Reverse Piercing of the Corporate Veil

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You have a claim against an individual, or perhaps you have a judgment against the person, but you discover he/she has no assets except that the person is a shareholder in a separate corporation which does have assets. Can you go after the assets of the corporation for the liability or debt of that shareholder? Some states, such as New York, Virginia and Wisconsin, say that under the right circumstances you can “reverse pierce” the corporate veil and get at the corporation’s assets for the liability or debt of the shareholder.

The Corporate Veil

The law treats a corporation as a separate legal entity acting in the corporate name. This enables a corporation to conduct business, to manage its own affairs, to own assets and to exist perpetually, separate and distinct from its stockholders and officers. Generally, the courts strictly maintain the distinction between the corporation as a legal entity and separate personality, and the corporate shareholders, directors and officers. Thus, corporate stockholders, directors and officers typically are not liable for the acts, omissions or debts of the corporation in the absence of their own wrongdoing. Likewise, a corporation generally is not liable for the personal obligations, debts or liabilities of its shareholders, officers or directors solely because of their status as a corporate shareholder, officer or director. This shield against corporate or shareholder/officer/director liability for the acts/omissions of the other is commonly referred to as the protection of the “corporate veil.”

Piercing the Corporate Veil

The “corporate veil,” however, is not impervious under all circumstances to protect a corporate shareholder, officer or director from personal liability for the acts or debts of the corporation. For example, under the long-standing “alter-ego” doctrine, the separate corporate entity will be disregarded or “pierced” to impose liability on shareholders for the acts or debts of the corporation when the corporation is found to be the “alter-ego” of its shareholder(s). Traditionally, the courts have disregarded the corporate veil when the corporation operated as a mere instrumentality or agent of its owner or parent corporation, or was a shell corporation dominated and controlled by its parent. In those situations, the courts have held the parent corporation or shareholder owner liable for the dominated corporation’s acts or debts. Note, however, the courts will not lightly disregard the corporate veil. The courts look for exceptional circumstances, such as whether the corporation was undercapitalized, commingling of funds of the corporation and the parent company or shareholder, whether the dominant shareholder siphoned corporate funds, whether the corporate books and formalities were maintained, whether the shareholder treated the corporation’s assets as his/her own and whether the corporation was insolvent at the time of the actions or debts. Even when given the presence of “alter-ego” circumstances, many courts will pierce the corporate veil only when necessary to promote justice.
Reverse Piercing of the Corporate Veil

In contrast to the traditional piercing of the corporate veil to reach the assets of a dominant owner or shareholder, suppose it is the reverse situation; that is, the individual defendant or debtor has few if any assets, but nonetheless may be a dominant owner or shareholder of a corporation in which he/she has deposited assets. Can you as a creditor or claimant reach those assets in the corporation to satisfy your claims against such a corporate “insider”? The answer can be yes, with the recently developing theory of “reverse-piercing” of the corporate veil.

In essence, the principle of “reverse-piercing,” sometimes also called “outsider reverse piercing,” simply holds that the same circumstances that would justify traditional piercing of the corporate veil to get at the assets of a dominant shareholder or owner are equally applicable so as to reach the assets of an “alter-ego” corporation to satisfy the obligations or debts of the dominant shareholder or owner.

In a recent decision, a federal court in Virginia held that Virginia law recognizes a cause of action for “reverse-piercing” of the corporate veil. This decision is in line with recent trends in other courts. In C.F. Trust, Inc. v. First Flight Limited Partnership, et al., No. Civ. A. 99-1742-A, 2000 WL 1262448 (E.D. Va. Aug. 31, 2000), two judgment creditors sought to collect on judgments totaling $7.3 million against an individual debtor and the corporate entities alleged to be the individual’s “alter-egos.” The court held that the creditors could “reverse-pierce” the corporate veil in order to reach the assets the debtor allegedly hid within his various corporations. The court stated that because Virginia law permits an “alter-ego” corporate entity and the dominant owner to be treated as a single person under the traditional corporate veil piercing doctrine, the creditors could reach the assets of the “alter-ego” corporations in order to satisfy their judgments against the individual debtor-shareholder, i.e. “reverse-piercing” of the corporate veil.

The federal court based its ruling on a 1998 Virginia state court decision which prevented a husband from avoiding his obligations under a divorce decree by hiding his assets in various partnerships and corporations. In that case the state court approved the piercing of the veil of “limited partnerships, trust and corporations” so as to permit the spouse to reach the assets of each of these entities to satisfy the terms of a divorce decree. Fox v. Fox, 1998 WL 114010 (Va. App. 1998). The federal court also reasoned that the law’s recognition of the separate legal existence of a corporation is for the purpose of promoting economic growth; when this form is abused, the court may disregard the fiction.

Although still the minority view, “reverse-piercing” has been adopted in other courts in various states. In 1992, a New York court for the first time held that piercing the corporate veil “in reverse” was permissible. The judge held two corporations liable for the $9.3 million debt of their president in a major Medicaid fraud case. In Minnesota, a trial court denied corporate shareholders an exemption for a farm homestead because title of the farm was held in the corporate name. Applying the doctrine of reverse piercing, the court looked at (1) the degree of identity between the shareholder and the corporation, (2) public policy and (3) whether a pierce would harm others. In 1996, the Court of Appeals of Wisconsin affirmed a lower court ruling
that “reverse-piercing” of the corporate veil was permissible. In the Wisconsin case, a client had sued an accounting firm and its sole shareholder and director to recover funds invested on his behalf. The plaintiff-client alleged, among other things, that the corporation’s owners fraudulently conveyed the office building to their daughter in order to avoid payments to the creditor. The Wisconsin court held that “reverse-piercing” of the corporate veil was justified based on an “alter-ego” theory. The court noted that it is particularly appropriate to apply the “alter-ego” doctrine in “reverse” when the controlling party uses the controlled corporate entity to hide assets or secretly to conduct business to avoid the pre-existing liability of the controlling party. *Id.*

There are, however, strong critics of “reverse-piercing.” Some fear that recent decisions permitting “reverse-piercing” will hinder commercialism. Others contend that the growing acceptance of “reverse-piercing” will threaten investors’ expectations that their corporations (and consequently, their investments) will be free from liability for claims against corporate insiders. Such reduced expectations could reduce the usefulness of the corporate form as a vehicle for raising and deploying capital. In *Floyd v. Internal Revenue Service*, 151 F.3d 1295 (10th Cir. 1998), the court refused to accept the theory of reverse veil-piercing for the reasons that, first, the theory bypasses normal judgment-collection procedures, and, second, there is the possibility of unfair prejudice to third parties, such as third party shareholders.

In response to such criticisms, other writers (and courts) assert that once the requirements necessary to permit parties to disregard the separate legal existence of corporate entities are met, then the direction of the piercing is irrelevant. Traditional piercing of the corporate veil functions to avoid fraud and to promote equity; the same purpose is accomplished by “reverse-piercing.” The courts will not allow an individual to treat his corporation as a separate legal entity only when convenient. Equity will intervene to cast aside the legal fiction of independent corporate existence.

The best that can be said at this time is that while there is no majority consensus in the courts on the acceptance of “reverse-piercing,” it is a theory of growing use. This puts corporate planners in a difficult position as they are unable to predict accurately when the courts will apply the reverse veil piercing doctrine. Nonetheless, be forewarned, recent decisions such as that of the federal court in Virginia are likely to lead to increased allegations of “reverse-piercing” so as to reach corporate assets to satisfy the debts of dominant “insider” individuals. In order to better protect a corporation from “reverse-piercing,” corporations must ensure that assets and funds are kept separate and that there is no commingling. Moreover, corporate affairs must be organized, controlled and conducted so that the corporation has a legal existence distinct from its shareholders. In the end, corporations must keep in mind that “reverse-piercing” of the corporate veil is an equitable doctrine, and when corporate formalities and corporate identities are not maintained the courts may very well elect to use the “reverse-piercing” doctrine to promote justice.

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