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Legal Environment of Business LGLS 1101

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## Legal Environment of Business Research Paper

### Piercing the Corporate Veil

#### **Statement of Facts**

The case in question deals with the claims of piercing the corporate veil and breach of duty of care. The defendant, Ted Mosby, after being fired from his previous job, decided to form his own architecture and civil engineering firm called Mosby Buildings and Design Inc. After receiving advice from an attorney, Marshall Eriksen, he decided to set up the business as a corporation to “protect himself and his personal assets” in case the business failed. There is a board of five directors or shareholders who individually own 10% of the company and invested \$2,000 for start-up costs. Ted owns 60% of the company and invested \$12,000. The corporation has two employees, Ted and his personal secretary. Ted did not work to separate his personal assets from the company’s assets: the office space utilized is Ted’s apartment and the company’s expenses and revenue are intermingled with his personal expenses because he used his personal checking account as the company’s bank account. In addition, Ted purchased the minimum business insurance required by state law to cover Mosby Buildings and Design Inc. The first project he undertook for the new company was the design of new headquarters for Goliath National Bank (GNB). Ted is required by corporation bylaws to conduct a meeting with the board of directors before each new business venture. At the meeting, held at a bar, Ted presented the potential design for the building with a 10 minute PowerPoint presentation. Only one of the directors

briefly challenged his ideas in which he reassured her that he knew what he was doing. The rest of the directors were preoccupied and hardly had any education or expertise about architecture to challenge him. Regrettably, one of the support beams collapsed during the construction of the building and the top two floors collapsed. Scooter, a construction worker, was “severely injured” and required \$250,000 worth of surgery. Due to this misfortune, Mosby Buildings and Design Inc. went bankrupt. Scooter is now personally suing Ted for damages because his minimum business insurance does not cover his injury and he believes Ted is personally liable for the accident. The argument of the plaintiff, Scooter, is that Ted is personally liable. He asking the court to identify the case as a “veil piercing claim,” disregard the corporation as a separate legal body, and require Ted’s private finances to pay for his hospital bill and other associated damages. The argument of Ted, the defendant, is that he is not personally liable for the damages and solely the corporation and the insurance of the corporation should be held responsible if the accident is proven to be a flawed design. The questions before the court include: Is Mosby Buildings and Design Inc. liable for Scooters injuries? Does Scooter have a legal privilege against Ted under the conditions of “veil piercing”? Are Ted’s personal assets susceptible to Scooter’s lawsuit under “veil piercing”? Should the case be settled or fought in court?

### **Prior Law**

There are two claims that work to govern this case: piercing the corporate veil and breach of duty of care. Breach of duty of care refers to negligence from one party that owed a duty of care to the other and by not offering that care; the defendant breached that duty and should be held liable (Hodge 158). For example, Ted owed Scooter a duty to create a design for the building that was safe and reasonable and he breached that duty which led to Scooter’s injury. “Piercing the corporate veil” is legal jargon that refers to holding the corporation and directors equally liable.

The definition set forth by Harvey Gelb says that piercing the corporate veil happens when the legal entity attempts to “defeat public convenience, justify wrong, protect fraud, or defend crime.” The courts enlisted the help of this doctrine to avert fraud and attain equity. Specific factors that lead to piercing the corporate veil include undercapitalization, failure to conduct proper business practices, and not paying debts (Gelb). In the case aforementioned, Ted is arguing that his corporation should be treated as a separate legal entity and the corporation is responsible for debts and expenses unsettled but when the veil is pierced, the owner, officer, or director of the company is held responsible. Every case sets precedent for the definition of “veil piercing” in which different measures or terms are added or retracted. According to *Radaszewski v. Telecom Corp.*, the Telecom Corporation was being held liable for the conduct of their employee of their subordinate corporation, Contrux Inc. Radaszewski was struck by a motorcycle and the court is trying the liability of the driver and the corporation who owns the business that employs that driver for recovery. To prove if there was “veil piercing” in this case, they utilized the Collet Test which has three requirements, and if these are met then the defendant would be held liable. Primarily, control of finances, policy, and business practices are merged with personal finances. In this case, Ted’s conduct merits liability for the incident because the person and the corporation have no “separate mind.” Secondly, the control of finances must have been used to commit fraud, violate legal duty, or unfair acts in infringement of the rights of the plaintiff. Finally, the control and breach of duty must be the cause of the injury or loss (*Radaszewski v. Telecom Corp.* 981 F.2d 305 (8th Cir.)). After reviewing *Radaszewski v. Telecom Corp.*, a case is defined as “piercing the corporate veil” when the party has complete financial control over and company and subsequently abuses that control and commits a breach of business policy. The second case that was precedent for Ted’s “piercing the

corporate veil” question was a car accident by a taxi cab. The court was deciding if the corporation that owned the taxi company was liable for the damages. According to *Walkovsky v. Carlton*, veil piercing can also be a product of negligence. The defendant in this case was a stockholder of 10 corporations and, similar to Ted, had only the “minimum automobile liability insurance required by law” worth \$10,000. Also similar to Ted’s corporation, the corporations he owns are each considered a single entity (*Walkovsky v. Carlton* 18 N.Y.2d 414 (Ct of Appeals NY)). Whenever anyone uses control of the corporation to further his personal benefit than that of the corporation’s business, he will be liable for the corporation’s acts. (*Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 95, 155 N.E. 58, 61, 50 A.L.R. 599.). This case is similar to Ted’s because he utilized the corporation’s profits for his personal expenditures. Comparably, according to Berle, *The Theory of Enterprise Entity*, 47 Col.L.Rev. 343, regardless of negligence, if the stockholder is running the corporation on strictly individual capabilities, he will be liable. However, in this case the Seon Cab Corporation was not conducting the business in his individual capacity yet the corporation was disjointed, intermingled with other accounts, undercapitalized, and negligently directed (*Weinstein-Korn-Miller*, N.Y. Civ.Prac., par. 3013.01 et seq., pp. 30—142 et seq.). Because Seon Cab Corporation’s assets and insurance does not cover the damages of the accident, there has to be a way to recover the injuries, and that is with personal assets of the stockholders (*Walkovsky v. Carlton* 18 N.Y.2d 414 (Ct of Appeals NY)). In addition, similar to Ted, the Seon Cab Corporation transferred personal assets in and out of the company’s account to suit their “immediate convenience” and personal benefits (*Weisser v. Mursam Shoe Corp.*, 2 Cir., 127 F.2d 344, 345, 145 A.L.R. 467, supra.). Thus, the definition of “piercing the corporate veil” in this case is to eliminate the prevalence of stockholder’s to shuttle out assets from their personal and corporate accounts for their opportuneness. The final case that utilized “piercing the

corporate veil involved a software program called C3. The corporation was Glazier Inc. and Glazier was the sole shareholder and independent contractor consultant. The case of Freeman v. Complex Computing Company was brought about when Glazier Inc. hired Freeman to do marketing work for them but did not pay him. Because the corporation did not have “assets beyond the license,” the case could potentially qualify as “piercing the corporate veil.” The qualifications for “piercing the corporate veil” have to include an “equitable owner,” like Ted who holds power over the business (Freeman v. Complex Computing Company 119.F.3d 1044 (2d Cir.)). Glazier had authority over the corporation and used the assets to manage and distribute on his own terms, similar to how Ted handled this assets (Lally, 603 N.Y.S.2d at 621). The corporation also had considerable “corporate independence” and “limited shareholder liability” since he was the sole shareholder (Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 139 (2d Cir.1991). Because the case occurred under New York Law, to “pierce the corporate veil” the plaintiff must prove that the owner used his corporation as an instrument and that the business dealings included fraud or other wrongdoing which can cause loss or injury to others (2 F.3d 24 (2d Cir.1993). Having control over the company alone isn’t enough to “pierce the corporate veil” there has to be some semblance of fraud or wrongdoing involved. “Complete control” of a corporation exists if there is a disrespect for regulations, undercapitalization, merging of personal and corporate funds, vague ownership and authority, shared office space of two separate entities, conducting business and pleasure simultaneously, treating corporation as an avenue for independent profit gain, and/or mixing property between two separate entities (Wm. Passalacqua Builders, 933 F.2d at 139). The court ruling in Freeman v. Complex Computing Company was a finding of innocence. Glazier did not engage in any of the former offenses against a corporation and only had “complete control” over his software

company (*Morris v. New York State Dep't of Taxation & Fin.*, 82 N.Y.2d 135, 603 N.Y.S.2d 807, 811, 623 N.E.2d 1157, 1161 (1993)). The inclusion of this case was helpful to understand which factors incriminate someone under the regulations of “piercing the corporate veil” and that it is not just fraudulence that can lead to a guilty verdict. In Ted’s case, there are five shareholders that invested in his company and there is a question if they should be held liable as well. David H. Barber defines a corporation as a “legal entity” that is distinct from its shareholders. He affirms that the responsibilities of the corporation should be in the hands of the corporate owner. The shareholders should be able to expect limited liability. Limited liability is that the shareholders are solely responsible for the monetary amount they invest in the business not a misconduct of business practices. If the limited liability incentive did not exist, investors would be discouraged to contribute capital to corporations. There are no cases in which the shareholders have been held liable in closely held corporations. Barber described that closely held corporations have two methods of financings: promoters who contribute their personal assets to the initial capital of the new corporation and, in Ted’s case, promoter-managers who contribute only a portion of the initial capital and raise the rest from shareholders who do not have the responsibility to manage the business. The purpose of Barber’s essay is to protect shareholders from being held personally liable if the veil is pierced because they are not actively involved in management and business practices (Barber). In legal actions, especially those involving negligence, the shareholders are “entitled to rely on information provided by the board or by individual directors and officers” which further upholds liability of the director and not the shareholder. The Company Investors Disqualification Act of 1986 extended upon the legal responsibility of the directors and officers of the corporation and Section 310 of the 1985 Companies Act removed any law that excuses a director of a company from liability due to

negligence, default, or breach of duty or breach of trust (Vann). Therefore, the law of “piercing the corporate veil,” is based on directors of a corporation who have complete control of the business, conduct fraudulent business practices, and intermingle personal and business assets. Also auditors and shareholders are provided with a considerable amount of protection through limited liability laws which shifts most of the liability to the director or owner of the company.

### **Analysis**

Ted should be held personally liable to Scooter for the accident because he did not operate the corporation according to proper business conduct. When the corporation was doing well, Ted used the corporation’s money to take women out on dates and enhance his social life, now that the corporation is not doing well; shouldn’t Ted be personally liable for the money damages that are incurred? Using corporate money for personal gain is an offense that merits punishment. He even used his own personal bank account as the company’s bank account, so there was no separation of business and pleasure in the finances. In addition, similar to the case of *Radaszewski v. Telecom Corp*, he had no “separate mind” between his personal finances and the company’s finances. Even though undercapitalization was not a factor and Ted had every intention to pay the bills for his corporation and had sufficient funds originally to do so, he violated the improper conduct element of the Collet test by using corporate funds to fund personal ventures and if any factors of the Collet test are violated, the case should be upheld as “piercing the corporate veil.” (*Radaszewski v. Telecom Corp*. 981 F.2d 305 (8th Cir.)). Moreover, Ted was negligent in the design of the building. Negligence was a large factor in the case of *Walkovsky v. Carlton*. The defendant in this case was negligently driving and held liable so Ted’s negligent design should follow suit. There are many similarities between the Seon Cab Corporation and Mosby Building and Design Inc. as well. Both corporations were to be

considered separate entities and only had the minimum business liability insurance required by law, which is negligent when Ted is constructing buildings which is a potentially very dangerous process. Ted is also negligent in conducting his business for individual capacity (*Walkovsky v. Carlton* 18 N.Y.2d 414 (Ct of Appeals NY)). Personal liability is the only logical choice in this case. The shareholders are not at fault for making a faulty design or carelessly spending corporate profits and besides Ted's secretary he is the only employee. The minimum insurance policy and assets of the design company, because it is bankrupt, do not cover Scooter's injuries so the only way Scooter can be compensated is with personal funds from Ted. Ted's actions are what caused the mishap so the only conceivable option is that he should be held liable.

According to the *Freeman v. Complex Computing Company*, having considerable control over the corporation and conducting dishonest business practices merits a veil piercing case. Ted exercised all the authority over his business and spent the assets as he saw fit. He also had full independence in drafting, design, and execution and his shareholders had limited say. Even though he presented a ten minute PowerPoint to the shareholders they were preoccupied and posed limited resistance to his plans because they know nothing about architecture. Ted's corporation had become his instrument as well: he siphoned money for his own personal use. He did not intentionally commit fraud to hurt Scooter but improper planning and unsafe architectural design led to the injury. Complete authority of company practices satisfies the equitable owner and control factors of the *Freeman v. Complex Computing Company* case which set the precedent. However, the case said that just having complete control over the company was not enough to merit it as a veil piercing case, dishonest business practices had to be conducted which Ted is also guilty of in his management of Mosby Buildings and Design Inc. He had "disregard of corporate formalities; inadequate capitalization; intermingling of funds;... common office



space...of corporate entities; ...whether the corporations are treated as independent profit centers” (Freeman v. Complex Computing Company 119.F.3d 1044 (2d Cir.)). His business tactics violated at least five of the factors due to his unprofessional treatment of the money and using his own personal apartment as his office. Ted dominated and controlled his corporation in a fraudulent way in addition to conducting an unjust act toward the plaintiff through his unsafe design. Based on all three cases, Ted should be found guilty of veil piercing. The shareholders should not be held liable because they have protection of limited liability. According to David H. Barber, only those “actively involved in managing the corporation will be held personally liable” (Barber). Finally, the shareholders are supposed to trust the information they are given by Ted since he is the one who has professional experience and education with draft and design (Vann). Although the auditors should have challenged his design and asked more questions, they are not obligated or legally bound to do so. Ted’s business conduct was negligent; he breached his duty to the construction workers who expected a considerable amount of safety of the structure Ted designed. His negligence and financial carelessness justifies this case as “piercing the corporate veil” and Ted should be held personally liable for his misconduct.

### **Advice**

I believe that the outcome of the lawsuit will be a guilty verdict in terms of “piercing the corporate veil.” Scooter will receive monetary damages from Ted because he should be held personally liable. The case should be taken to court because Scooter deserves reparations for his injury.

### **Works Cited**

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