 1995). "Neither *Sturkie* nor any other case cited by the parties has set forth the weight that must be accorded to each of the eight factors, nor has any case required that

each factor be accorded equal weight with the others." *Hunting*, 359 S.C. at 225, 597 S.E.2d at 807. The eight factors will be discussed separately and in some depth later in this article in the context of the *Hunting* case.

General Description of the Second Prong of the Test

The **second prong** of the test "need not be reached until and unless the requirements of the first prong are met." *Hunting*, 359 S.C. at 225, 597 S.E.2d at 807. The second prong requires "that there be an element of injustice or fundamental unfairness if the acts of the corporation be not regarded as the acts of the individuals" and "is perhaps more elusive." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809. "The corporate form may be disregarded only where equity requires the action to assist a third party." *Woodside v. Woodside*, 290 S.C. 366, 370, 350 S.E.2d 407, 410 (Ct. App. 1986). "[F]undamental unfairness can exist in the absence of fraud [and] may be proved by a lesser showing than the defendant's reckless disregard for whether claims against the corporation exist." *Multimedia Publishing of S.C., Inc.*, 314 S.C. at 554, 431 S.E.2d at 572.

"The burden of proving fundamental unfairness requires that the plaintiff establish (1) that the defendant was aware of the plaintiff's claim against the corporation, and (2) thereafter, the defendant acted in a self-serving manner with regard to the property of the corporation and in disregard of the plaintiff's claim in the property." *Sturkie*, 280 S.C. at 459, 313 S.E.2d at 319. A person is "aware" of a claim against the corporation "if he has notice of facts which, if pursued with due diligence, would lead to knowledge of the claim." *Multimedia Publishing of S.C., Inc.*, 314 S.C. at 555, 431 S.E.2d at 572. "The essence of the fairness test is simply that an individual businessman cannot be allowed to hide from the normal consequences of carefree

entrepreneuring by doing so through a corporate shell." *Multimedia Publishing of S.C., Inc.*, 314 S.C. at 556, 431 S.E.2d at 573.

"One court has suggested that . . . since the issue is one of fact, [courts] should take pains to spell out the specific factual basis for its conclusion." *DeWitt*, 540 F.2d at 685.

Under the DeWitt/Sturkie test, "piercing the corporate veil" will not occur if the "fundamental unfairness" standard of the second prong can be avoided, which is what occurred in the *Sturkie* case. In *Sturkie*, Carolina Furniture suffered a loss during its 1½ years in business. The shareholders moved about $7,000 of inventory out of the corporation and ceased operations. Jay Ruple was the exclusive sales agent for Carolina Furniture and obtained a $39,000 default judgment against the corporation, apparently for wages and commissions fees. A receiver appointed in supplemental proceedings brought an action to pierce the corporate veil. The trial judge "questioned the propriety of the receiver's action in bringing the suit, the integrity of Ruple's judgment and his 'clean hands' with respect to the corporation's financial problems." 280 S.C. at 456, 313 S.E.2d at 318. The plaintiff in *Sturkie* failed to convince the trial court that it would be fundamentally unfair not to hold shareholders personally liable. The appeals court in *Sturkie* affirmed the trial court as the record was "totally devoid of any evidence from which we can determine that the respondents were aware of the claim presented by the receiver at the time they engaged in the acts relied on by the receiver to establish personal liability." 280 S.C. at 459, 313 S.E.2d at 319. The fact that a shareholder knows about a claim and thereafter moves assets out of the debtor corporation indicates the possible presence of the second prong of the DeWitt/Sturkie test.

Hunting v. Elders

In *Hunting*, Catherine L. Hitchcock suffered permanent brain damage in an accident caused by Chris Gordon (Gordon), a drunk driver, on April 2, 1994. In January 1995, Hitchcock's guardian ad litem brought suit against (1) Gordon as the drunk driver, (2) Elmyer Enterprises, Inc. (Elmyer Enterprises) as the owner and operator of a bar named Willie's, and (3) William Elders (Elders) as the alter ego of the corporation. Gordon alleged that he was served alcohol at Willie's despite being obviously intoxicated. Actual damages of $1.5 million (as well as a small amount of punitive damages) were awarded against Gordon and Elmyer Enterprises in September 1997. The second phase of the trial resulted in a holding in June 2001 that Elders was the alter ego of Elmyer Enterprises, justifying piercing the corporate veil. Elders appealed, but the South Carolina Court of Appeals affirmed the trial court. 359 S.C. at 220-221, 597 S.E.2d at 805. The author's law firm was involved in the first phase of the trial of this case. This is an academic paper and the facts set forth above are taken from the order and opinions in the case. They are in no way representative of the positions of any of the parties.

Articles of Incorporation were filed for Elmyer Enterprises on November 18, 1981. Articles of Amendment were filed on June 22, 1993, by which the corporation elected to be a South Carolina statutory close corporation. A statutory close corporation is a designation under state corporate law pursuant to Chapter 18 of the South Carolina Business Corporation Act of 1988 (the "Act"). Chapter 18 is the "Statutory Close Corporation Supplement" of the Act.

The opinion in *Hunting* does not include a specific finding that Elmyer Enterprises was a Subchapter S corporation, but that was apparently the case. A subchapter S corporation is a status for state and federal income tax purposes and was added to the Internal Revenue Code (the "IRC") in 1958. (P.L. 85-866 added subchapter S to the Internal Revenue Code.)

A South Carolina statutory close corporation is allowed to organize and operate less formally than "the classical model of a corporation." An encouraging statute for business lawyers, S.C. Code Ann. §33-18-250 provides as follows: "The failure of a statutory close corporation to observe the usual corporate formalities or requirements relating to the exercise of its corporate powers or management of its business and affairs is not a ground for imposing personal liability on the shareholders for liabilities of the corporation." This statute seems to indicate that the owner of a statutory close corporation need not worry about corporate formalities. A comment to this section, however, suggests that it may not mean quite what it says. The Official Comment explains the statute as follows: "This section does not prevent a court from 'piercing the corporate veil' of a statutory close corporation if the circumstances should justify imposing personal liability on the shareholders were the corporation not a statutory close corporation. It merely prevents a court from 'piercing the corporate veil' <u>***because***</u> it is a statutory close corporation." (Emphasis added)

Subchapter "S" corporations have been in use for over 45 years. South Carolina statutory close corporations have been in use for about 18 years. *Hunting* is the first South Carolina case to apply the veil piercing doctrine to a subchapter S, statutory close corporation.

The Court of Appeals seemed sensitive to the distinction between traditional corporations and statutory close corporations.

> [I]n applying the eight-factor test of the first prong set out in *Sturkie*, significant changes in basic South Carolina corporate law and federal and state tax law have somewhat complicated the analysis. The ability under state corporate law to adopt and operate under a statutory close corporation status has, as a practical matter, diminished the importance of several of the eight factors. In the same fashion, the ability of corporations to avoid double taxation by adopting S corporation status under federal income tax law has lessened the importance of applying the factor concerning the nonpayment of dividends.

> The *Sturkie* factors which now have less importance include the failure to observe corporate formalities, nonfunctioning of other officers or other directors, the absence of corporate records and, as stated above, the nonpayment of dividends. The adoption of the statutory device allowing the creation of a statutory close corporation was designed to lessen the formalities necessary to maintain a corporation.
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> The advent of the statutory close corporation has also had an impact on the type and extent of corporate records required to be maintained and the number and duties of corporate officers and directors.

Hunting, 359 S.C. at 225-226, 597 S.E.2d at 807.

It is instructive to review each factor separately, but keep in mind that the factors can overlap and blur into each other at times. It should be noted that the South Carolina cases reviewed generally do not tick off each factor in turn, separately, as this article does below.

(1) **Whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking**. One of the most important factors considered by South Carolina courts (if not the most important factor) is **gross** undercapitalization. Contrast this with the following finding from an empirical study performed on a national basis: "Undercapitalization and corporate informalities often lead to piercing, but appear in a relatively small percentage of all cases in which courts pierce." Thompson, supra, 13 Conn.J.Int'l L. at 385.

The importance of capitalization in veil-piercing is not new. A 60 year old treatise provided as follows: "It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." Ballentine,

Corporations, 303 (rev. ed. 1946), which was quoted with approval in *DeWitt*, 540 F.2d at 686, footnote 13.

"One fact which all the authorities consider significant in the inquiry, and particularly so in the case of the one-man or closely-held corporation, is whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking. [citations omitted] And, '(t)he obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter * * * during the corporation's operations.'" *DeWitt*, 540 F.2d at 685-686. Note that in South Carolina, a corporation may have to remain properly capitalized at all times.

The Court held that Elmyer Enterprises failed to remain properly capitalized as an ongoing business. It was initially funded with $2,000 which "was minimal at best." *Hunting*, 359 S.C. at 227, 597 S.E.2d at 808. The Court found that the corporation appeared to have sufficient cash flow to experience growth, however, "no evidence was produced showing that that growth was ever reflected in the corporation's capital account." *Id*. The amount of capital deemed sufficient will vary from business to business. The Court stated that "a corporation established for the purpose of serving alcohol has more inherent risks and should be adequately protected from liability associated with those risks. The failure to properly protect the business and others should be considered when determining whether the corporation is properly capitalized." *Hunting*, 359 S.C. at 227-228, 597 S.E.2d at 808.

Procuring insurance in an amount and coverage that is reasonable for a client's industry should be sufficient to "protect the business and others." Elmyer Enterprises had liability insurance, but no dram shop coverage. The plaintiff should not have been able to pierce the veil if the corporation had, for example, $1,000,000 of dram shop coverage (even though the $1,500,000 judgment would have exceeded such coverage).

(2) **Failure to observe corporate formalities**. According to the trial court's order dated June 20, 2001, Mr. Elders produced corporate minutes of "numerous shareholder meetings" but "no credible evidence was presented that would support a finding that the shareholder meetings . . . ever took place." In one case where shareholders did not provide documentation during discovery, the Court of Appeals stated that "the absence of evidence created a strong inference that corporate formalities were not observed." *Ball v. Canadian American Exp. Co., Inc.*, 314 S.C. 272, 277, 442 S.E.2d 620, 623 (Ct.App. 1994). According to the Court of Appeals, "Elders maintained a bare minimum of corporate records." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

"While disregard of corporate formalities is a circumstance to be considered, it is generally held to be insufficient in itself, without some other facts, to support a piercing." *DeWitt*, 540 F.2d at 686, footnote 14. "[T]he failure to adhere to these formalities alone cannot be used to pierce the corporate veil." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808. At least one court has stated that "the informalities are considered of little consequence." *Zubik v. Zubik*, 384 F.2d 267, 271 (3d Cir. 1967), cert. denied, 390 U.S. 988, 88 S.Ct. 1183, 19 L.Ed.2d 1291 (1968), footnote 4. (Compare, however, with the 3rd Circuit's subsequent decision in *United States v. Pisani*, 646 F.2d 83 (3d Cir. 1981) wherein the absence of corporate formalities was an important factor.)

"All rules of statutory construction are subservient to the one that the legislative intent must prevail if it reasonably can be discovered in the language used, and that language must be construed in light of the intended purpose of the statute." *Dumas*, 320 S.C. at 195, 463 S.E.2d at 645.

Statutory close corporations are allowed by statute to operate on a less formal basis than a regular corporation. For example, a statutory close corporation is allowed to operate without a board of directors, without bylaws, and without holding an annual meeting. A plain reading of S.C. Code Section 33-18-250 suggests that corporate formalities are not necessary for a statutory close corporation. Because of the Official Comment to the statute, however, the Court in *Hunting* did not interpret the statute in this manner. The Official Comment indicates that the purpose of Section 33-18-250 is to provide explicitly that a corporation will not have its corporate veil pierced merely because it organizes and operates in accordance with the Statutory Close Corporation Supplement. As a result of this interpretation, a statutory close corporation cannot completely ignore corporate formalities with immunity. The same is highly likely for an LLC since §33-44-303(b) of the LLC Act contains the same language as appears in §33-18-250 of the corporate Act. In support of the Court's finding is the following language from the South Carolina Reporters' Comments to §33-18-230: "The fact that no annual meeting is required does not mean that minutes documenting all significant corporate action do not need to be prepared."

As a matter of law, the Court in *Hunting* held that the "failure to observe corporate formalities" is less important in the case of a statutory close corporation. Therefore, the factor is not irrelevant, but it is less important. *Hunting*, 359 S.C. at 225-226, 597 S.E.2d at 807. "Admittedly, Elmyer Enterprises was not required to follow the same corporate formalities as a regular business corporation." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808. The Court did not focus much attention on whether or not this factor was present. Such focus was not necessary since the Court found the presence of four to five other factors, which is a sufficient number to pass the first prong of the test.

(3) **Non-payment of dividends**. In general, a closely-held "C" corporation prefers to distribute a majority of its profits to its shareholders as compensation (salary and bonuses) to obtain a deduction for income tax purposes. A "C" corporation cannot deduct dividends paid to shareholders. In contrast, after paying its employees reasonable compensation, a closely-held "S" corporation prefers to pay out a portion of its profit to its shareholders as dividends to minimize Social Security and Medicare taxes.

Similar to a partnership, an "S" corporation is a "pass through" vehicle for tax purposes. In other words, an "S" corporation pays no income tax at the corporate level.

> As to the factor concerning the payment or nonpayment of dividends, its importance in the overall scheme of things has been diminished by the election now allowed by federal tax law. Elders asserts that because the corporation elected to operate as an S corporation pursuant to 26 U.S.C. §§ 1361-1399 (2002), the failure to pay dividends should not be considered a factor against it in determining whether to pierce the corporate veil. We agree, because the net income of the corporation would be passed to the shareholders in direct proportion to their ownership percentage. However, at the same time, this lessens the importance of this factor.

Hunting, 359 S.C. at 227-228, 597 S.E.2d at 808. The Court agreed with the defendant that the failure of Elmyer Enterprises to pay dividends would not be held against Elders, but also pointed out that the payment or nonpayment of dividends is not as important as the other factors in an analysis involving an "S" corporation.

Although this article focuses primarily on South Carolina law, a smattering of law from other jurisdictions is included. That includes the following quote from the District Court in *Trustees of the National Elevator Industry Pension v. Lutyk*, 140 F.Supp.2d 447 (E.D.Pa. 2001), aff'd, 332 F.3d 188 (3rd Cir. 2003).

> 5. *Dividends*. American did not pay dividends, and the non-payment of dividends is usually a factor favoring piercing of the corporate veil. However, as the defendant is the sole shareholder, non-payment of dividends takes on a divided significance, as it *may be evidence that the defendant did not seek to siphon assets* from the company, albeit while disregarding the corporate formalities of dividend payment. (Emphasis added.)

Id., 140 F.Supp.2d at 459. The Third Circuit in *Lutyk* agreed with the District Court.

> In piercing the corporate veil, the District Court did not afford any weight to either American's failure to pay dividends or the non-functionality of the corporation's officers . . . such failures by a closely-held corporation such as American are not unusual, and not a strong factor in favor of piercing . . . many jurisdictions actually hold that the payment of dividends at a time when a corporation is insolvent *favors* piercing the corporate veil.

Lutyk, 332 F.3d at 196.

This factor assumes that a traditional corporation, if profitable, will declare and pay a dividend. This is how a shareholder who is not an employee enjoys a current return on his investment. Close corporations with very few shareholders do not declare and pay dividends the same way as traditional corporations. In many, if not most cases, the shareholders of a closely held corporation work in the business and receive wages. A closely held "C" corporation might not ever pay a dividend.

(4) **Insolvency of the debtor corporation at the time**. "Even though the corporation was able to pay its debts and thereby escape the classical definition of insolvency, the evidence indicates that Elders left in the till only so much as was necessary to pay basic expenses." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809.

In general, S.C. Code Section 33-6-400(c) provides that no distribution may be made to shareholders if, after giving it effect, (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation's total assets would be

less than the sum of its total liabilities. (For limited liability companies, see S.C. Code Ann. §33-44-406.) S.C. Code Section 33-1-400(7) "defines 'distribution' to include virtually all transfers of money, indebtedness of the corporation or other property to a shareholder in respect of the corporation's shares." The Official Comment to S.C. Code Section 33-6-400. Note that compensation for services rendered (wages, salary and bonuses) is not included in the definition of distribution. The equity insolvency test (Section 33-6-400(c)(1)) and the balance sheet test (Section 33-6-400(c)(2)) are described in more detail in the Official Comment to S.C. Code Section 33-6-400.

(5) **Siphoning of funds of the corporation by the dominant stockholder**. More so than the other factors, "siphoning of funds" has a bad connotation. For example, "failure to observe corporate formalities" sounds as though the owner was lazy or unsophisticated. The phrase "siphoning of funds," however, sounds as though the owner committed a knowingly wrongful act. This factor is perhaps the most dangerous since it not only counts towards the first prong of the test, but it can also result in a finding of "injustice or fundamental unfairness."

"The factors dealing with undercapitalization, siphoning of funds, and whether the corporation was a facade for its dominant shareholder are closely related." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 808. The South Carolina cases reviewed do not specifically define what is meant by "siphoning of funds." In *C.T. Lowndes & Co. v. Suburban Gas & Appliance Co., Inc.*, 307 S.C. 394, 415 S.E.2d 404 (Ct.App. 1991), the court stated that McLaughlin "siphoned the net proceeds [from the sale of Suburban's assets] out of Suburban for his own benefit and for the benefit of Southside [McLaughlin's wholly owned corporation]" rather than pay an insurance agent of Suburban.

Is "siphoning of funds" the distribution of money to or for the benefit of a dominant shareholder at any time when there is a legal debt outstanding? If so, then it occurs on a daily basis in every closely held corporation operating today. A narrower and more accurate description may be that siphoning of funds occurs when there are insufficient funds to pay **all** currently known and due claims and the dominant shareholder (knowing there are insufficient funds) prefers himself over some over creditor. The definition of a currently due claim would include debt service in any given month but would exclude the remainder of the outstanding debt until the maturity date of the loan or its acceleration because of a default.

Case law indicates that one way to satisfy the second prong of the test (i.e., the "injustice or fundamental unfairness" standard) is if the "siphoned funds" can be associated directly with the unpaid debt. In *Cumberland Woods Products v. Bennett*, 308 S.C. 268, 417 S.E.2d 617 (Ct.App. 1992), for example, Tri-Wood placed orders with Cumberland. Cumberland shipped the ordered products to Greif. Greif paid Tri-Wood for the Cumberland products. At least a portion of the receipts from Greif should have been disbursed by Tri-Wood to Cumberland in payment for the products shipped. Instead, the shareholder caused Tri-Wood to use some of the funds to pay his salary. This association between the "siphoned funds" and the unpaid debt is also easily made in the *Dumas* and *DeWitt* cases, whose facts indicating the presence of the second prong are set forth in this article below.

Although this article generally confines itself to South Carolina precedent, given the importance of this factor, some non-South Carolina case law is included below to provide further guidance.

- "The repayment of legitimate shareholder loans by itself does not constitute siphoning . . . [h]owever, the repayment of loans from shareholders or other diversion of corporate assets at a time when the company's finances are troubled may strongly indicate siphoning." *Trustees of the National Elevator Industry*

Pension v. Lutyk, 140 F.Supp.2d 447, 458 (E.D.Pa. 2001), aff'd, 332 F.3d 188 (3rd Cir. 2003). "The use of corporate funds for personal benefits – again, particularly at a time of financial distress – also supports piercing the corporate veil." *Id.*, 140 F.Supp.2d at 459.

- "The repayment of legitimate loan obligations by a corporation, to its shareholders, does not, by itself, establish siphoning of funds. . . Shareholder loans to a closely held corporation are not improper. . . . Nor can any inference be raised that the 'management fees' paid by Pelbro to PR & W and Ren-Koe resulted in the siphoning of funds." The management fees were paid "for services rendered" and were "far less than an amount that would be considered reasonable compensation." Regarding transfers of equipment and motor vehicles to Pelbro's shareholders, "[i]t is very questionable whether the transfers under any circumstances would be viewed as 'siphoning', as the transfers were in consideration of preexisting indebtedness of Pelbro to its shareholders." *Connors v. Peles*, 724 F.Supp. 1538, 1568-1569 (W.D.P. 1989).

- "Even more significant to the alter ego analysis is the reason why Golden Acres was insolvent and incapable of paying dividends: defendants were siphoning funds out of the corporation at regular intervals. Despite a mounting mortgage debt and an insolvent corporate shell, after paying bills and payroll each month, Mario Capano would write a check to himself, to his brother, or to companies they controlled for whatever balance remained in the corporate checking account. . . . By acting with total disregard for corporate formalities and financial well-being in their operation of Golden Acres, defendants effectively used the corporation as an 'incorporated pocketbook.'" *United States v. Golden Acres, Inc.*, 702 F.Supp. 1097, 1106 (D.C.D. 1988), aff'd without opinion, 879 F.2d 857 and 879 F.2d 860 (3rd Cir. 1989).

- "The district court opinion considered these factors [from DeWitt Truck Brokers] carefully. It stated: . . . 'The reduction of the corporation's indebtedness to Dr. Pisani from approximately $184,000 in 1967 to $0 in 1969 indicates that Dr. Pisani siphoned corporate funds.' . . . . Pisani followed no corporate formalities, operated the corporation with his personal funds, loaned large sums to the corporation and then repaid the loans to himself with corporate funds while the corporation was failing, and kept the corporation undercapitalized by loaning it money instead of investing equity in it. . . . . [W]e hold that this case is appropriate for applying the alter ego doctrine as set forth in DeWitt Truck Brokers." *United States v. Pisani*, 646 F.2d 83, 88-90 (3rd Cir. 1981).

In *Hunting*, the focus was primarily on income derived from video poker machines in the bar. The "Findings of Fact" in the trial court's order was 11 pages long, about 6 pages of which discussed the corporation's revenue. "The trial court found Elders siphoned substantial funds

from the corporation, and the evidence substantiates this finding. Using documents from the corporation, the forensic accountant testified there was a significant amount of income not reported, and she determined that Elders siphoned $400,000 to $800,000 from Elmyer Enterprises over a three-year period." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 808-809.

As noted, close corporations do not pay dividends in the same way as traditional corporations. Corporate profit (if any) is paid or distributed to the owner unless needed in the business for some necessary or advisable expenditure (for example, to purchase equipment, materials or inventory). The only legal limitation is that the corporation is suppose to pay its bills first and remain solvent. Whether the money received by the owner is characterized as "compensation" or as a "dividend" may be based on the most favorable result from a tax point of view.

As previously noted, the court found that Elders left enough in the till to pay basic expenses. This is probably how the large majority of close corporations operate. Is there something inherently wrong with the practice? The *Hunting* court seemed to hang its hat on unreported income which, according to a forensic accountant, might have added up to as much as $800,000. But why is this siphoning? Would not the owner have been entitled to this income even if it had been reported on the corporation's tax return? Arguably, this was more of an issue for the IRS and S.C. Department of Revenue (the tax authorities) than for the plaintiff. Yet the court appeared satisfied that the owner's receipt of income "off the books" was the equivalent of siphoning, even though it may have had no practical effect on the corporation's available funds. At the end of the day, the Court's analysis does not really fit the way a close corporation works.

(6) **Non-functioning of other officers or other directors**. According to the Articles of Amendment filed with the Secretary of State, Elmyer Enterprises elected to operate without a

board of directors. Elders designated his wife as a vice president and his niece as secretary and treasurer of the corporation. However, the niece knew nothing about her selection as an officer. *Hunting*, 359 S.C. at 222, 597 S.E.2d at 805. Elders produced minutes indicating that his wife and niece were present during meetings. However, the niece testified she never attended any corporate meetings. *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808.

(7) **<u>Absence of corporate records</u>**. Maintaining records is (or at least should be) a normal activity for all businesses. For example, records must be maintained for purposes of a business license. Section 5 of the Business License Ordinance of the City of Charleston requires a business to certify under oath that "gross income is accurately reported." Violation of the ordinance can result in a $200 fine or 30 days of imprisonment pursuant to Section 17. Section 10 of the Ordinance provides as follows:

> [An] authorized agent of the City is empowered to enter upon the premises of any person subject to this ordinance to make inspections, examine and audit books and records, and it shall be unlawful any such person to fail to refuse to make available the necessary books and records. Books and records include, but are not limited to, financial statements, federal and state tax returns, payroll returns, sales and revenue ledgers, inventory accounts, accounts receivable and expense ledgers. The information requested will be information normally utilized by a business preparing its records in accordance with generally accepted accounting principals.

In addition to the business license ordinance, S.C. Code Section 33-16-200 provides that a corporation shall furnish an annual financial statement to each of its shareholders. Another example is tax returns, which are signed under penalty of perjury and must be filed and may be audited. Although status as a statutory close corporation may lessen the importance of the "corporate records factor," it does not eliminate it.

> Although Elders maintained a bare minimum of corporate records, normal business records were definitely lacking in sufficiency.

> The corporation did not have adequate records of income from the video poker machines or from the operation of the bars. It did not have records of cash receipts, cash expenses, sales, inventory, or other profit and loss statements that normally would be expected.

Hunting, 359 S.C. at 226, 597 S.E.2d at 808.

(8) **The fact the corporation was merely a facade for the operations of the dominant stockholder**. Mr. Elders owned 99% of the stock of Elmyer Enterprises and the trial court found that the evidence "established that Elders controlled all aspects of the business." "The trial court found Elders lacked credibility in his explanation for the difference in the income and what was reported. The court specifically found the money was never accounted for and must have been siphoned by Elders. This is additional evidence that the corporation was used as a mere facade for the benefit of the dominant shareholder, justifying the ultimate conclusion reached by the trial court." *Hunting*, 359 S.C. at 228, 597 S.E.2d at 809.

In addition to meeting the **first prong** of the test, the Court in *Hunting* held that the **second prong** was satisfied. "There is evidence that indicates Elders knew of the plaintiff's claim against the corporation and that, as the trial court found, he nevertheless acted in a self-serving and unfair manner by siphoning off substantial sums of money, commingling and transferring assets which he held in his own name to different entities, transferring stock in the corporation to other individuals without a valuable consideration, and then finally dissolving the corporation." *Hunting*, 359 S.C. at 229, 597 S.E.2d at 809.

Facts Indicating The Presence of the Second Prong

According to the author's research, eight of the nine reported state court decisions in South Carolina applying the *DeWitt* test pierced the corporate veil (the sole exception being *Sturkie)*. The limited liability shield therefore failed in almost 89% of the reported cases. In one

empirical study performed nationwide, it was found that courts pierced the corporate veil in approximately 40% of all reported cases. Thompson, supra, 13 Conn.J.Int'l L. at 384.

This would seem to indicate that state courts in South Carolina are more likely to rule in favor of veil piercing than courts in other states. Regardless of the first prong, piercing the veil can be avoided if the second prong is not present. Therefore, lawyers should have a good understanding of how the second prong of the DeWitt/Sturkie test has been applied.

Reviewing some of the facts of the case law will provide guidance on how to avoid the second prong. In each of the following cases, the second prong of the test was met and the court allowed the corporate veil to be pierced. The facts related below were selected by the author from each case for the sole purpose of illustrating the second prong of the test.

Wilson. In *Wilson v. Friedberg*, 323 S.C. 248, 473 S.E.2d 854 (Ct.App. 1996), Richard Friedberg was the sole shareholder in Royal Promotions, Inc., the corporate general partner in two limited partnerships. Each partnership was formed to sponsor a single event: Shag Musical Review L.P. (an original musical review) and Fight Night Charleston No. 6 L.P. (a professional boxing promotion). Four limited partners invested $20,000 in Shag Review and $16,000 in Fight Night. Although both events lost money, not all of the invested money was spent. The corporate general partner was ordered to return to the limited partners a pro rata share of each person's original investment and Friedberg was held personally liable for returning the capital. The South Carolina Court of Appeals was satisfied that the second prong of the test was met because of the standard of conduct which a general partner owes to a limited partner, quoting with favor the conclusion of the master:

> This case is based on the fiduciary duty of the general partner to the limited partners. I find that Friedberg and Royal Promotions were one and the same for the operation of Fight Night [and Shag Musical Review] and there would be fundamental unfairness if the acts of the corporation not be regarded as the act[s] of Friedberg.

Wilson, 323 S.C. at 253, 473 S.E.2d 856-857.

Dumas. In *Dumas v. InfoSafe Corporation*, 320 S.C. 188, 463 S.E.2d 641 (Ct.App. 1995), InfoSafe Corporation applied for an SBA loan and stated in the application that a portion of the proceeds would be used to pay back wages due to employees. Robert H. Maguire, the sole shareholder of InfoSafe, repeatedly assured InfoSafe's employees that back wages would be paid upon receipt of the SBA loan proceeds. In reliance upon Maguire's assurances, Jerome E. Dumas continued to work full-time for InfoSafe without receiving pay. Dumas' employment was terminated on June 29, 1992. In September 1992, InfoSafe received the SBA loan. Maguire used the SBA loan proceeds to repay loans he and his wife extended to InfoSafe, to pay employees other than Dumas for past due wages, and to pay other creditors. "InfoSafe funds were regularly transferred to Maguire and his wife, allegedly for repayment of certain loans to the company. . . . The record contains an abundance of evidence that although Maguire was aware of Dumas's claims against InfoSafe, Maguire acted in a self-serving manner with regard to InfoSafe's funds available for unpaid salaries and in disregard of Dumas's claim to those funds." *Dumas*, 320 S.C. at 193, 463 S.E.2d at 644.

Multimedia. In *Multimedia Publishing of S.C., Inc. v. Mullins*, 314 S.C. 551, 431 S.E.2d 569 (1993), J.R. Mullins (Mullins) was the sole director and shareholder of Food Stores of Greenville (FSG), which operated one grocery store in Greenville. FSG obtained newspaper

advertising with the Greenville News-Piedmont (Multimedia). Two grocery stores in Myrtle Beach run by FSSC (a related corporation) closed and transferred assets to FSG as an inter-corporate loan. When FSG closed the Greenville grocery store, Multimedia was left unpaid. FSG had transferred approximately $144,000 in cash and assets to Mullins and other corporations in which he was the dominant or sole shareholder, purportedly to repay personal and inter-corporate debts owed by FSG.

Cumberland. In *Cumberland Woods Products v. Bennett*, 308 S.C. 268, 417 S.E.2d 617 (Ct.App. 1992), John Clark Bennett (70%) and his wife (30%) were the sole shareholders of Tri-Wood Products, Inc. (Tri-Wood). In 1986, Tri-Wood placed purchase orders with Cumberland Wood Products, Inc. (Cumberland). Cumberland, in turn, shipped the products to the receiving party, Greif Bros. Corp. (Greif). Although Tri-Wood received full payment for the products from Greif, Tri-Wood did not pay Cumberland any portion of these funds. Although Tri-Wood had an operating loss in 1986, Tri-Wood paid Bennett a salary "determined by his needs at home" and listed automobiles valued in excess of $23,000 as assets. "Additionally, Tri-Wood used the money that was paid by Greif for Cumberland's products to pay other creditors and 'for other investments or things.' . . . The only attempt Tri-Wood made to pay Cumberland was to knowingly issue it bad checks." *Cumberland Woods Products*, 308 S.C. at 272, 417 S.E.2d at 619.

C.T. Lowndes. In *C.T. Lowndes & Co. v. Suburban Gas & Appliance Co., Inc.*, 307 S.C. 394, 415 S.E.2d 404 (Ct.App. 1991), Tucker McLaughlin (McLaughlin) owned all of the stock in Southside Oil Co., Inc. (Southside). Southside purchased all of the stock of Suburban Gas & Appliance Co. (Suburban) for $1,500,000 on July 8, 1986. That same day, Suburban sold the majority of its assets to Petrolane Gas Services, Inc. for $1,575,000. C.T. Lowndes & Company

(Lowndes) was an insurance agent of Suburban. Suburban was indebted to Lowndes for earned premiums. "The trial court found that McLaughlin directed the payment of $626,073 for the use and benefit of himself, his family, friends, associates and Southside . . . The court . . . held that McLaughlin personally caused the assets of Suburban to be sold to Petrolane and siphoned the net proceeds of that sale out of Suburban for his own benefit and for the benefit of Southside, which he owned, and that the funds received by Southside inured solely to McLaughlin's benefit as its sole owner." 307 S.C. at 395-396, 415 S.E.2d at 405.

FDIC. In *Federal Deposit Insurance Corp. v. Sea Pines Company*, 692 F.2d 973 (4th Cir. 1982), Sea Pines Company (the parent corporation) owned 90% of the stock of Point South, Inc. (the subsidiary corporation). American Bank & Trust Company (AB&T) made a construction loan to Point South, Inc. in February 1973 to build a reception center on a parcel of the subsidiary's property (the Property). By February 1974, Point South, Inc. was insolvent and continued to lose money thereafter. Even though Sea Pines Company did not guarantee the AB&T loan, the Fourth Circuit Court of Appeals held the parent corporation liable for the loan, finding fundamental unfairness and injustice based on two bad acts of the parent. First: in October 1974, while Point South, Inc. was insolvent, its directors mortgaged the only unencumbered piece of property owned by Point South, Inc. (the subsidiary) as collateral for loans of Sea Pines Company (the parent). Second: Point South, Inc. had sold the Property in August 1973 and leased it back, with Sea Pines Company guaranteeing the rent. Then, in May 1975, while Point South was insolvent, the common directors of the corporations caused Point South to repurchase the Property — this caused the sale and leaseback to be cancelled and released Sea Pines Company from its guarantee of rent payments. "Counsel admitted there was

no benefit to the insolvent subsidiary but rather the cancellation and repurchase was for the sole benefit of the parent." *Federal Deposit Insurance Corp.*, 692 F.2d at 977.

DeWitt. In *DeWitt*, supra, W. Ray Flemming owned at least 90% of W. Ray Flemming Fruit Company, Inc. The corporation was engaged in the business of a commission agent, selling fruit produce for the account of growers of farm products. The corporation never purported to own the products. Under the arrangement, the corporation was to remit to the grower the full sales proceeds **less** any transportation costs incurred in transporting the products from the growers' farm or warehouse to the purchaser and the corporation's sales commission. An integral part of the collections was the transportation charges of DeWitt Truck Brokers, Inc. In its accounting with the growers, Flemming represented that the transportation charges had been paid and he claimed credit in his settlement with the growers. "At the time, however, Flemming was withdrawing funds from the corporation at the rate of at least $15,000 per year; and doing this, even though he must have known that the corporation could only do this by withholding payment of the transportation charges due the plaintiff . . . And, it is of some interest that the amount due the plaintiff for transportation costs was approximately the same as the $15,000 minimum annual salary the defendant testified he was paid by the corporation." *DeWitt*, 540 F.2d at 689.

Given that even the smallest client may have more than one business entity, the following discussion touches on veil piercing in the context of parent-subsidiary corporations, reverse-piercing and brother-sister corporations.

Parent-Subsidiary Corporations

C.T. Lowndes & Co. v. Suburban Gas & Appliance Co., Inc., 307 S.C. 394, 415 S.E.2d 404 (Ct.App. 1991) (discussed above) is a state case which involved piercing the veil of two

corporations to hold the shareholder of the parent corporation liable for the debt of a subsidiary corporation. While the Court set forth facts indicating what the subsidiary did wrong to warrant piercing, there is little to indicate what the parent did wrong to warrant piercing its corporate veil.

Federal Deposit Insurance Corp. v. Sea Pines Company, 692 F.2d 973 (4th Cir. 1982) (discussed above) is a federal case in which a parent corporation was held liable for a loan that a bank made to a subsidiary corporation. The Fourth Circuit Court of Appeals in *FDIC* reaffirmed the two prong test that it had adopted six years earlier in *DeWitt*.

In *University Medical Associates of Medical University of S.C. v. UnumProvident Corp.*, 335 F.Supp. 2d 702 (D.S.C. 2004), the District Court applied *Sturkie* and declined to pierce the corporate veil between a parent and subsidiary corporation because the plaintiffs did not put forward any evidence that the defendant had failed any of the eight factors of the first prong of the test. In addition, "since Provident has agreed that it is responsible for the acts of the UNUMProvident employees that dealt with plaintiffs, any unfairness in recognizing the corporate form is reduced." 335 F.Supp. 2d at 708.

In addition to the two-prong DeWitt/Sturkie test, a second method of holding a parent corporation responsible for the debts of a subsidiary is by application of the instrumentality doctrine or alter ego theory. In *Duplan Corp. v. Deering Milliken, Inc.*, 444 F.Supp. 648 (D.S.C. 1977), the District Court of South Carolina adopted an "alter ego" or "instrumentality" test which applied a non-exclusive list of nine factors. The Court in *Duplan* pierced the veil between the parent and subsidiary corporations. *Duplan Corp.*, 444 F.Supp. at 689. *Duplan* was decided less than 15 months after *DeWitt* but did not cite the Fourth Circuit's decision in *DeWitt*. Instead, the District Court in *Duplan* cited *Bay Sound Transportation Company v. United States*,

350 F.Supp. 420, 426 (S.D. Tex. 1972), aff'd, 474 F.2d 1397 (5th Cir. 1973) as authority. *Duplan* was cited with favor by the Fourth Circuit Court of Appeals in the *FDIC* case. *Federal Deposit Insurance Corp.*, 692 F.2d at 976.

Peoples Federal Savings & Loan Association v. Myrtle Beach Golf & Yacht Club, 310 S.C. 132, 425 S.E.2d 764 (Ct. App. 1992) stands for the proposition that the instrumentality doctrine or alter ego theory remains viable in South Carolina today. Peoples Federal Savings & Loan (Peoples) formed Peoples Joint Venture Group, Inc. (Peoples Venture) to participate in a real estate development partnership. A party in the case attempted to pierce the corporate veil of Peoples Venture so as to make Peoples a partner in the partnership. The South Carolina Court of Appeals refused to pierce the veil after applying the *DeWitt/Sturkie* test. 310 S.C. at 141-142, 425 S.E.2d at 770. The Court acknowledged the existence of the instrumentality or alter ego theory, citing with favor *Krivo Indus. Supply Co. v. National Distillers & Chem. Corp.*, 483 F.2d 1098 (5th Cir. 1973). However, the Court held that Peoples Venture was not the instrumentality or alter ego of Peoples. It should be noted that the Fourth Circuit in *DeWitt* cited *Krivo* with favor. *DeWitt*, 540 F.2d at 683.

In *Osborn v. University Medical Associates of Medical University of South Carolina*, 278 F.Supp.2d 720 (D.S.C. 2003), the District Court cited *Peoples*, *Krivo* and *Sturkie* with favor. The District Court discussed the instrumentality doctrine or alter ego theory at some length and concluded "that Osborn has failed to provide any genuine issue of fact as to whether the PDC was effectively operated as an 'alter ego' or 'instrumentality' of any of these corporate defendants." 278 F.Supp.2d at 726-729.

Reverse-Piercing and Brother-Sister Corporations

Given the scarcity of law on the subject in South Carolina, it may be difficult for a creditor of a shareholder to get at the assets of a corporation by downstream reverse-piercing. The case law in South Carolina is discussed below.

Elkay Industries, Inc. ("Elkay") was the parent corporation of Skyline Manufacturing Company, Inc. ("Skyline"). Skyline made a payment to United Screen Printers, Inc. ("USP") within 90 days of Elkay filing a bankruptcy petition. The bankruptcy trustee of Elkay sought to recover the "preferential payment" that Skyline made to USP. The District Court of South Carolina stated: "In a reverse piercing case, the shareholder attempts to have the corporate form of his own corporation disregarded for his own benefit. . . . the court's research has revealed no South Carolina law addressing the precise issue currently before the court." *Elkay Industries, Inc., v. United Screen Printers, Inc.*, 167 B.R. 404, 410 (D.S.C. 1994). The Court went on to hold that the bankruptcy trustee in Elkay could assert that the debtor corporation (Elkay) was the alter ego of its subsidiary corporation (Skyline). The application of this case may be limited to bankruptcy proceedings.

In a brother-sister structure of corporations, going upstream from the corporation to its individual shareholders and back downstream to a sibling corporation is also known as "reverse-piercing." An example of such a case in a jurisdiction outside of South Carolina is *Sea-Land Services, Inc., v. Pepper Source*, 941 F.2d 519 (7th Cir. 1991). Piercing a brother-sister structure results in personal liability for the individual shareholders of the brother-sister corporations. Piercing a subsidiary results in liability to the parent corporation but not the individual shareholders of the parent (unless the facts warrant piercing the parent as well, which is what occurred in the *C.T. Lowndes* case mentioned above).

Kincaid v. Landing Development Corporation, 289 S.C. 89, 344 S.E.2d 869 (Ct.App. 1986) involved three brother-sister corporations involved in the development of a subdivision. One corporation owned the land. A second corporation handled sales and marketing. A third corporation constructed homes. The plaintiffs' lawsuit was based on negligent construction. The plaintiffs sought recovery, however, from the sales and marketing corporation as well as the other two. The Court of Appeals was perfunctory in its finding that all three corporations were liable for the damages.

> The trial court ruled the evidence revealed "an amalgamation of corporate interests, entities, and activities so as to blur the legal distinction between the corporations and their activities." We agree.

289 S.C. at 96, 344 S.E.2d 874. The Court recited facts that the three corporations had common shareholders, officers and corporate offices, but not much more. The Court did not cite its two year old decision in *Sturkie* as authority.

In *Magnum v. Maryland Cas. Co.*, 330 S.C. 573, 577, 500 S.E.2d 125, 127 (Ct.App. 1998), a corporate automobile was involved in an accident which resulted in the death of a son of the shareholders (Tyler). The driver of the automobile was at fault. Tyler was a passenger in the car. The corporation owned the car and was the named insured. The parent-shareholders were appointed Personal Representative of Tyler's estate. The parents asserted "they are Class I insureds under the corporation's policy because they are, in essence, the corporation." As such, they claimed that Tyler was entitled to stack UIM coverage. The Court rejected the reverse piercing argument citing cases with similar facts from Georgia and North Carolina. The holding in this case may be limited to parties seeking to stack automobile insurance coverage.

Summarizing the Hunting Case

The South Carolina Court of Appeals in *Hunting* pierced the corporate veil of Elmyer Enterprises. In the first prong of the test, the Court found that Elmyer Enterprises was not properly capitalized. The Court observed that undercapitalization (factor 1), siphoning of funds (factor 5) and the corporation as a facade for the operations of the dominant shareholder (factor 8) are closely related. In addition to these three factors, the Court found the presence of two other factors, for a total of five out of eight: "Admittedly, Elmyer Enterprises was not required to follow the same corporate formalities as a regular business corporation. Although the failure to adhere to these formalities alone cannot be used to pierce the corporate veil, coupling the dearth of corporate business records [factor 7] and the inactivity of other corporate officers [factor 6] with the evidence of substantial siphoning of funds [factor 5] provides evidence upon which the trial court, at least in part, based its decision." *Hunting*, 359 S.C. at 226, 597 S.E.2d at 808. In the second prong of the test, the Court found that injustice or fundamental unfairness would result if Elders were not held personally responsible based primarily on the finding that he siphoned off "substantial sums of money." 359 S.C. at 229, 597 S.E.2d at 809.

It is fair to ask what Elders should have done differently, besides reporting all income. What should any small business do when threatened with a massive tort judgment? Mr. Elders did not think the corporation was liable. Whether the drunk driver had ever been to Willie's Bar on the evening in question was hotly disputed in the first phase of the trial. Should he have "saved up" corporate funds in anticipation of a judgment? "'The primary inquiry of this Court is to ask whether, under the circumstances, reasonably prudent [individuals] with general business background would deem the company undercapitalized.''' *Trustees of the National Elevator Industry Pension v. Lutyk*, 332 F.3d 188, 197 (3rd Cir. 2003), affirming, 140 F.Supp.2d 447

(E.D.Pa. 2001). Must a small business quit paying its owner anything (even a reasonable salary for services rendered) and put all of its income in escrow whenever threatened with a tort judgment? Such a requirement would have serious financial consequences and should not be imposed without some deliberation.

If the *Hunting* case does stand for such an extreme proposition, an extreme counter measure would be in order. What if Elders had simply "froze" the corporation once the complaint was filed? He could have closed the bar, sold the real estate (which he owned outside of Elmyer Enterprises), and formed another corporation to operate a new bar at a new location. Under these circumstances, the plaintiff's recovery should be limited to the assets owned by Elmyer Enterprises at the time it was frozen. The corporation might have been undercapitalized in the eyes of the court, but Elders would have stood a better chance surviving a veil piercing challenge given the absence of the "siphoning of funds" factor. As occurred in the *Sturkie* case, the plaintiff in *Hunting* might not have been unable to pierce the veil because she might not have been able to satisfy the second prong of the test.

If there is any ready answer to the *Hunting* case, it is that the corporation should have purchased dram shop coverage. Such coverage, in a reasonable amount, would probably have forestalled any further inquiry into the corporation's capitalization and finances. At least it should have forestalled any further inquiry. Put another way, a properly capitalized close corporation is one with adequate funds on hand to pay its regular operating expenses including the cost of insurance against tort liabilities it can reasonably anticipate.

Conclusion — Advice for Business Lawyers

"The concept of distinct corporate entity has long served useful business purposes, [which includes] encouraging risktaking by individual investors . . ." *Valley Finance, Inc. v. United States*, 629 F.2d 162, 171 (D.C.Cir. 1980), cert. denied, 451 U.S. 1018 (1981).

When an entrepreneur forms a new legal entity, one of his or her principal goals is obtaining limited liability for the owners of the business venture. The judicially created doctrine of "piercing the corporate veil" is probably unknown to most small business owners. Owners often times end up with Articles filed with the Secretary of State and little else. It is not unusual for a business organized years ago to have a pre-packaged corporate kit with incomplete and unexecuted fill-in-the-blank forms inside the minute book.

> The granting of a charter by the State does not create a corporation. It is merely permissive. It authorizes the petitioners to organize, to create, and to bring into being the corporation which the State has authorized. It devolves upon the parties themselves to form the corporation by their acts, such as issuing stock, the holding of meetings of the stockholders and of the directors, the keeping of minutes, records and accounts, the passing of by-laws, and similar organizational functions. We are not attempting here to prescribe what acts of the parties are essential to the organization of a corporation, but we do say that the evidence in this case justifies the decision that the parties made no attempt to perform the usual acts attendant upon the formation of any corporation.

Parker Peanut Company v. Felder, 200 S.C. 203, 221-222, 20 S.E.2d 716, 723 (1942).

There are more limited liability companies being formed today than corporations. The two-prong test for piercing a corporate veil will presumably be applied to limited liability companies. In that eventual analysis, a limited liability company should enjoy the same status as a statutory close corporation given their similarities. The Comment to Section 33-44-408, for example, states: "Recognizing the informality of many limited liability companies, subsection (a) does not require a company to maintain any records."

Business owners should consider taking several steps, especially if they are concerned about asset protection. Adopting and operating as a statutory close corporation status or a limited liability company will diminish the importance of failure to observe corporate formalities, nonfunctioning of other officers or other directors, and the absence of corporate records. These three factors appear to be closely related. *Hunting* specifically states that undercapitalization, siphoning of funds, and whether the corporation is a facade for its dominant shareholder are closely related. To counter these factors and stave off application of the second prong of the test, business owners should maintain adequate insurance and reserves based on their industry. The business may be a member of an association that has guidelines or studies as to what working capital or reserves are normal for its industry. Adopting S corporation tax status or partnership tax status will lessen the importance of making dividends or distributions.

In addition to seeing that it is properly formed, business lawyers should consider providing guidance to their clients on the application of the veil piercing doctrine. Lawyers may want to develop a standard letter with recommendations, for example: "you must respect the separate legal existence of your corporation if you expect a court to do likewise;" "do not commingle corporate funds with those of other legal entities or that of a shareholder;" "maintain adequate insurance and a reasonable amount of capital in the business based on your industry;" "do not pay any personal bills of a shareholder out of the corporate bank account;" "maintain adequate business records including records of income, expenses, sales, inventory, and profit and loss statements;" "prepare minutes of meetings or owner consents to document major decisions such as electing officers, declaring dividends, taking out a loan and buying real estate;" "in the event a lawsuit or major claim arises, cease distributing money to yourself or for your benefit in any form (including salary) until you have consulted with this office."

Based on the holding in *Hunting*, lawyers should consider advising a risk adverse client to elect to be a statutory close corporation for corporate law purposes and a subchapter S corporation for tax law purposes. Most small newly formed close corporations elect to be S corporations, but probably a significantly lesser number elect statutory close corporation status.

If a business owner is looking for some "rule of thumb" advice, it would be to (1) buy substantial insurance; (2) operate the business in a limited liability vehicle, keeping personal matters separate; and (3) contribute and maintain an adequate amount of working capital. Advise the client to put some capital at risk, rather than put everything he or she owns at risk by opening the door to a pierce the veil argument.