

ARE YOU PERSONALLY INSULATED FROM LIABILITY AFTER CREATING A CORPORATE ENTITY?

I. INTRODUCTION

Utilizing the corporate form to operate a formally organized business provides a multitude of benefits. Many of these benefits vary depending upon the type of corporate form selected (i.e. corporation, partnership, limited liability company, etc.). However, regardless of the type of legal entity selected, one of the invariable benefits of operating as a company is the aversion of personal financial risk. Simply, legally formed businesses operate and exist as distinct entities separate and apart from the owner's personal life. Financial and legal obligations are incurred by the company and not the individual owner. This safe haven is often referred to as the "corporate privilege." The concept that a corporation is separate from its shareholders is fundamental to business entity law.

Insulation from personal liability is not absolute. If the corporate privilege is abused, the corporate veil may be "pierced" to hold individuals liable for the obligations and liabilities of their companies when the company form is used to achieve an unjust result. The two most common theories for piercing the corporate veil are the alter ego theory and the single business enterprise theory. The alter ego theory is often alleged when the owner(s) of the company disregard the corporate entity resulting in a unity of identity between the owner(s) and the company, itself. In these instances, because the principals have disregarded the subject entity, courts will not allow them to hide behind the entity to avoid company obligations. The single business enterprise theory is most commonly asserted when multiple corporations have integrated resources to pursue a common business purpose and incurred obligations in the name of the subject entity in pursuit of a common purpose. When corporations integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for the debts incurred by the other component entities in pursuit of that business purpose. Courts have held these theories are "separate and distinct," although they share the common purpose of finding "a means of imposing liability where none would otherwise exist."¹

II. ALTER EGO

The alter ego theory is used to pierce the corporate veil when there is unity of identity between a person and a corporation so that the separateness of the

¹ *Aluminum Chemicals (Bolivia), Inc. v. Bechtel Corp.*, 28 S.W.3d 64, 68 (Tex.App.–Texarkana 2000, *no pet.*).

corporation has ceased and holding only the corporation liable would result in injustice.

a. Proving Alter Ego

Alter ego is shown from the total dealings of the corporation and the individual and to prove a claim under this theory, a complainant must show there is such unity that the separateness of the corporation and another corporation or individual has ceased.² Additionally, the claimant must show that holding *only* the corporation liable, rather than *both* the corporation and individual or other corporation, would create an injustice.³ The claimant must also show the defendant has some stake in the corporation, be it in ownership, financial interest, or control.⁴ Lastly, the claimant must prove fraud.⁵ The fraud must be actual with a contract claim, and constructive with a negligence claim.⁶ Constructive fraud can be demonstrated by simply showing a transaction “is so grossly unfair as to amount to constructive fraud.”⁷

b. Factors in Determining Alter Ego

There are a number of factors a court examines to determine whether a corporation is serving as an alter ego for an individual or another company. Courts have considered the following in their examination of alter egos: (1) corporate and individual property have not been kept separately; (2) corporation transfers money to personal bank account from corporate account; (3) commingling of personal funds of the individual with the corporation; (4) no distinguishing between personal and corporate property; (5) corporate funds used to pay person expenses without correct accounting; (6) personal loans to individual are not repaid and/or not listed as account receivable; (7) property usually considered personal is purchased by the corporation for individual’s personal use; (8) corporation does not file tax returns, issue stock, enter into contracts or hold property titles in corporation’s name; (9) corporation uses same employees, same duties, same offices, and same name on door after corporation receives transfer of assets; (10) pattern of informal decision making to best serve

² See *Lifshutz v. Lifshutz*, 61 S.W.3d 511, 516 (Tex.App.–San Antonio 2001, *pet denied*).

³ *Id.* at 516.

⁴ See *Stewart & Stevenson Servs., Inc. v. Serv-Tech, Inc.*, 879 S.W.2d 89, 108 (Tex.App.–Houston [14th Dist.] 1994, *writ denied*).

⁵ See *North Amer. Van Lines, Inc. v. Emmons*, 50S.W.3d 103, 119 (Tex.App.–Beaumont 2001, *pet. denied*).

⁶ *Western Horizontal Drilling, Inc. v. Jonnet Energy Corp.*, 11 F.3d 65, 68 (5th Cir. 1994).

⁷ *Castleberry v. Branscum*, 721 S.W.2d 270, 273 (Tex. 1986).

the convenience of the owners. Each individual case requires the balancing of the equities to determine whether the corporate veil should be pierced.⁸

III. SINGLE BUSINESS ENTERPRISE

Single business enterprise imposes liability on one business for the actions of another business when the corporations are not operated as separate entities, but rather, those corporations integrate their resources to achieve a common business purpose. Single business enterprise is an equitable remedy when the corporate form is used as part of an unfair device to achieve an inequitable result.

The single business enterprise theory is a muddled area of law. The Texas Supreme Court has not decided whether the theory of single business enterprise is a necessary addition to Texas law. Several Texas appellate courts have, however, recognized the single business enterprise theory as a method of piercing the corporate veil. Other states generally decline to create liability under a theory similar to single business enterprise. Only three states—Texas, Louisiana, and Indiana—recognize single business enterprise as a theory of liability.⁹ In Louisiana, the Louisiana Supreme Court requires a showing of fraud and a wholesale disregard of corporate formalities.¹⁰ In Indiana, the court of appeals has recognized single business enterprise, but similar to Texas, the Indiana Supreme Court has never approved the theory.¹¹

a. Proving Single Business Enterprise

To pierce the corporate veil under the single business enterprise theory, the claimant must prove the corporations were not acting as two separate and distinct entities. The claimant must show the corporations combined their resources to achieve a common business goal, and sustained the subject obligation in reaching the common goal.¹² Courts look to a variety of factors in determining whether separate corporations should be treated as one business.

⁸ See *Torregrossa v. Szalc*, 603 S.W.2d 803 (Tex. 1980).

⁹ See generally Marilyn Monsanto, Comment, *The Single Business Enterprise Theory in Texas: A Singularly Bad Idea?*, 55 BAYLOR L. REV. 1163, 1173–77 (2003) (identifying only three states—Texas, Louisiana, and Indiana—where single business enterprise theory is recognized).

¹⁰ See *Riggins v. Dixie Shoring Co.*, 590 So.2d 1164, 1168 (La. 1991).

¹¹ See *Oliver v. Pinnacle Homes, Inc.*, 769 N.E.2d 1188, 1191–92 (Ind. Ct. App. 2002); *Smith v. McLeod Distrib., Inc.*, 744 N.E.2d 459, 462–63 (Ind. Ct. App. 2000).

¹² See *National Plan Admin., Inc. v. Nat'l Health Ins. Co.*, 150 S.W.3d 718, 714 (Tex.App.–Austin 2004, *pet. filed* Feb. 2, 2005).

b. Factors in determining a Single Business Enterprise

All courts of appeals considering the theory hold consistently that at trial, single business enterprise theory is a fact question for the jury, which can be weighed however the fact-finder desires. The various courts of appeals are inconsistent, however, in the factors to apply or the weight to give any particular factor, including whether fraud is required.¹³ Factors recognized by various courts of appeals include some subset of the following: (1) common employees; (2) common offices; (3) common business name; (4) centralized accounting; (5) payment of wages by one corporation to another corporation's employees; (6) services rendered by the employees of one corporation on behalf of another corporation; (7) undocumented transfers of funds between corporations; (8) unclear allocation of profits and losses between corporations; (9) common record keeping; (10) common officers; (11) same shareholders; (12) same phone number; (13) using one company's letterhead for correspondence relating to another company; and (14) creating ambiguities as to which company is represented by a company officer in a transaction.¹⁴

Many of the factors considered by the courts of appeals are present in many affiliated corporations, making the longstanding rule of corporate separateness almost illusory. In addition, the vagueness of the above factors leaves defendants without sufficient guidance to avoid liability.

c. Is Fraud Required to Establish the Single Business Enterprise Theory?

Article 2.21 of the Texas Business Corporation Act is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds, owns, or subscribes to shares of a corporation, or any affiliate thereof.¹⁵

Article 2.21 of the Texas Business Corporations Act provides:

¹³ See *infra* Section re: Fraud.

¹⁴ See e.g., *Olympic Fin. Ltd. v. Consumer Credit Corp.*, 9 F. Supp.2d 726, 728 (S.D. Tex. 1998); *El Puerto De Liverpool, S.A. De C.V. v. Servi Mundo Llantero S.A. De C.V.*, 82 S.W.3d 622, 637 (Tex. App.—Corpus Christi 2002, pet. dism'd w.o.j.); *Beneficial Pers. Servs. of Tex., Inc. v. Rey*, 927 S.W.2d 157, 166 (Tex. App.—El Paso 1996), writ ref'd w.r.m., 938 S.W.2d 717 (Tex. 1997); *Paramount Petroleum Corp. v. Taylor Rental Ctr.*, 712 S.W.2d 534, 536 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

¹⁵ See *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74, 87 (Tex. 2003).

A corporate owner or affiliate is not liable for “any contractual obligation of the corporation *or any matter relating to or arising from the obligation* on the basis that the holder, owner, subscriber, or affiliate is or was the alter ego of the corporation, or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud, *or other similar theory*,” unless the owner or affiliate perpetuated an actual fraud on the corporation’s obligee “for the direct personal benefit of the holder, owner, subscriber, or affiliate.”¹⁶

Under Article 2.21 a corporate owner or affiliate can be held liable for any contractual obligation of the corporation *or any matter relating to or arising from the contractual obligation* on the basis of alter ego or other similar theory of liability.¹⁷ “To reinforce the legislative policy of limiting shareholder liability for contractual obligations except under specific circumstances involving intentional fraud, Subsection (2) of Section A was amended in 1991 to specifically state that the provisions of Article 2.21 did apply to alter ego theory as well as ‘any other similar theory.’”¹⁸ Thus, a showing of actual fraud should be required before liability may be imposed.

Only two courts of appeals have actually applied the statutorily defined showing of fraud when alleging liability based on single business enterprise. For example, the 4th Court of Appeals in San Antonio¹⁹ and the 6th Court of Appeals in Texarkana²⁰ require a showing of actual fraud to impose liability via single business enterprise. All other courts of appeals have either affirmatively rejected the use of fraud or have not opined about its application.

The federal district court for the Northern District of Texas, when interpreting Texas law, held in *NorDar Holdings v. Western Securities* that single business enterprise theory fit within the requirements of Article 2.21.²¹ The court held that the statute, when including the phrase “other similar theory,” allowed for the inclusion of single business enterprise under Article 2.21.²² Single business

¹⁶ TEX. BUS. CORP. ACT. art. 2.21(A)(2) (Vernon 2003) (emphasis added).

¹⁷ See TEX. BUS. CORP. ACT. ANN. art 2.21 (A)(2), (B).

¹⁸ TEX. BUS. CORP. ACT. ANN. art 2.21, cmt.

¹⁹ See *Pharaon v. Fesco, Inc.*, 1999 Tex. App. LEXIS 4997, *3–4 (Tex. App.—San Antonio 1999, no pet.).

²⁰ See *Aluminum Chems., Inc. v. Bechtel Corp.*, 28 S.W.3d 64, 68 (Tex. App.—Texarkana 2000, no pet.).

²¹ *NorDar Holdings v. W. Sec.*, 969 F. Supp. 420, 423 (N.D. Tex 1997).

²² *Id.*

enterprise is another such similar theory of liability.²³ The court also relied on the bar committee's comments to the Texas Business Corporation Act when it stated the liability created by Article 2.21 is exclusive and preempts any other liability under common law or otherwise.²⁴

In *Southern Union Co. v. City of Edinburg* when reversing the 13th Court of Appeals, the Texas Supreme Court appears to follow the reasoning of the federal court in *NorDar* when it stated it need not decide whether single business enterprise is a recognized theory of liability in Texas because the 13th Court of Appeals, regardless of what theory it relied on for liability, improperly failed to include the requirements of Article 2.21 of the Business Corporations Act in the jury instruction.²⁵ This statement by the Supreme Court is an important indication that, at least as that time, the Court was leaning towards requiring a showing of actual fraud for single business enterprise theory of liability based on Article 2.21.

Cases Recently Decided on Appeal to Texas Supreme Court:

Recently, the Texas Supreme Court considered two cases²⁶ through which it could have finally approved of or declined to apply the single business enterprise theory. However, the Court sidestepped the issue, and ruled on each case on other grounds.²⁷

In *PHC-Minden v. Kimberly-Clark*, appellants attempted to create jurisdiction based on single business enterprise theory in order to use the contacts of the affiliated company to create minimum contacts with Texas for the primary defendant. The appellate court examined eight factors that could be used to determine whether two businesses are operating as a single business enterprise, such as common employees and a common name. However, the Court held the appellate court's analysis was flawed because "veil piercing for purposes of liability ('substantive veil piercing') is distinct from imputing one entity's contacts

²³ *Id.*

²⁴ *Id.*; see also TEX. BUS. CORP. ACT. art. 2.21, cmt.

²⁵ *S. Union Co.*, 129 S.W.3d at 87.

²⁶ See *PHC-Minden L.P. v. Kimberly-Clark Corp.*, 202 S.W.3d 193 (Tex. App.—Tyler 2005, pet. granted); *Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, 150 S.W.3d 718 (Tex. App.—Austin, 2004, pet. granted).

²⁷ See *PCH-Minden L.P. v. Kimberly-Clark Corp.*, No. 05-0823, 2007 Tex. LEXIS 796 (Tex. Aug. 31, 2007); see also *Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, No. 05-0006, 2007 Tex. LEXIS 928 (Tex. Sept. 28, 2007).

to another for jurisdiction purposes ('jurisdictional veil piercing')."²⁸ The standard for piercing the jurisdictional veil is much higher, for the plaintiff must show that the parent controls the internal business operations and affairs of the subsidiary, and the degree of control the parent exercises "must be greater than that normally associated with common ownership and directorship."²⁹ In this case, the Court found the appellate court's analysis on the single business theory "irrelevant" for jurisdictional purposes, and held that the sort of control necessary for jurisdiction purposes was not met.³⁰

The Court sidestepped the single business enterprise theory again in *National Plan Administrators v. National Health Insurance*, as it decided the case on other grounds and not on whether single business enterprise can be used to pierce the corporate veil. The Court held, "[w]e do not reach the question of, and express no opinion on, whether the single-business enterprise theory is a viable doctrine to pierce the corporate veil."³¹

IV. CONTRACT VS. TORT CLAIMS

Piercing the corporate veil is treated differently in tort claims than in contract claims.³² With tort claims, courts are more likely to pierce the corporate veil because tort claimants are involuntary victims of their tortfeasors. If a business is involved in a high-risk operation and causes harm to others, this harm should not be transferred to an innocent claimant.³³ Once harm is caused, the shareholders should be held responsible for the risk.

Contract claims, however, involve two or more parties who voluntarily choose to work with each other. One party can research the other party to decide whether or not it wants to deal with the other, based on aspects such as financial

²⁸ See *PCH-Minden L.P. v. Kimberly-Clark Corp*, No. 05-0823, 2007 Tex. LEXIS 796, at *26 (Tex. Aug. 31, 2007).

²⁹ *Id.* at 30-31 (citing *BMC Software Belg., N.V. v. Marchand*, 83 S.W.3d 789, 799 (Tex. 2002)).

³⁰ *Id.* at 33.

³¹ See *Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co.*, No. 05-0006, 2007 Tex. LEXIS 928, at *22 (Tex. Sept. 28, 2007).

³² See *Lucas v. Tex. Indus. Inc.*, 696 S.W.2d 372, 375 (Tex. 1984) ("Courts have generally been less reluctant to disregard the corporate entity in tort cases than breach in contract cases."); See also *Hickman v. Rawls*, 638 S.W.2d 100, 102 (Tex.App.-Dallas, 1982, writ ref'd n.r.e.) ("the overriding public policy necessary to disregard the corporate entity must be more stringent in contract cases than in tort cases.").

³³ See *Lucas*, 696 S.W.2d at 375.

capabilities. Contractual claimants have the ability to protect themselves against future harm and losses through the negotiating process, while negligence claimants cannot.

Given the foregoing perspective on tort v. contract claims, constructive fraud does not justify the piercing of the corporate veil when the matter in dispute is a contractual obligation. If the underlying claim is based on or relates to the contractual obligations of the corporation, the corporate veil may be pierced if the defendant perpetrated *actual* fraud primarily for the defendant's direct and personal benefit. If the claim is based on or relates to a tort committed by the corporation, the fraud requirement may be satisfied by proving *constructive* fraud.

SUMMARY

The ability of courts to pierce the corporate veil shows the importance of following corporate formalities after creating a corporate entity. These formalities include, but are not limited to:

- Maintaining appropriate capital
- Signing in the appropriate capacity
- Treat as a separate entity
- Maintain proper licenses and submit proper reports
- Making informed decisions that benefit the entity
- Recognizing a fiduciary duty