Piercing the Limited Liability Veil:
The Application of the Corporate Veil Piercing Rules
to Limited Liability Entities

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Over the past few decades, smaller firms have formed as limited liability companies or partnerships to avoid the tax consequences and regulatory burdens of the corporate form. The shareholders and partners of limited liability companies and partnerships share the same limited liability as corporate shareholders, but they also receive flow-through tax treatment and increased flexibility in the operation of their firms. Most states now recognize these business organizations and have established laws specifically permitting and governing these limited liability entities.

With the rise of new business organization structures, such as the limited liability company and limited liability partnership, claimants have begun to bring veil piercing claims against subsidiaries, affiliated companies, shareholders, and partners of limited liability companies (LLCs) and limited liability partnerships (LLPs). This development has given rise to debate among legal scholars as to whether the line of jurisprudence permitting veil piercing in corporations should also be extended to limited liability companies and partnerships. However, the veil piercing, or alter ego theory has itself undergone various changes over the past century. As many expected, the courts, thus far, have not been sympathetic to smaller firms when the courts feel the members created a sham company in an attempt to prevent members or investors from being held liable in the event of the company’s insolvency.

Following the Enron, Worldcom, Tyco and other corporate scandals, corporate officers have been indicted and convicted of corporate fraud. Congress also passed the Sarbanes-Oxley Act (SOX), requiring corporate executives to certify financial statements and creating auditing regulations and restrictions. Partnerships such as Arthur Anderson and KPMG have also become targets of SEC and federal investigations, with the individual partners themselves facing scrutiny, possible jail time, and seizure of their personal assets.

The piercing of the limited liability veil hugely impacts professional liability insurers. The courts’ willingness to hold directors, officers, partners, and members of limited liability entities liable for the debts of their firms and/or the wrongful acts of the organization’s other partners and members indicates a greater likelihood that professional liability insurers will be called upon to pay more claims with potentially higher damages. Intentional act exclusions may have no effect on veil piercing claims if courts find the partners and members of limited liability entities liable simply due to partnership or membership status. The courts’ application of corporate veil piercing theories to limited liability companies and partnerships signifies that no partner or member is protected from liability solely because of the limited liability nature of the business entity.
A Brief Summary of the Veil Piercing/Alter Ego Doctrine

Since the commencement of the use of the corporate form in the business world, parties have utilized the corporate form to insulate other entities, stakeholders, members and shareholders from liability. A strong presumption exists for the separate nature of a corporation and its members, shareholders or related entities. “Limited liability is the rule not the exception.” Courts and legal scholars have characterized this limited liability as a corporate veil, which may be pierced only in exceptional circumstances.

Most courts have held that the corporate veil should be pierced if the plaintiff can prove that the member, shareholder or parent company exercised domination or control over the firm at issue, that fraud or abuse of the corporate form existed, and that this fraud or abuse gave rise to a tangible injury. Depending on the jurisdiction, courts have considered numerous factors in determining whether the corporate form should be disregarded, and whether the company at issue should be treated as the alter ego of the parent company, members or shareholders. None of these factors alone are sufficient to pierce the limited liability, corporate veil. With regard to whether the shareholders, members or parent companies dominated or controlled the company at issue, courts have weighed the following factors:

1) Whether the corporation has complied with corporate formalities the law has imposed upon it, including the maintenance of corporate records;

2) Whether the corporation was sufficiently capitalized, considering the nature of the business and the risks inherent to the business;

3) Whether inappropriate transactions or comingling of funds transpired between the company at issue and the shareholders, members, or related entities;

4) Whether overlaps existed in officers and directors; and

5) Other factors, such as the filing of consolidated tax returns or financial statements, the utilization of the same office for both companies’ corporate headquarters and whether the firm in question was solvent.

Ultimately, courts are more likely to pierce the corporate veil if an element of injustice or fundamental unfairness exists. Moreover, the courts are less likely to ignore the corporate form in a contract case versus a tort action.

The Veil Piercing Doctrine as Applied to LLPs and LLCs

With the growing popularity of limited liability partnerships and companies, more state legislatures and courts have been forced to address whether the shareholders, parent companies or

1 Escobedo v. BHM Health Assoc., Inc., 818 N.E.2d 930,933 (Ind. 2004).
members may be held liable in tort or contract for the obligations of LLPs and LLCs. Despite the statutes and cases addressing this issue, the question of whether the limited liability veil should be pierced varies from case to case and remains a fact intensive question.

**Statutes**

Most states have passed statutes allowing the creation of LLPs and LLCs and recognizing their limited liability. Yet, only some state legislatures have tried to specifically address flow-through liability for an LLP or LLC and have clarified whether they intended the limited liability exceptions in the corporate arena to apply to LLPs and LLCs.

Specifically, with regard to LLCs, some states, such as Wyoming, do not address whether the limited liability can be disregarded in certain circumstances. Other states, such as Wisconsin and Tennessee, hold individual members or shareholders of the LLCs liable for their own acts, but not for the acts and obligations of the entity or other partners or members. States following the Uniform Limited Liability Company Act §303, such as Mississippi and Oklahoma, absolve LLC members and managers from liability solely due to their positions in the company. Yet, some states, such as Texas, have passed statutes which attempt to prohibit the application of the veil piercing doctrine to LLCs. Section 101.114 of the Texas Business Organizations Code states:

> Except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.

However, statutes such as these have not withstood court scrutiny. As with corporations, courts have continued to disregard the company status in situations where the courts perceive an injustice would be committed in upholding the limited liability of the firm.

For LLPs, all states, with the exception of Louisiana, have adopted either the Revised Uniform Partnership Act (RUPA) or the Revised Uniform Limited Partnership Act (RULPA), limiting the liability of limited partners for the acts of their other partners and the obligations of the partnership. Similar to LLCs, states with statutes mimicking RUPA or RULPA refuse to hold partners liable for the negligence of other partners and have declined to extend a partner’s liability to the contractual debts of the firm.

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9 Revised Uniform Partnership Act, §306(c); Revised Uniform Limited Partnership Act, §303.
Further, RUPA, RULPA and the states applying their provisions prohibit partners from being held liable “solely by reason of being or acting as a partner.” The courts have also recognized veil piercing theories against limited partners in exceptional circumstances.

**Cases**

**LLCs**

Courts throughout the United States have continued to recognize causes of action against partners and members of limited liability entities, although they do not always find the partners and members liable for the debts and wrongdoings of the entity or a fellow member or partner. Generally, courts have applied veil piercing factors similar to corporate veil piercing theories. For example, in *Anderson, LLC v. Stewart*, 234 S.W.3d 295 (Ark. 2006), the Arkansas Supreme Court used the corporate veil-piercing rules to pierce the limited liability veil of an LLC, holding the owners liable to the plaintiff. The court stated:

The evidence demonstrated that Check Mart and its owners failed to properly maintain business records, thereby failing to comply with the Check Casher’s Act. In addition, Stout [owner manager] withdrew Check Mart’s letters of credit and canceled the bond Check Mart had posted shortly after this lawsuit was filed, an act which Stewart contends was designed to ensure that Check Mart would not have the appropriate assets to satisfy any judgment that might be entered against the company. Further, Sharon Harper’s testimony revealed that, even after Check Mart closed, the same individuals were operating the same kind of business in the form of D&L Service Company.

*Anderson LLC v. Stewart*, 234 S.W.2d at 211-212.

Similarly, in a recent case out of Connecticut, *Tzvolos v. Wiseman*, 2007 WL 1532760 (Conn. Super. 2007), the court held that the firms’ failure to distinguish themselves as separate entities warranted the piercing of LLC and corporate veils. The court opined that its decision was supported by evidence of the firms’ common office space, overlaps in ownership and management, lack of separate corporate formalities, lack of independence from one another, and an absence of arms length dealings, in addition to other evidence.

Courts have even disregarded the wording of state statutes suggesting that the limited liability of LLC’s is indestructible and have pierced the veil of limited liability entities. For instance, despite the strong wording of the Texas LLC statute, cited above, a Texas bankruptcy court in *In Re: JNS Aviation, LLC v. JNS Aviation, Inc.*, 376 B.R. 500 (Bankr. N.D. Tex. 2007), pierced an LLC veil to hold two owners personally liable for the debts of a bankrupt entity. The court rejected the owners’ assertion that the corporate veils of LLCs could not be pierced pursuant to Texas Business Organizations Code Section 101.114. Citing *McCarthy v. Wani Venture, A.S.*, 2007 Tex. App. LEXIS 5059, W.L. 1845088 (Tex. App.--Houston [1 Dist.] June 28, 2007), the court reasoned, “Texas courts and other jurisdictions, have applied to LLCs the same state law principles for piercing the corporate veil that they have applied to corporations.” In *Re: JNS Aviation, LLC v. JNS Aviation, Inc.*, 376 B.R. 500, 526.

Other courts have acknowledged that the corporate veil piercing principles also apply to limited liability companies, but found the facts of the cases did not warrant disregarding the

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10 Id.
LLPs

LLPs have also been subject to veil piercing claims, which the courts have applied to hold limited partners personally liable for the partnership’s debts. Most recently, courts have pierced the limited partnership veil when partnerships have failed to follow formalities established by statute. For instance, in Campbell v. Lichtenfels, 2007 WL 447919 (Conn. Super. 2007), the court held a partner personally liable for a malpractice claim against the partnership due to the partnership’s failure to file a certificate of limited liability partnership with the Secretary of State.

Similarly, the appellate court in Edward B. Elmer, M.D., P.A. v. Santa Fe Properties, Inc., 2006 WL 3612359 (Tex. App. 2006), the court determined that a partner could be held individually liable for the partnership’s breach of a lease. The court reasoned that the partner was liable since the partnership was not properly registered pursuant to the Texas Revised Partnership Act at the time the lease was contracted.

Yet, in a recent federal case out of Texas, Software Publishers Association v. Scott & Scott, LLP, 2007 WL 92391 (N.D.Tex. 2007), the court denied a motion to dismiss a case against a law firm’s managing partner, finding that the plaintiff’s allegation that the partner “controlled” the firm’s activities was sufficient to state a claim against the partner. The court stated that the allegation supported the plaintiff’s theory that the partner either was directly involved in the wrongful acts or possessed knowledge of the wrongful acts but refused to take steps to prevent them.

Other courts have refused to hold limited partners liable for the obligations of LLPs, but have simultaneously acknowledged the existence of a cause of action against partners if evidence sufficient to support a veil piercing theory was present. In City of Bridgeport v. C.J. Fucci, Inc., 2007 WL 1120537 (Conn. Super. 2007), the Connecticut Superior Court declared that limited partners may not be held liable for their partner’s wrongful conduct solely because a partnership exists. Likewise, in PCO, Inc. v. Christensen, Miller, Fink, Jacobs, Glaser, Weil & Shapiro, LLP, 150 Cal. App. 4th 384 (Cal. App. 2 Dist. 2007), the court noted that the partner of an LLP is not liable for the partnership obligations if those obligations did not arise from the negligence or misconduct of the partner.

Recent Current Events Which May Give Rise to the Liability of Limited Liability Partners

The business world watched with amazement as the fall of Enron also gave rise to the fall of one of the largest accounting firms in the US: Arthur Anderson. Certain of Arthur Anderson’s partners’ allegiance to Enron and the partners’ willingness to shred documents to assist their client caused hundreds of Arthur Anderson’s partners and thousands of employees to scrounge for work with other firms. These select Arthur Anderson partners subjected themselves, their partners and their associates to personal liability, both on a criminal and civil level.
The Arthur Anderson accounting scandal led to the disclosure of other scandals involving auditing and accounting firms, as well as the accounting arms of other types of organizations. Most recently, KPMG has faced scrutiny for its role in the subprime mortgage collapse. Specifically, KPMG performed auditing for New Century Financial, one of the first subprime lenders that collapsed in 2007. A five month U.S. Justice Department investigation released in March 2008 suggested that New Century engaged in imprudent and improper practices in its accounting for troubled loans it repurchased from investors. The report claimed that KPMG overlooked these accounting practices to retain its client, New Century. Although KPMG strongly disagrees with the report’s findings and claims that a national standards committee approved the practice in question, its name has been tarnished.

Undoubtedly, litigation will ensue against KPMG, its partners, New Century and its top executives, in which damaged parties and creditors will likely assert veil piercing claims against the partners and shareholders of both entities. If KPMG experiences financial distress due to this scandal and any evidence of fraud or recklessness on KPMG’s part is revealed, courts may be more willing to pierce KPMG’s LLP veil to adequately compensate damaged parties.

**Conclusion**

The prevalence of corporate scandals involving accounting firms, law firms, and other service entities with LLP and/or LLC statuses has raised suspicion as to whether courts will more generously apply the veil piercing theories to compensate injured parties. Certainly, partners and directors of such organizations are facing criminal and/or civil liability for their own actions. However, their business partners who look the other way to further the interest of the company also have reason for concern.

Courts are ignoring the corporate limited liability forms of LLCs and LLPs when the corporate veil piercing theories are applicable. LLCs and LLPs should be careful 1) in complying with the corporate formalities imposed by law, 2) in sufficiently capitalizing the firm, 3) in maintaining the funds of the partners, members, shareholders and the entity separate, 4) in appointing separate directors and officers, and 5) in keeping the companies separate from the partners, investors and directors. If a court suspects fraud or that a sham was created to avoid liability, it will ignore the limited liability form, regardless of whether the state legislature attempted to prevent flow-through liability in the state statutes. In this new age of corporate scrutiny in which entities face endless regulation, the partners of KPMG and members and directors of other limited liability entities should not expect protection simply because the words “limited liability” appear in their titles. Professional liability insurers should keep this in mind when underwriting professional liability insurance, especially directors and officers coverage, and in setting reserves for future claims.

**References**


