Avoiding Piercing of the Corporate Veil – Best Practices

by Kevin Schlosser, Esq.

Basically, the "corporate veil" refers to how doing business through a legal entity, such as a corporation, limited liability company or limited partnership can limit the legal obligations and debts to the entity itself rather than imposed upon its owners or affiliated companies. Courts "pierce" that corporate veil, however, and extend liability to owners or affiliated entities where the formalities of the entity are not followed and the result effectuates some fraud or other unfair wrongdoing to those with whom the entity has dealt.

There are two basic prongs that the courts apply to effectuate the veil piercing: "In order to pierce the corporate veil, a plaintiff must show [1] that the dominant corporation exercised complete domination and control with respect to the transaction attacked, and [2] that such domination was used to commit a fraud or wrong causing injury to the plaintiff (*see Matter of Morris v New York State Dept. of Taxation & Fin.*, 82 NY2d 135, 141 [1993])." *Fantazia Intl. Corp. v CPL Furs N.Y.*, 67 AD3d 511, 512 [1st Dept 2009]).

Avoiding corporate veil piercing is particularly challenging for the many companies with a single or group ownership that form multiple legal entities to try to limit liabilities of each business venture within the family of companies. It becomes difficult to limit and separate legal exposure, for example, because the very purpose of using joint management, employees, bank accounts, space or other resources of the overall business is to reduce cost and take advantage of combined resources.

Best Practices for Entity Accounting/Financial Advisers

To minimize the risk of inter-company veil piercing, in-house accounting/financial personnel and advisers must be keenly mindful of the need to maintain certain formalities to the extent possible, such as:

1. Robust Documentation of Inter-Company Transactions

- Formalize all inter-company transactions (e.g., loans, services, resource sharing) with written agreements that specify terms, pricing, and payment schedules as if the parties were unrelated.
- Charge market rates for shared services, space, or personnel, and document the basis for those rates.
- Record all inter-company ledger entries with clear explanations and supporting documentation, showing legitimate business purposes and compliance with transfer pricing rules.

2. Clear Allocation of Costs and Revenues

- Allocate costs and revenues to the correct entity based on actual usage or benefit, using reasonable and consistent methodologies.
- Avoid blanket or arbitrary allocations; instead, use time sheets, usage logs, or other objective measures to support allocations.
- Ensure each entity's financial statements reflect its true economic activity and obligations.

3. Segregation of Decision-Making Authority

- Define and document the scope of authority for shared employees. For example, if a CFO serves multiple entities, specify which decisions are made for which company, and keep records of board or management approvals for major actions.
- Maintain separate minutes and resolutions for each entity's board or management meetings, even if the same individuals are present.

4. Regular Review and Audit of Inter-Company Arrangements

- Conduct periodic internal audits to ensure that inter-company transactions are properly documented, priced, and reflected in each entity's books.
- Review compliance with corporate formalities and update policies as needed to address any areas of risk identified in audits.

5. Transparency in Centralized Functions

- If centralized cash management or payroll is used:
- Document the business rationale (e.g., lender requirements, efficiency).
- Ensure each entity's obligations are met independently—for example, by maintaining sub-accounts or ledgers that track each entity's cash position and liabilities.
- Avoid using centralized systems to shield assets or render subsidiaries judgment proof; ensure subsidiaries retain sufficient liquidity to meet their obligations.

6. Adequate Capitalization and Solvency

- Ensure each entity is adequately capitalized for its business activities and contractual obligations.
- Avoid creating or maintaining subsidiaries that are undercapitalized or unable to pay creditors, especially if entering into significant contracts.

7. Contingency Planning for Dissolution or Insolvency

- If a subsidiary is to be dissolved, make appropriate reserves for contingent liabilities and document the business reasons for dissolution.
- Avoid dissolving entities solely to defeat creditor claims.

The enterprise's in-house or outside general counsel should be consulted on a consistent basis to ensure that these salutary practices are followed properly and to answer any questions or concerns as issues arise. As the saying goes, *an ounce of prevention is worth a pound of cure.*

Kevin Schlosser, Esq.

Mr. Schlosser is a Shareholder and Chair of the Litigation and Alternative Dispute Resolution Department at Meyer, Suozzi, English & Klein, P.C., a member of the Suffolk County Bar Association Commercial Division Committee and author of the New York Fraud Claims Blog, www.nyfraudclaims.com