

Avoiding piercings

By R. Randy Lee SPECIAL TO THE NATIONAL LAW JOURNAL

IPOP AN IMAGINARY water balloon at periodic meetings with my clients that own close corporations. Those in attendance almost always get the point—if a court pierces the corporate veil, there is going to be a mess.

This year, the focus of businesspeople and their attorneys is certain to shift from public companies and the Sarbanes-Oxley Act to private companies, as courts continue to hold individual shareholders responsible for corporate acts. While courts generally support the corporate/limited liability company form, judges will be increasingly vigilant at piercing the corporate veil when the formalities are ignored or when there are supportable allegations of fraud.

To avoid problems, I tell my clients to issue stock, elect directors and maintain corporate records, annually. I also tell them to keep separate funds and to deal with related entities at arms' length. Sharing office space, addresses and telephone numbers is also a big no-no, unless treated with proper formalities. Despite how easy maintaining a separate identity can be, private corporate executives continue to disregard the guidelines. I think the key is strong business counseling and industry awareness.

Private business owners maintain the advantage because judges are reluctant to penetrate the holy shroud that surrounds business entities. That said, in a 2004 decision that set the stage for more focus on the issue this year, a federal judge in the Southern District of New York, in *JSC Foreign Economic Ass'n Technologoexport v. Int'l Development and Trade Services Inc.*, reiterated that if some or all of the following factors exist, shareholders had better start worrying:

- The absence of corporate formalities, i.e., the issuance of stock, election of directors, maintenance of corporate records, etc.

- Inadequate capitalization.
- Funds that are used for personal, rather than corporate, purposes.
- An overlap in ownership, officers, directors and personnel.
- Common office space, address and telephone numbers of corporate entities.
- A lack of business discretion displayed by the allegedly dominated corporation.
- Nonarms' length dealings between the related corporations.
- The payment or guarantee of debts of the dominated corporation by other corporations in the group.
- The use of the property of the corporation in question by other corporations as if it were their own.

If one or two of the above issues creep up, there may not be a cause for concern, but if more than that pops up, clients need to take steps to rectify things. If there is a practice of sloppy bookkeeping or mixing things up between entities or with their personal finances, lawyers

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should bring a filled water balloon to their next client meeting.

By way of example, take last fall's decision in *Pariser Industries Inc. v. T&T Laundry Corp.* issued by the Civil Court of New York, Kings County. Pariser sued T&T to recover approximately \$13,000 for goods sold. Over the course of Pariser's relationship with T&T, Todd Pincus paid it from the accounts of TPD Corp., Todd & Issac Services LLC, Modern Towel and Linen Service Inc., in addition to T&T. According to the testimony of Pincus' sister, Pincus was the principal of all of these entities. While the plaintiff did business with an entity called Modern Linen, it sought payment of its outstanding invoices from T&T because T&T was doing business as Oceana Towel & Linen Service or Oceana-Modern Linen.

In her decision, Judge Kathy J. King stressed that generally a court does not have the authority to look beyond the corporate form, except when necessary "to prevent fraud or achieve equity." In this case, the court held that T&T exercised dominion and control over the day-to-day operations of Modern Linen. It shared the same address, employees, checking account and billing records. Goods

were also delivered to Oceana-Modern Linen at T&T's corporate address. It was so dominated by T&T, that it was clearly the other's alter ego. Accordingly, King ruled in Pariser's favor and required T&T to pay Pariser \$13,600.79 with interest, plus costs and disbursements.

You do not have to be lawyer of the year to see that the judgment could easily have been prevented. How difficult is it to have separate bank accounts, minute books, records and addresses? Frankly, if it is too difficult for clients, lawyers should consider advising them to consolidate their businesses, because they will eventually be skewered.

Documentary formalities

Interestingly, while a limited liability company is often viewed as a hybrid between a corporation and a partnership, the same rules as for a corporation would apply. Unlike C-corporation shareholders, LLC members can report expenses and income on their personal tax return for pass-through taxation purposes. They can also deduct health and life insurance benefits. But, like a corporation, an LLC has documentary formalities, e.g., operating agreements and articles of organization, that must be executed. The veil that exists in corporations and the rules for piercing that veil would seem to be the same for LLCs and, probably, limited partnerships, but in each case all of the rules have to be followed.

While private companies remain outside the purview of the Securities and Exchange Commission and free from most federal corporate governance restrictions, their executives need to engage in serious and honest operations with all formalities observed. If the law is too confusing, I tell people to use basic common sense because perceptions count, sometimes as much as substance. If that doesn't work for you in 2005, I have some extra water balloons. **ML**

Corporate executives must heed guidelines.

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