

Can the Corporate Veil Be Pierced?

Protection from Liability is Not Absolute

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There are several possible reasons why you might incorporate a business. One of the main advantages unrelated to taxes is the protection of the “corporate veil” (also known as the “corporate shield”). Under this basic principle of law, a business owner cannot be held personally liable for the debts and obligations of the corporation. Nevertheless, be aware that the corporate shield is far from invincible.

Background: A corporation is separate and distinct from its individual shareholders. Although they are not corporations, this distinction also applies to limited liability companies (LLCs), whose owners are “members,” and limited liability partnerships (LLPs), whose owners are “partners”, but not general partnerships or self-employed operations. As a result, corporate shareholders (or LLC/LLP owners) are not legally required to “make good” on the corporation’s debts when creditors come calling.

However, in certain situations, a court may still hold officers, directors and shareholders (or owners) personally liable for debts. This is often referred to as “piercing the corporate veil.” It happens more often to owners of small, closely held businesses than it does to officers of Fortune 500 companies.

When the corporate veil is pierced, creditors can pursue your personal assets—such as your home, bank accounts and investments—to satisfy the corporate debt. But courts will impose personal liability on individuals only in limited circumstances.

For example, the appropriate court may consider the following factors in determining whether or not to pierce the corporate veil:

- If the corporation (or LLC/LLP) engaged in fraudulent behavior
- If the corporation (or LLC/LLP) failed to comply with corporate formalities
- If the corporation (or LLC/LLP) is inadequately capitalized (i.e., it never had enough funds to operate as a separate entity that could stand on its own)
- If one person, or a small group of closely related people, is in complete control of the corporation (or LLC/LLP)

Based on those factors, owners of closely held companies are more vulnerable to losing protection than are shareholders of large, publicly traded corporations. For instance, a small company may not observe

all the corporate formalities, such as recording minutes for significant business decisions. To be on the safe side, small corporations should hold annual meetings of directors and shareholders or members; keep accurate and detailed minutes of important decisions at meetings; adopt company bylaws; and make sure that officers and agents abide by those bylaws.

A small-business owner is also more likely to be guilty of commingling assets. For example, an owner might divert corporate assets for his or her own personal use by writing a check from the company account to pay the mortgage on a home or depositing a check made out to the corporation/LLC/LLP into a personal bank account.

Better approach: The corporation/LLC/LLP should maintain its own bank account, and the owner should not use the company account personally in any way, shape or form.

When a business owner handles things on the straight and narrow, a corporation can provide a formidable shield from personal liability should dire financial situations occur. But blurring the lines between your business and your personal affairs is only asking for trouble.

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