PRESERVING ENTITY SHIELDING: HOW CORPORATIONS SHOULD RESPOND TO REVERSE PIERCING OF THE CORPORATE VEIL

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I. INTRODUCTION

Piercing the corporate veil is an intensely debated topic. The application of the doctrine requires courts to ignore a deeply ingrained principle of corporate law—limited liability. Scholars have described the application as an "unprincipled hodgepodge of seemingly ad hoc and unpredictable results."[1] A uniform test has not been adopted between jurisdictions and there still exists some confusion about the application of the doctrine within a given jurisdiction.[2] Some courts focus on the idea that

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1. David Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 Emory L.J. 1305, 1311 (2007).

2. *See, e.g.*, PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983) (suggesting that court decisions regarding veil piercing are "irreconcilable and not entirely comprehensible"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 54-55 (1984) ("Tests used by courts - whether a corporation has a 'separate mind of its own,' whether it is a 'mere instrumentality,' and so forth - are singularly unhelpful.").

the corporation is an "alter ego" of the shareholders, while other courts refer to the "complete domination" of the corporation by the shareholders.[3] Some courts will only allow veil piercing if it is necessary to avoid fraud or injustice, while other courts do not address questions of equity.[4]

If veil piercing is problematic, an even more controversial and haphazard topic is the application of the doctrine in reverse.[5] Despite diverse and competing theories concerning veil piercing, in general, most states recognize it. In contrast, states are split regarding the recognition of reverse veil piercing. Some states have expressly rejected the doctrine, while other states have adopted it under one approach, and still others have adopted it under a second or third approach.[6] In some instances, courts apply the same standard for reverse veil piercing as they do for traditional veil piercing.[7] In other instances, courts have added additional factors to the traditional veil piercing analysis in the reverse piercing context.[8]

With such variance in the application of the doctrine, the question remains: how should corporations protect themselves from reverse veil piercing? Imposition of liability upon the corporation for the sins of the shareholders has a huge impact on corporate structure and financial planning. This Article will provide corporations with possible approaches to handle the risk of reverse veil piercing and limit its impact through an exploration of various states' approaches to the doctrine. Part III will examine the development of reverse piercing in the states that accept it and the reasoning of the courts in the states that have rejected it. Part IV will outline some preventive measures that corporations can take prior to and after an action for reverse veil piercing has commenced. It will discuss the

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3. *See, e.g.*, Baillie Lumber Co. v. Thompson, 612 S.E.2d 296 (Ga. 2005) (allowing veil piercing under an alter ego theory); S. Sash Sales and Supply Co. v. Wiley, 631 So. 2d 968 (Ala. 1994) (allowing veil piercing if the corporation is a mere instrument or alter ego of the shareholders); State v. Easton, 647 N.Y.S.2d 904 (N.Y. Sup. Ct. 1995) (allowing veil piercing when shareholders have exercised complete domination of the corporation in relation to the transaction involved in the underlying claim); Glenn v. Wagner, 329 S.E.2d 326 (N.C. 1985) (requiring a showing of complete domination before allowing veil piercing).

4. *See, e.g.*, Kline v. Kline, 305 N.W.2d 297 (Mich. Ct. App. 1981); Amoco Chems. Corp. v. Bach, 567 P.2d 1337 (Kan. 1977); Polaris Indus. Corp. v. Kaplan, 747 P.2d 884 (Nev. 1987).

5. Nicholas B. Allen, *Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice*, 85 ST. JOHN'S L. REV. 1147, 1153 (2011) (reverse veil piercing imposes liability on a corporation for the obligations of the shareholders).

6. *Id.* at 1148-49.

7. Kurtis A. Kemper, *Acceptance and Application of Reverse Veil Piercing*, 2 A.L.R. 6th 195 (2005) ("The same considerations are usually at issue regardless of which direction a third party attempts to reach through the veil.").

8. *See* Michael Richardson, *The Helter Skelter Application of the Reverse Piercing Doctrine*, 79 U. CIN. L. REV. 1605, 1616-22 (2011) (examining the different factors that the courts have considered in determining whether or not to allow reverse veil piercing).

benefits and costs of each possible solution and the considerations that corporations should take into account in making any decisions.

II. DEVELOPMENT OF THE DOCTRINE OF PIERCING THE CORPORATE VEIL

A fundamental characteristic of a corporation is limited liability.[9] The shareholders in a corporation are shielded from the debt of the corporation (known as owner shielding) while the corporation is shielded from the debt of its shareholders (known as entity shielding).[10] Owner shielding is essential to induce investors to purchase stock in a corporation because it ensures the investors that they will not need to provide unlimited capital to the corporation to satisfy its debts.[11] But owner shielding is not a universal characteristic of firms. Partnerships, for example, do not have owner shielding, although they do have entity shielding. Without limited liability, publicly-held corporations would not exist.[12] The doctrine started as a judicially-developed concept but has since been included in most states' corporation statutes.[13]

Entity shielding, sometimes called affirmative asset partitioning, is an indispensable aspect of corporate law.[14] Essentially, the principle "protects the entity and its creditors against the claims of the creditors of the owners, a risk that otherwise might dissipate the assets of the business, or discourage investors from making initial investments."[15] If the shareholders become

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9. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1039-41 (1991) (discussing the purpose of limited liability within the corporate form).

10. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89-92 (1985) (explaining the principles behind limited liability).

11. Thompson, *supra* note 9, at 1040; John H. Matheson, *The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test for Waiving Owners' Limited-Liability Protection*, 75 WASH. L. REV. 147, 154 (2000) ("By limiting responsibility for corporate actions to the assets of the corporation while immunizing the owners' personal assets, corporations can attract other owners whose risk of loss is limited by the amount of capital contributed to the corporation.").

12. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262 (1967).

13. *See* Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 591-94 (1986) (providing a background on the development of limited liability). *But see* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80 (1991) (contending that limited liability should be contractually provided for, not imposed by the state).

14. *See* Giacomo Rojas Elgueta, *Divergences and Convergences of Common Law and Civil Law Traditions on Asset Partitioning: A Functional Analysis*, 12 U. PA. J. BUS. L. 517, 519-20 (2010) (discussing the partitioning of personal assets from a pool of other assets through incorporation).

15. Robert B. Thompson, *Agency Law and Asset Partitioning*, 71 U. CIN. L. REV. 1321, 1323 (2003).

insolvent, the shareholders' personal creditors could try to force liquidation of corporate assets to satisfy their claims upon exhausting the shareholders' personal assets. Such actions may impair the corporation's ability to cover its day-to-day costs as well as decrease its profitability. However, the shareholders' personal creditors are prevented from taking such actions by the doctrine of entity shielding.[16]

Moreover, entity shielding reduces the costs to shareholders to bring in additional equity investors.[17] If the personal actions of the investors could result in a loss of corporate assets, current shareholders would not be willing to include investors outside of their known associates. Entity shielding eliminates this risk and allows current shareholders to bring in unknown investors without associated monitoring costs.[18] In addition, entity shielding affords the corporation's creditors confidence that their rights will not be impaired by the shareholders' personal obligations.[19] If it did not exist, potential creditors would increase the cost of debt to offset the uncertainty they would face or simply refuse to provide credit in the first place.[20] Unlike owner shielding, entity shielding is a characteristic of all modern forms of business organizations, including partnerships.[21]

Some critics of limited liability point to the moral hazard created by the externalization of risk.[22] Owner shielding allows the shareholders of a corporation to reap all of the benefits of the corporation's risky behavior without suffering the consequences, which encourages them to direct the corporation in a riskier manner.[23] Entity shielding encourages the shareholders to engage in opportunistic behavior by transferring their assets to the corporation in an effort to subordinate personal creditors.[24] Due to

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16. Thomas K. Cheng, *The Corporate Veil Doctrine Revisited: A Comparative Study of the English and the U.S. Corporate Veil Doctrines*, 34 B.C. INT'L & COMP. L. REV. 329, 404 (2011).

17. Reinier Kraakman, Henry Hansmann & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1344-45 (2006).

18. *Id.*

19. Benito Arruñada, *Institutional Support of the Firm: A Theory of Business Registries*, 2 J. LEGAL ANALYSIS 525, 539 (2010).

20. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L. J. 387, 402 (2000).

21. Henry Hansmann & Reinier Kraakman, Property, *Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373, 406 (2002).

22. *See, e.g.,* Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 65-76 (1980); Paul Halpern, Michael Trebilcock, & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148 (1980) ("[I]n the case of small, tightly held companies, a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors . . . .").

23. Easterbrook, *supra* note 10, at 103-04.

24. Kraakman, Hansmann & Squire, *supra* note 17, at 1351-52.

these dangers, and despite the fact that states generally view limited liability as an absolute,[25] courts have disregarded the limited liability of a corporation and pierced the corporate veil to allow creditors to recover from the assets of the shareholders or the corporation, depending on the situation.

A. Traditional Veil Piercing

There is no universal standard to determine when it is proper to disregard limited liability and pierce the corporate veil.[26] Each court adopts its own test in determining when it is appropriate to apply the doctrine.[27] The doctrine is judicially created and is largely ignored in state corporation statutes.[28] While two common theories applied by courts are alter ego or instrumentality,[29] as a general rule,

> the courts have required that the party seeking to pierce the corporate veil satisfy a two prong test: "(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow."[30]

This general rule has been adopted and modified by state courts to focus on the factors that they delineate as essential in determining when to pierce the corporate veil.

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25. Easterbrook, *supra* note 10, at 109.

26. Michael J Gaertner, *Reverse Piercing the Corporate Veil: Should Corporation Owners Have it Both Ways?*, 30 WM. & MARY L. REV. 667, 678 (1989).

27. *See* Richard v. Bell Atl. Corp., 946 F. Supp. 54, 61 (D.D.C. 1996) (setting out four possible tests for courts to use: "(1) the 'agency' test under which the plaintiffs must establish that the parent exercised a significant degree of control over the subsidiary's decision-making; (2) the 'alter ego' test which is founded in equity and permits the court to pierce the corporate veil when the court must prevent fraud, illegality or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability from a crime; (3) the 'instrumentality' test under which the plaintiff must establish that the parent exercises extensive control over the acts of the subsidiary giving rise to the claim of wrongdoing; and (4) the 'integrated enterprise' test under which the court considers (a) interrelations of operations, (b) centralized control of labor relations, (c) common management, and (d) common ownership or financial control").

28. Thompson, *supra* note 9, at 1041; *see* David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 429 (1998) ("The inability of any one understanding of limited liability entities to obtain complete dominance is perhaps a reason that the law of piercing the veil . . . remains a predominantly common law doctrine, un-codified by statute in most states.").

29. Gaertner, *supra* note 26.

30. David H. Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L. REV. 371, 376 (1981) (quoting Automotriz del Golfo de Cal. v. Resnick, 306 P.2d 1, 3 (Cal. 1957)).

Alter ego theory requires a showing of domination by the shareholders of the corporation. "When a corporation has been so dominated by an individual or another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result."[31] In *Austin Powder Co.*, the New York Supreme Court, Appellate Division pierced the veil of Tri-State, the defendant corporation, and held McCullough, the sole shareholder, liable under an alter ego theory.[32] McCullough was the director of Tri-State, and he directly owned all of the business assets used by Tri-State.[33] The court focused on the disregard of corporate formalities, such as the lack of a board of directors, in deciding that it was appropriate to pierce the veil.[34]

While courts often cite the lack of corporate formalities in determining domination, they consider a wide range of factors. Another important factor is whether the corporation is a close or public corporation.[35] The ability of a corporation to elect close corporation status varies among the states, but it is common to restrict it to corporations with a specific number of shareholders (usually 30-35 or fewer) and no public stock offering.[36] The nature of close corporations reduces the fear that courts will hold shareholders liable for corporate actions over which they have no control since the separation of ownership and control is limited.[37] Courts have only allowed veil piercing with close corporations, never with public corporations.[38]

Undercapitalization is another factor courts often cite.[39] "It is . . . recognized as the policy of the law that shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities."[40] It is unsurprising that undercapitalization is considered in veil piercing cases since the doctrine was partially developed to counteract the moral hazard created by limited liability.[41] "[T]he lower

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31. Austin Powder Co. v. McCullough, 628 N.Y.S.2d 855, 856 (N.Y. App. Div. 1995).

32. *Id.*

33. *Id.*

34. *Id.*

35. Easterbrook, *supra* note 10, at 109-10.

36. Michael Spadaccini, *What is a "Close Corporation"?*, ENTREPRENEUR (June 7, 2005), http://www.entrepreneur.com/article/78032.

37. Easterbrook, *supra* note 10, at 109-10.

38. Thompson, *supra* note 9, at 1039.

39. *See* William O. Douglas & Carol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 218 (1929) (stating that the inadequacy of capitalization of the corporation by the shareholders weighs heavily in determining whether or not to respect limited liability).

40. HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 303 (Callaghan and Company rev. ed. 1946).

41. Easterbrook, *supra* note 10, at 113.

the amount of the firm's capital, the greater the incentive to engage in excessively risky activities."[42] Holding the shareholders liable in situations of undercapitalization reduces the likelihood that they will engage in conduct that they cannot afford. Despite the relationship of undercapitalization to the development of the doctrine, it is not the be-all and end-all of veil piercing. Courts are not always willing to pierce in cases where undercapitalization is present, and they have pierced in cases where undercapitalization was not present.[43] In *Minton v. Cavaney*, the California Supreme Court stated that the shareholders must actively participate in the conduct of corporate affairs for undercapitalization to be relevant.[44] In that case, the defendant served as secretary and treasurer for a corporation that did not own any assets.[45] The court held that the defendant's conduct supported the inference that the defendant was a shareholder of the corporation and that the failure to provide adequate capitalization was within his control.[46]

The instrumentality theory, similar to the alter ego theory, requires a showing of complete domination.[47] In addition, it must be shown that the defendant used that control to commit fraud or wrongdoing and that the control and resulting breach of duty caused the injury.[48] In *Naples v. Keystone Building & Development Corporation*, the Connecticut Supreme Court did not pierce the corporate veil under the instrumentality theory to allow the plaintiffs to recover from the principal agent.[49] The court acknowledged that Bourbeau, the principal agent, controlled the affairs of the defendant company; however, such control was without wrongful or deceitful intent.[50] "The plaintiffs do not point to any evidence that [the defendant company] did not serve a legitimate business purpose, or that failing to pierce its corporate veil and hold Bourbeau personally responsible would perpetrate a fraud or other injustice."[51] The court emphasized the element of fraud as a necessary component of the instrumentality theory.[52]

But not all courts apply the alter ego theory or instrumentality theories, opting for such theories as agency or inequitable results. As scholars have noted, piercing the corporate veil is a chaotic and

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42. *Id.*
43. Thompson, *supra* note 9, at 1065-66.
44. 364 P.2d 473, 475 (Cal. 1961).
45. *Id.* at 474.
46. *Id.* at 475.
47. Zaist v. Olson, 227 A.2d 552, 558 (Conn. 1967).
48. *Id.*
49. 990 A.2d 326, 330 (Conn. 2010).
50. *Id.* at 340.
51. *Id.* at 341.
52. *Id.*

unpredictable doctrine.[53] A noteworthy part of the chaos results from the indiscriminate application of the theory to significantly different factual scenarios.[54] In addition, "[t]he failure of state courts to adhere to a single veil-piercing theory also creates much confusion."[55] This confusion only becomes worse with the doctrine of reverse veil piercing.

B. Reverse Veil Piercing

Whereas traditional veil piercing holds shareholders liable for the acts of a corporation, reverse veil piercing imposes liability on a corporation for the obligations of a shareholder.[56] In other words, traditional veil piercing disregards the corporate law principle of owner shielding while reverse veil piercing disregards entity shielding. In an outside reverse veil piercing claim, a third party seeks to pierce the corporate veil to impose liability on the corporation in order to satisfy the personal debts of shareholders.[57] The third party is seeking to recover from the corporation, after bringing a successful claim against the shareholders for their actions, because the shareholders have used the corporation to hide their personal assets.[58]

The concept of reverse veil piercing was first introduced in *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*[59] The plaintiff sought to collect debts owed by the defendant corporation, following repairs made at its request, by attaching the assets of a subsidiary.[60] The court recognized the possibility that the subsidiary may be held liable for the debts of the parent corporation but held that "such instances, if possible at all, must be extremely rare, and there is not the slightest evidence" to support such an action in this case.[61] The court focused on the level of control the subsidiary had over the parent corporation in regards to the specific action that gave

53. *See* Millon, *supra* note 1.

54. Elvin R. Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597, 621-22 (1936).

55. Gaertner, *supra* note 26, at 680 (illustrated by the application of the alter ego theory by the New York courts in some cases and the instrumentality theory in other cases).

56. Allen, *supra* note 5, at 1153 (citing Connolley v. Englewood Post No. 322 Veterans of Foreign Wars of the U.S., Inc. (*In re* Phillips), 139 P.3d 639, 644 (Colo. 2006) (en banc)).

57. Gregory S. Crespi, *The Reverse Pierce Doctrine: Applying Appropriate Standards*, 16 J. CORP. L. 33, 37 (1990). There are two types of reverse veil piercing: insider and outsider. Insider reverse veil piercing involves corporate insiders who attempt to pierce the corporate veil to take advantage of claims that they would be unable to bring otherwise. *Id.* For an example of insider reverse veil piercing, see *Roepke v. W. Nat'l Mut. Ins. Co.*, 302 N.W.2d 350 (Minn. 1981). This Article will only examine outsider reverse veil piercing claims.

58. Allen, *supra* note 5, at 1154.

59. 31 F.2d 265 (2d Cir. 1929).

60. *Id.* at 265.

61. *Id.* at 267.

rise to the dispute, essentially applying the traditional veil piercing doctrine in reverse.[62] However, the court "failed to conduct a full analysis of how closely reverse piercing cases resembled their traditional counterparts, and to what extent the same interests were involved."[63]

Following the Second Circuit's admonition in *Kingston*, courts were reluctant to allow reverse veil piercing.[64] It was not until *W.G. Platts, Inc. v. Platts* that the doctrine reemerged.[65] In *W.G. Platts*, a lien was placed on real property held by W.G. Platts, Inc. during divorce proceedings between the corporation's sole shareholder and his wife.[66] The Supreme Court of Washington found that the lien was appropriate because the corporation was the alter ego of the shareholder, and the interests of justice required the court to disregard the corporate entity.[67] The facts that the court found to be noteworthy included the transfer of the real property from the shareholder to the corporation after he formed it and his complete control of all business affairs.[68] Since then, jurisdictions have adopted a myriad of tests to determine if reverse veil piercing is appropriate.

III. Application of Reverse Veil Piercing in State Courts

Courts have generally adopted three approaches to reverse piercing: never allowing it, allowing it based on the traditional veil piercing approach, or allowing it if equity so requires. Some states have not discussed the issue at all.[69]

A. States That Do Not Allow Reverse Veil Piercing

Courts have cited a variety of reasons for refusing to apply the doctrine of reverse veil piercing. Two common arguments are that the doctrine ignores normal judgment collection procedures, and it fails to protect innocent third parties that would suffer a detriment if the corporation's assets were attached.[70] Additional concerns have been raised by various courts.

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62. *Id.*
63. Richardson, *supra* note 8, at 1610.
64. Allen, *supra* note 5, at 1155.
65. 298 P.2d 1107 (Wash. 1956).
66. *Id.* at 1108.
67. *Id.* at 1109.
68. *Id.*
69. *See, e.g.*, *In re* ALT Hotel LLC, 479 B.R. 781, 802 (Bankr. N.D. Ill. 2012) ("Delaware itself has never recognized any form of reverse piercing. Only four decisions, none of them published, even mention the theory.").
70. *See, e.g.*, Cascade Energy and Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990) ("The reverse-pierce theory presents many problems. It bypasses normal judgment-collection procedures, whereby judgment creditors attach the judgment debtor's

In *Acree v. McMahan*, the Georgia Supreme Court rejected the doctrine of reverse veil piercing.[71] Acree formed Memorial Health Services, Inc. (MHS) to manage small hospitals, including Irwin General Hospital. Acree, McMahan, and Jackson formed AJM, Inc., from which Acree eventually bought out their interests. When Acree failed to make payments to McMahan, McMahan sought to recover from the assets of MHS, whose sole connection with the dispute was through Acree.[72] The court listed several reasons for rejecting the doctrine, including concern about innocent shareholders. Furthermore, the court stated that reverse veil piercing would inhibit the raising of capital by the corporation since corporate creditors would not feel secure in the loan.[73] Without reverse veil piercing a plaintiff could reach the assets of the corporation through traditional theories of judgment collection, such as conversion, fraudulent conveyance of assets, *respondeat superior*, and agency law, and such collection methods are preferable to reverse veil piercing.[74] The court foreclosed the application of reverse veil piercing unless the legislature chooses to incorporate the doctrine into Georgia's statutes.[75]

In *Postal Instant Press, Inc. v. Kaswa Corp*, the California Court of Appeals rejected the doctrine of reverse veil piercing.[76] Rangoonwala and Ahmed purchased a Postal Instant Press (PIP) franchise. In an unrelated matter, they also formed and capitalized Kaswa Corporation. After Ahmed left the partnership, a dispute arose between Rangoonwala and PIP regarding royalties. PIP received an arbitral award against Rangoonwala, which was confirmed by the courts. PIP sought to recover that judgment from Kaswa Corporation, as an alter ego of Rangoonwala.[77] The court stated that the aim of traditional veil piercing—to prevent the misuse of the corporate form—does not exist in reverse veil piercing.[78] The goal of reverse veil piercing, to prevent the fraudulent transfer of assets by the shareholders to the corporation, can be achieved through other legal remedies.[79] In addressing the problems with reverse veil piercing, namely

shares in the corporation and not the corporation's assets. Moreover, to the extent that the corporation has other non-culpable shareholders, they obviously will be prejudiced if the corporation's assets can be attached directly.").

71. 585 S.E.2d 873 (Ga. 2003).
72. *Id.* at 873-74.
73. *Id.* at 874-75 (citing Floyd v. I.R.S., 151 F.3d 1295, 1299-1300 (10th Cir.1998)).
74. *Id.* at 875 (citing *Cascade*, 896 F.2d at 1577).
75. *Id.*
76. 77 Cal. Rptr. 3d 96 (Cal. Ct. App. 2008).
77. *Id.* at 98-100.
78. *Id.* at 105.
79. *Id.*

the lack of protection for innocent shareholders, the court concluded that "they reflect inherent and insurmountable flaws in the doctrine itself."[80]

Some courts have never allowed the application of reverse veil piercing but have not foreclosed the possibility of doing so. In *Messick v. PHD Trucking Service, Inc.*, the Utah Supreme Court would not apply the doctrine to the facts of the case at hand, but it indicated a willingness to look at the doctrine in future cases.[81] The plaintiff owed a debt to the defendants in their individual capacities, and the trial court offset that debt by the amount owed to the plaintiff by the defendant corporation, concluding that the individual defendants and the defendant corporation were alter egos.[82] The Supreme Court reversed, finding that "[n]o evidence was adduced to establish the corporation's neglect of statutory formalities nor was any evidence received to the effect that observance of the corporate entity would sanction a fraud, promote injustice, or produce an inequitable result."[83] Unlike the California Supreme Court in *Postal Instant Press*, the Utah Supreme Court did not reject reverse veil piercing on its merits; rather, it did not think that the facts of this case justified piercing.[84] It reiterated its willingness to consider reverse veil piercing in *Transamerica Cash Reserve, Inc. v. Dixie Power and Water, Inc.*[85] The stockholder had defrauded the plaintiff, and the plaintiff sought to attach corporate funds on deposit.[86] The court stated that reverse veil piercing "has yet to be addressed in Utah, although it follows logically from the basic premise of the alter ego rule and appears consistent with our case law. But even assuming we would so extend the doctrine, Transamerica has not made out a case for the doctrine's application here."[87]

B. States That Allow Reverse Veil Piercing

The opinion in most states that allow reverse veil piercing is that the remedy is a logical extension of traditional veil piercing because the underlying equitable goals remain unchanged and so the test should remain

80. *Id.* at 106.

81. 678 P.2d 791 (Utah 1984).

82. *Id.* at 792-93.

83. *Id.* at 794 (quoting Norman v. Murray First Thrift & Loan Co., 596 P.2d 1028 (Utah 1979)).

84. *Compare* Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 104-05 (Cal. Ct. App. 2008) (providing the court's reasoning for rejecting the doctrine in general), *and* Mathias v. Rosser, Nos. 01AP-768, 01AP-770, 2002 WL 1066937, at *6 (Ohio Ct. App. May 30, 2002) (stating that reverse veil piercing is not a viable option in Ohio, even if the facts were sufficient), *with Messick*, 678 P.2d at 793-95 (recognizing the doctrine but finding that the facts do not satisfy the requirements for its application).

85. 789 P.2d 24 (Utah 1990).

86. *Id.* at 25.

87. *Id.* at 26.

the same.[88] Those states tend to apply the traditional veil piercing theory in reverse, requiring the satisfaction of the same elements and consideration of the same factors. In *State v. Easton*, the court stated that "[t]he direction of the piercing is immaterial where the general rule has been met."[89] Since the purpose of reverse veil piercing is to prevent fraud or achieve equity, it is not antithetical to traditional veil piercing and there is no reason to not apply the traditional rule.[90]

In *Litchfield Asset Management Corp. v. Howell*, the Connecticut Appellate Court allowed reverse veil piercing without considering any factors beyond the traditional veil piercing approach.[91] Litchfield entered into a contract with Mary Ann Howell Interiors, Inc. to perform services at a facility in Texas. After a disagreement arose, Litchfield received a default judgment against Howell as the sole shareholder of Mary Ann Howell Interiors. While enforcement proceedings were pending, Howell transferred assets to Mary Ann Howell Interiors and Architectural Designs, LLC (Design) and Antiquities Associates, LLC (Antiquities). Litchfield then sought to recover from Design and Antiquities as well as Howell.[92] The court "recognize[d] that under the appropriate circumstances, i.e., when the elements of the identity or instrumentality rule have been established, a reverse pierce is a viable remedy that a court may employ when necessary to achieve an equitable result and when unfair prejudice will not result."[93] In this instance, Howell formed the limited liability companies to protect her assets from collection and without any legitimate purpose. She continued to use the funds, which she transferred as if they were her own, and deprived Litchfield of any means of collecting the judgment against her. Such actions satisfied the requirements of the instrumentality rule, and the court found it unnecessary to address other concerns.[94]

Some states that apply reverse veil piercing consider issues that are specifically implicated in the reverse piercing situation, such as the impact on innocent third parties.[95] In *C.F. Trust, Inc. v. First Flight L.P.*, the Virginia Supreme Court, in response to a certification by the United States Court of Appeals for the Fourth Circuit, recognized the concept of outsider reverse veil piercing.[96] C.F. Trust held two promissory notes and sought to

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88. *See* LFC Mktg. Grp., Inc. v. Loomis, 8 P.3d 841, 846 (Nev. 2000); Olen v. Phelps, 546 N.W.2d 176, 181 (Wis. Ct. App. 1996); Crum v. Krol, 425 N.E.2d 1081, 1088-89 (Ill. App. Ct. 1981).
89. 647 N.Y.S.2d 904, 909 (N.Y. Sup. Ct. 1995).
90. *Id.*
91. 799 A.2d 298 (Conn. App. Ct. 2002).
92. *Id.* at 303-05.
93. *Id.* at 312. For an explanation of the instrumentality rule, see *supra* Part II.A.
94. *Id.* at 313-15.
95. 580 S.E.2d 806 (Va. 2003).
96. *Id.* at 810.

collect payment on them from Peterson. When Peterson failed to pay the amount, C.F. Trust sought to recover from First Flight, a limited partnership for which Peterson held the controlling interest.[97] The court stated that the test for reverse veil piercing is the same as for traditional veil piercing, requiring a showing that: (1) there was such unity of interest and ownership so that the corporation and the owner were no longer separate; and (2) adherence to the separation of the corporation and the owner would create an injustice.[98] Additional factors the court held to be relevant were: (1) the impact on innocent shareholders; (2) the impact on innocent creditors; and (3) the availability of other remedies.[99] Based on this information, the Court of Appeals for the Fourth Circuit determined that Peterson used his partnership interest in First Flight to evade liability to creditors and allowed C.F. Trust to recover the judgment from First Flight.[100]

In *LFC Marketing Group v. Loomis*, the Nevada Supreme Court recognized the existence of reverse veil piercing in "those limited instances where the particular facts and equities show the existence of an alter ego relationship and require that the corporate fiction be ignored so that justice may be promoted."[101] The Loomises received a judgment against Lange Financial Corporation (LFC) in regards to a failed real estate transaction. They were seeking to recover the judgment from William Lange, the sole shareholder of LFC. LFC Marketing is a corporation within a consortium of companies with which LFC is associated, owned by Lange's brother as sole shareholder.[102] The court applied the traditional veil piercing in reverse, requiring a finding that: (1) the corporation was the alter ego of the owner;[103] (2) there was unity of interest and ownership; and (3) failure to pierce would promote an injustice.[104] In addition, the court recognized that "there are other equities to be considered in the reverse piercing situation-namely, whether the rights of innocent shareholders or creditors are harmed by the pierce."[105] The court determined that Lange's brother would not suffer any detriment and allowed the Loomises to recover from LFC Marketing.[106]

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97. *Id.* at 808-10.

98. *Id.* at 809-10 (citing Greenberg v. Commonwealth, 499 S.E.2d 266, 272 (Va. 1998)).

99. *Id.* at 811.

100. C.F. Trust, Inc. v. First Flight L.P., 338 F.3d 316 (4th Cir. 2003).

101. 8 P.3d 841, 846 (Nev. 2000).

102. *Id.* at 843-44.

103. Factors considered in determining if an alter ego relationship existed included, but were not limited to: (1) undercapitalization; (2) treatment of corporate assets as the individual's own; and (3) failure to observe corporate formalities. Id. at 847 (citing Polaris Indus. Corp. v. Kaplan, 747 P.2d 884, 886 (Nev. 1987)).

104. *Id.* at 846-47 (citing *Polaris*, 747 P.2d at 887).

105. *Id.* at 847.

106. *Id.*

IV. PROTECTION FROM REVERSE VEIL PIERCING FOR CORPORATIONS

Considering the cases discussed above, it is clear that reverse veil piercing, like many areas of corporate law, is fact intensive. As a result, there is no absolute protection against the doctrine, and there are few things that corporations can do to defend against a claim for reverse veil piercing. Knowing the law of the jurisdictions in which the corporation operates is critical. However, being in a jurisdiction that has not recognized the doctrine is not dispositive since courts that have not expressly rejected the doctrine may be willing to apply it under the right circumstances. Below are a few steps that corporations can take that may make them less likely to be pierced.

A. Prior to a Request to the Court

Corporations can take steps to protect themselves against potential claims for reverse veil piercing. Such actions will need to be weighed against the ongoing needs of the corporation in other areas and may only be appropriate if the shareholders anticipate future problems with creditors.

1. *Adjustments to Corporate Capital Structure*

As previously stated, courts have only allowed reverse veil piercing in close corporations, never in public corporations. The definition of close corporation varies between states and is usually dependent upon the number of shareholders or the trading of the stock in the securities market.[107] Within close corporations, courts are most inclined to apply traditional veil piercing when there is only one shareholder (a piercing result in about half of the reported cases), somewhat less if there are two or three shareholders, and significantly less is there are three or more individual shareholders.[108] This trend is likely to be similar in reverse veil piercing cases since most courts consider the same variables as traditional veil piercing. In addition, one of the major concerns of courts is the impact of reverse veil piercing on innocent shareholders. If the corporation has only one shareholder, the person whose debts are trying to be satisfied, applying reverse veil piercing will not injure any innocent shareholders. With this in mind, corporations can make changes to their capital structure in order to protect themselves from claims for reverse veil piercing.

A corporation can choose to go public. In an initial public offering (IPO), the corporation increases its number of shareholders by allowing the

107. F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORP AND LLCS: LAW AND PRACTICE § 1:2 (rev. 3d ed. 2013).

108. Thompson, *supra* note 9, at 1054-55.

public to purchase shares. Courts have expressed concern about the impact on the innocent shareholders if they allow the creditors of a single shareholder to collect from the corporation.[109] An IPO produces a large number of innocent shareholders and decreases the amount of influence a single shareholder has on a corporation, making courts less likely to reverse pierce. In addition to providing protection from reverse veil piercing, an IPO has several benefits. It allows a corporation to accumulate a great deal of unrestricted capital and permits it to borrow more money.

However, IPOs come with a lot of costs. IPOs are usually undertaken with the assistance of an investment bank acting in the capacity of underwriter. Underwriters tend to begin the offering "with an artificially low price, allowing key beneficiaries access to this bargain. The low price attracts investors to the initial offering, which stimulates demand for the shares in the secondary market."[110] A conflict of interest exists between the corporation, who may want to mitigate underpricing of shares, and the underwriter, who may choose to reward repeat customers, such as brokerage customers, over issuers.[111] The corporation will bear the expense of this conflict of interest.[112]

Furthermore, the Securities and Exchange Commission (SEC) requires the filing of a registration statement with strict requirements regarding the prospectus and communication about the offering.[113] Such a process is complex and corporations pursuing this option should consult an attorney who specializes in securities law.[114] "Because of the cost, a full-blown registration by a small issuer desiring to sell a few thousand dollars' worth

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109. *See supra* Part III.B.

110. Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 724 (2005). *See also* HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 248 (2000) (hypothesizing that investment banks underprice issues to create demand for the purpose of motivating investors to form a "bandwagon").

111. Francois Derrien & Kent L. Womack, *Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets*, 16 REV. FIN. STUDS. 31, 60 (2003).

112. The corporation selects the underwriter and could change if it is unsatisfied; although, some critics have suggested that the market for investment banks is not truly competitive given the small number of investment banks. Both investor–plaintiffs and issuer–plaintiffs alleging antitrust violations against investment banks in setting underwriting fees have commenced litigation. *See In re* Initial Publ. Offering Sec. Litig., 174 F. Supp. 2d 61, 62 (S.D.N.Y. 2003).

113. *See* SEC Regulation C, 17 C.F.R. § 230.400–.479 (2011).

114. *See* Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21, 29-54 (2001) (providing a step-by-step guide for conducting an initial public offering); JOHN L. NESHEIM, HIGH TECH START UP 252-55 (The Free Press rev. ed. 2000) (outlining the role of attorneys in creating a prospectus for an initial public offering).

of stock is impractical."[115] And since the stock offered during the IPO is usually underpriced in comparison to the level at which the stock will trade on the market,[116] the corporation may not raise enough capital to cover the costs. That makes an initial public offering an unattractive option as protection against reverse veil piercing, although it would be the most effective.

If a corporation wants to remain a close corporation while protecting itself from reverse veil piercing, it may privately increase the number of shareholders, within the limits allowed by state statutes. Such an action would not trigger registration requirements by the SEC.[117] The corporation may issue stock through negotiated transactions with people known to the existing shareholders or through a third-party intermediary. Such transactions would produce shareholder agreements, with a clear outline of the investors' duties and privileges.[118] Traditionally, the shareholders in a close corporation serve multiple functions: providing the capital for the business, managing the daily business as officers, and serving on the board of directors.[119] If the existing shareholders do not want the new shareholder to have an active role in the corporation, they should be explicit in the shareholder agreement.

This option has a few downsides associated with it. If the corporation were to sell a few additional shares of stock, the new minority shareholders would not necessarily have the same duality of function that existing shareholders have.[120] "Thus, a minority shareholder in a close corporation is vulnerable to abuses of the majority's discretion, particularly with respect to the shareholder's employment or the distribution of dividends, which may

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115. Rutheford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure From the Capital Market*, 1977 DUKE L.J. 1139, 1140 (1977).

116. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1516-17 (1989).

117. *See* C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1 (2001).

118. *See* Robert C. Illig, *Minority Investor Protections as Default Norms: Using Price to Illuminate the Deal in Close Corporations*, 56 AM. U. L. REV. 275, 325 (2006) (explaining that all investors are in a position to negotiate for power, though some investors accept lower purchase prices in exchange for limited power).

119. William S. Hochstetler & Mark D. Svejda, *Statutory Needs of Close Corporations - An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. CORP. L. 849, 853-56 (1985).

120. A minority shareholder may not have an active role in the decision-making process for the business. This is especially true if the minority shareholder is unknown to the existing shareholders and the existing shareholders serve as the officers of the corporation. Furthermore, if the existing shareholders are seeking additional shareholders solely for the purpose of protecting against reverse veil piercing, the existing shareholders are unlikely to give the new shareholders positions of authority within the corporation.

be the minority shareholder's only source of cash from the corporation."[121] And since there is no market in which the minority shareholder can dispose of his or her shares, making those shares practically illiquid, the shareholder is trapped into the investment.[122] The courts have responded to this problem in multiple ways. Some courts have imposed enhanced fiduciary duties on shareholders in close corporations.[123] Shareholders in a close corporation owe the same duty to each other as the board of directors owes to shareholders, and the majority shareholders must not receive something to the detriment of the minority shareholders.[124] Other states have expressly refused to impose a heightened duty on shareholders of close corporations.[125] If the corporation is choosing to issue additional shares as a protection against reverse veil piercing, it should be aware of the court's attitude towards minority shareholders in its jurisdiction.

Moreover, there is the possibility that problems will arise if the shareholders disagree on the management of the corporation. Once additional shareholders have been brought in, agency costs will be generated by the divergence between the interests of the original shareholders and those of the new shareholders.[126] This is particularly true if the corporation was previously managed by a sole shareholder since, in the management of the corporation, that shareholder will be used to making operating decisions that maximize his or her own utility. New shareholders will need to incur monitoring costs to insure that their interests in the corporation are protected.[127] This may affect both their willingness to invest and the amount they invest. It may also lead to litigation costs if existing shareholders and new shareholders decide to dispute the operation of the corporation.[128]

A third option is to increase the amount of debt that the corporation has through the issuance of bonds, without changing the amount of equity.

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121. Shannon Wells Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1142 (2001).

122. CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 454 (3d ed. 1999).

123. Stevenson, *supra* note 121, at 1146.

124. *See, e.g.,* Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505 (Mass. 1975); J Bar H, Inc. v. Johnson, 822 P.2d 849, 859 (Wyo. 1991); Gay v. Gay's Super Mkts., Inc., 343 A.2d 577, 582 (Me. 1975); Frank Lerner & Assocs., Inc. v. Vassy, 599 N.E.2d 734, 738 (Ohio Ct. App. 1991).

125. *See, e.g.,* Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993); Hunt v. Data Mgmt. Res., Inc., 985 P.2d 730, 732-33 (Kan. Ct. App. 1999).

126. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

127. *Id.*

128. *See, e.g.*, Redmon v. Griffith, 202 S.W.3d 225 (Tex. Ct. App. 2006) (the minority shareholders sued the other shareholders for not managing the corporation fairly or appropriately).

Courts have expressed concern about the impact on the corporation's creditors if they allow the shareholders' creditors to collect from the corporation.[129] Corporate bonds may be offered through private or public placements. If the bonds are being offered through a public placement, the same requirements apply as those for an initial public offering.[130] The SEC exempts a private placement from such registration requirements if the bonds are sold to accredited investors and such bonds are protected from resale.[131] A private placement would also be exempted from registration requirements if the bonds are not sold nationally, which is preferable for small businesses since investors tend to invest close to home.[132] The problem with using a private placement over a public placement is the difficulty in finding people to purchase the bonds. The SEC prohibits resale of bonds that have been privately placed within a given number of years after issuance, making the bonds practically illiquid.[133] To make such bonds more attractive, they are generally higher yield.[134]

This option has several downsides associated with it. First, bonds require periodic payments of interest, unlike stock dividends whose payments are dependent upon the performance of the corporation and within the discretion of the board of directors.[135] A corporation should not issue new bonds unless it is in the financial position to make interest payments. Second, similar to the conflict between majority and minority shareholders, there is a conflict between the existing shareholders and the new bondholders. Courts have generally held that the interests of the bondholders are subordinated to the interests of the common shareholders.[136] "Bondholders and preferred shareholders can therefore look only to the express terms of their contracts for protection of their interests since corporate officials are under a legal mandate to maximize shareholder wealth within those contractually-imposed limitations without regard for the impact of their actions upon those other financial claimants."[137] Thus, corporations should be careful in the drafting of the indentures. The

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129. *See supra* Part III.B.

130. *See* SEC Regulation C, 17 C.F.R. § 230.400–.479 (2011).

131. *See* SEC Rule 506 of Regulation D, 17 C.F.R. § 230.506 (2008).

132. Jennifer J. Johnson, *Private Placements: A Regulatory Blackhole*, 35 DEL. J. CORP. L. 151, 176 (2010).

133. *See* 17 C.F.R. § 230.506.

134. Frank J. Fabozzi & Frank J. Jones, *The Primary and Secondary Bond Markets*, *in* THE HANDBOOK OF FIXED INCOME SECURITIES 38 (7th ed. 2005).

135. *See* Frank J. Fabozzi, Michael G. Ferri, & Steven V. Mann, *Overview of the Types and Features of Fixed Income Securities*, *in* THE HANDBOOK OF FIXED INCOME SECURITIES 5-9 (7th ed. 2005).

136. Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 214 n.3 (1999).

137. Gregory S. Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. REV. 141, 141 (2002).

inclusion of protective covenants will likely be necessary to induce people to purchase the bonds;[138] however, such covenants cannot change the locus of the fiduciary duty upon the bondholder and away from the shareholders.[139] Current shareholders can contract in order to protect the interests that they deem to be necessary.

Of the three options discussed, the issuance of new bonds is the most optimal. While an initial public offering would be the most effective in protecting the corporation, it comes at a very high cost. Issuance of new bonds in a private placement provides the benefit of creating innocent creditors without the associated costs of registration and with the limited conflict of interest inherent in private offerings of stock. It is unclear, however, how many innocent creditors must be present before the court will refuse to pierce the veil. In addition, if the corporation is considering going public in the future, the amount of debt it has can influence the stock price. Long-term corporate planning should be considered before changing the corporation's capital structure.

2. *Negotiated Protection in Shareholders' Personal Contracts*

Shareholders may act in the corporation's best interest by including provisions in their personal contracts with creditors that make reverse veil piercing less likely. Restrictive covenants, such as a limitation on a transfer of assets, have been utilized in bond contracts for years in an effort to minimize the stockholder–bondholder conflict.[140] The same concept can be applied to private debt contracts. The first type of provision may specifically state that the shareholders' personal creditors cannot collect from the assets of the corporation. Another contractual remedy is the inclusion of choice-of-law clauses that require application of the law of a state that has expressly discarded reverse veil piercing. Such clauses would be an effective means of preventing reverse veil piercing without regard to the state where the case has been brought. The concern would be the courts' enforcement of the clause. Many critics of choice-of-law clauses believe that parties should not be able to evade rules of law by simply writing contracts providing for application of alternative law.[141] Generally, courts

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138. *See* Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 8-14 (1989) (discussing the necessity of covenants in bondholder contracts to reduce the risk of moral hazard that bondholders face as a result of limited liability).

139. Crespi, *supra* note 136, at 147.

140. *See* Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

141. *See* Ernest G. Lorenzen, *Validity and Effects of Contracts in Conflicts of Law*, 30 YALE L.J. 655, 658 (1921) ("The validity or invalidity of a legal transaction should result

have enforced choice-of-law clauses as long as there is at least some connection between the parties and the chosen law.[142] If the chosen law does not have a substantial relationship to the parties, the court may still enforce the clause if a reasonable basis exists for choosing that law.[143] A reasonable basis may include that the chosen state's law on a particular topic, related to the subject matter of the contract, is well-developed.[144]

The feasibility of these options is limited by the number of shareholders that the corporation has. A large number of shareholders increases monitoring costs since each shareholder would need to be intimately involved in the personal affairs of the other shareholders to ensure that they are including the provisions in their contracts.[145] In addition, the inclusion of such clauses is hotly contested during the negotiation process. A party's bargaining power and desire for the inclusion of other contractual provisions affects the likelihood of inclusion of a contractual provision to protect against reverse veil piercing. Furthermore, the ability of contracting parties to enter into contracts that address all contingencies is limited by the parties' ability to predict potential problems.[146] Contractual protections against reverse veil piercing are not very effective considering the costs and inability to adequately account for all circumstances.

B. Pending Reverse Veil Piercing Actions

Once a reverse veil piercing action has been brought by a creditor, the above-mentioned suggestions to avoid the doctrine are no longer useful options. The corporation must identify other features of the case that courts have recognized as important in order to persuade the court to not apply the doctrine. Since courts have often cited the lack of adequate alternative

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from fixed rules of law which are binding upon the parties. Allowing the parties to choose their law in this regard involves a delegation of sovereign power to private individuals.").

142. Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363, 374-77 (2003).

143. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(a) (1971).

144. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 cmt. f (1971).

145. Hansmann, Kraakman & Squire, *supra* note 17, at 1340. Similarly, since monitoring is difficult, the "free rider" problem results in a tendency to "reduce the incentive of each stockholder to become knowledgeable and negotiate effective contractual protections." Tauke, *supra* note 138, at 16.

146. *See* Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 232 (1988) (stating that the ability of a contract to cover all bases is limited by the "bounded rationality" of the parties—the limits of the human mind in comprehending and solving complex problems).

remedies as a reason for applying the doctrine of reverse veil piercing,[147] the corporation should show that such remedies are available.[148]

The first alternative remedy is fraudulent conveyance. The Uniform Fraudulent Conveyance Act, which has been adopted by forty-three states, supplies protections against attempts to hinder, delay, or defraud creditors of corporations within the zone of insolvency.[149] A creditor who discovers that the debtor has fraudulently conveyed assets can reduce his claim to judgment and recover from property that is now no longer in the debtor's hands if the property is not held by a bona fide purchaser for value.[150] The doctrine of fraudulent conveyance is a fairly elastic concept that gives broad discretion to courts to circumvent unwanted debtor behavior when other tools are not available.[151] Over the last several years, "there has been an increasing tendency to treat transfers of property of insolvent debtors in which the debtor received nothing or too little in return as fraudulent conveyances."[152]

The difficulty with the argument of fraudulent conveyance as an adequate alternative remedy is proving the element of intent. Fraudulent intent is often argued in the traditional veil piercing context when a corporation has transferred its assets to one or more shareholders as part of the instrumentality test.[153] It is fairly easy to prove due to the infrequency of transfers from a corporation to shareholders, aside from dividends and distributions. In the reverse context, however, it is harder to prove fraudulent intent since shareholders often transfer assets to the corporation as needed. For instance, shareholders may transfer assets to a corporation to aid in the continued operation of the day-to-day business. "The existence of a separate corporate entity can allow a debtor to circumvent the transfer requirement by utilizing corporate assets as a personal piggybank instead of transferring personal assets to the corporation, thus making it hard to prove

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147. *See supra* Part III.B.

148. *See* Richardson, *supra* note 8, at 1623-24 (arguing against the use of reverse veil piercing because "[f]orcing collection to go through the traditional channels would be advantageous to many parties involved in such a dispute directly or indirectly").

149. 11 U.S.C. § 548(a)(1) (2006).

150. *See* Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954).

151. Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1620 (2008).

152. Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 830 (1985).

153. *See* Robert Charles Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 505 (1977) (contending that the argument for the application of veil piercing is substantially the same as the argument for the court finding that there was a fraudulent conveyance); *see also* Peter B. Oh, *Veil-Piercing Unbound*, 93 B.U. L. Rev. 89, 120-21 (2013) (arguing that the use of veil piercing is necessary when fraudulent conveyance is not sufficient, such as where the transfer is disguised as a distribution of dividends).

fraudulent intent."[154] Intent is easier to prove where the transfer has occurred after the creditor has sued or threatened to sue the shareholder.

Another problem with fraudulent conveyance as an adequate alternative remedy is that the statute of limitations begins to run when the transfer is made.[155] Under the Uniform Fraudulent Conveyance Act, there is a four year statute of limitations, and many states have either increased or decreased this statutory period.[156] If the transfer is made prior to a claim being brought by the creditor, fraudulent conveyance may not be a viable remedy if it falls outside of the statute of limitations, in which case a court may be more willing to reverse pierce. So even if the corporation can prove intent, it may still be thwarted from successfully arguing fraudulent conveyance as an alternative remedy.

The second alternative remedy is conversion. Conversion is an intentional exercise of dominion or control over another's property that so seriously interferes with the owner's right to control it that the converter may be required to pay the owner the property's full value.[157] The problem with conversion as an adequate alternative remedy is that, in certain cases, a judgment for conversion will not provide the creditor with a means of acquiring the shareholders' assets that have been transferred to the corporation, thus satisfying the shareholders' obligations.[158] The property must have belonged to the creditor in the first place. Most reverse veil piercing cases involve shareholders hiding their personal assets in the corporation, as opposed to assets that belong originally to the creditors.[159] Conversion may be successfully argued when there is a fact pattern similar to *Postal Instant Press*.[160] In that case, the creditor was a franchisor seeking to obtain royalties from its franchisee. The royalties were the property of the franchisor since they were the result of the sale of the franchisor's products and when the franchisee transferred them to another corporation, he converted those assets. Conversion is less likely to be successful where the cause of action against the shareholders does not involve the assets that the shareholders transferred to the corporation.[161] Thus, conversion as an

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154. Allen, *supra* note 5, at 1167.

155. *See* Sands v. New Age Family P'ship, 897 P.2d 917, 920 (Colo. App. 1995) (citing Fish v. East, 114 F.2d 177 (10th Cir. 1940)).

156. *See, e.g.*, FLA. STAT. ANN. §56.29(6)(a) (West 2011) (creating a one year statute of limitations once a judgment has been rendered); N.Y. C.P.L.R. § 213 (McKinney 2011) (establishing a six year statute of limitations for fraudulent transfers).

157. RESTATEMENT (SECOND) OF TORTS § 222A(1) (1965).

158. Allen, *supra* note 5, at 1178-79.

159. *Id.* at 1179.

160. Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 98-100 (Cal. Ct. App. 2008).

161. Consider a factual scenario similar to *Litchfield Asset Management Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2002). In that case, the plaintiff received a judgment in a breach of contract case against the defendant who transferred her personal assets to the

alternative remedy is limited in its efficacy and can only be argued in very specific circumstances.

The third alternative remedy is traditional judgment collection procedures. In *Owens & Sons*, a creditor sued the Guastella East Corporation on a promissory note signed only by its shareholders.[162] The Louisiana Supreme Court held that if the shareholders were found to be titleholders to the assets sought, they could be levied directly.[163] Alternatively, the creditor could receive the benefits of the corporation's assets by selling the shareholders' shares and using the proceeds to pay the debt.[164] Therefore, the court reversed the decision of the trial court and found that Guastella East was not liable for the debt of its shareholders.[165] These traditional judgment collection procedures may not be viable in all situations, particularly where the action involves a limited liability company, not a corporation. Limited liability companies do not issue stock; instead, they issue membership interests.[166]

Moreover, the sale of the shareholders' shares is more easily said than done. "Where there are [multiple] shareholders, they would have an opportunity to purchase a greater interest or at least a guarantee that a new holder of the shares will have an interest in making economically viable decisions about the corporation's assets."[167] However, if the corporation is owned by a sole shareholder, finding a market for the shares may be difficult.[168] Valuation of stock is complicated and if the stock is not traded on the public market, the market value cannot be used to determine the price.[169] Furthermore, close corporations are less likely to pay dividends and tend to avoid regular distributions, which affects the value of the stock to third parties. If a corporation is arguing in favor of the sale of the shareholders' shares as a traditional judgment collection procedure, it should find a buyer or buyers for the shares prior to the litigation. Such preparation would strengthen the corporation's argument for the existence of an adequate alternative remedy.

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defendant businesses before the plaintiff could collect on the judgment. In that case, conversion would not be a possible remedy since the assets that the defendant businesses had never belonged to the plaintiff.

162. Owens & Sons, Inc. v. Guastella East, Inc., 354 So. 2d 571 (La. 1977).

163. *Id.* at 571.

164. *Id.* at 572.

165. *Id.*

166. Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069, 1095 (1992).

167. Richardson, *supra* note 8, at 1626-27.

168. *See* O'KELLEY, *supra* note 122, at 454 (stating that stock in a close corporation is practically illiquid).

169. *See* Piemonte v. New Boston Garden Corp., 387 N.E.2d 1145, 1149 (Mass. 1979) (stating that the lack of an active market makes the market price a bad indicator of value).

C. Monitor Changes in Courts' Attitudes

Outside of any potential or actual claims for reverse veil piercing, corporations should be aware of changing applications of the doctrine by courts. In a recent case, the Connecticut Supreme Court was asked to expressly overrule *Litchfield*.[170] The court declined to do so since "the facts proven [in this case] do not support the application of reverse veil piercing as that doctrine has been applied in other jurisdictions, [thus] we need not answer the question of whether the doctrine should be disallowed in Connecticut under any and all circumstances."[171] While the court declined to express an opinion on the continued vitality of *Litchfield*,[172] the decision in *State Five* suggests that Connecticut courts are unlikely to apply reverse veil piercing. And if they were to apply the doctrine, they would need to take into consideration factors outside of the traditional veil piercing approach, namely innocent shareholders and third-party creditors.[173]

Monitoring of these issues is essential for choosing the right preventive measure suggested above. Each suggested preventive measure has costs and benefits and some are likely to be more effective than others. Prior to *State Five*, the changes to capital structure that were suggested as preventive measures would not have been effective because Connecticut courts did not consider the impact on innocent third parties.[174] Considering the cost of those measures and the decreased efficacy, corporations subject to Connecticut law should not have adopted any changes to their capital structure. However, after *State Five*, the efficacy of such changes has increased since Connecticut courts will now consider additional factors beyond the traditional veil piercing approach.[175] This may tip the scales in favor of adopting such changes as preventive measures.

In addition to changes in state laws, corporations should be aware of how federal courts have treated state law on reverse veil piercing.[176] The Tenth Circuit Court of Appeals has had two occasions to apply the doctrine of reverse veil piercing under different state laws, and it has declined to do so in both circumstances.[177] There is some debate regarding the extent to

170. Comm'r of E.P.A. v. State Five Indus. Park, Inc., 37 A.3d 724 (Conn. 2012).

171. *Id.* at 731.

172. Comm'r of E.P.A. v. Farricielli, 59 A.3d 789, 797 n. 10 (Conn. 2013).

173. *State Five*, 37 A.3d at 734-36.

174. *See* Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298, 313-15 (Conn. App. Ct. 2002).

175. *See State Five*, 37 A.3d at 734-36.

176. Federal courts sitting in diversity must apply the law of the state in which they sit. *See* Erie R. Co. v. Tompkins, 304 U.S. 64, 78 (1938).

177. *See* Cascade Energy and Metals Corp. v. Banks, 896 F.2d 1557 (10th Cir. 1990) (deciding a case based on Utah law); Floyd v. I.R.S., 151 F.3d 1295 (10th Cir. 1998) (deciding a case based on Kansas law).

which the court deferred to state law, so the following cases should not be used as dispositive on how a state court would rule.[178] In *Cascade Energy*, the court refused to reverse veil pierce "[a]bsent a clear statement" by the Utah Supreme Court adopting the doctrine.[179] As previously stated, the Utah Supreme Court has neither adopted nor rejected the doctrine of reverse veil piercing.[180] It has never reverse pierced the corporate veil on the facts before it, but it has stated that the doctrine is consistent with Utah law.[181] However, based on *Cascade Energy*, this is insufficient for the Tenth Circuit to reverse veil pierce. This decision suggests that the Tenth Circuit views reverse veil piercing as solely judicially-created and not an inherent principle in corporate law, requiring an affirmative mandate by the state courts in order for the doctrine to be applied.

In *Floyd*, the Tenth Circuit refused to apply reverse veil piercing because it concluded that outsider reverse veil piercing was not recognized in Kansas law.[182] The district court relied upon the Kansas Supreme Court's decision in *Pemco*, which recognized the ability of a parent corporation to pierce the corporate veil of its subsidiary.[183] The Tenth Circuit differentiated between insider and outsider reverse veil piercing, and while *Pemco* discusses insider reverse veil piercing, it does not address outsider reverse veil piercing.[184] This reasoning suggests that the Tenth Circuit would not only require a clear statement by the highest state court accepting the doctrine, but moreover, such a statement must be made in a context similar to the factual scenario pending before the court. Based on *Cascade* and *Floyd*, it appears that federal courts will resolve ambiguities in state law as not accepting the doctrine of reverse veil piercing.

However, the Fourth Circuit, while not rejecting the position of the Tenth Circuit, appears to be less stringent in its requirements.[185] It has held, in the reverse veil piercing context, that when a state appellate court "rests its considered judgment upon the rule of law which it announces, that is a datum for ascertaining state law which is not to be disregarded by a federal court unless it is convinced by other persuasive data that the highest court of the state would decide otherwise."[186] Thus, it does not require a statement

178. Richardson, *supra* note 8, at 1615-16.

179. *Cascade Energy*, 896 F.2d at 1577.

180. *See supra* Part III.A.

181. Transamerica Cash Reserve, Inc. v. Dixie Power and Water, Inc., 789 P.2d 24, 26 (Utah 1990).

182. *Floyd*, 151 F.3d at 1300 (stating that "in the absence of a clear statement of Kansas law by the Kansas courts, we will not assume that such a potentially problematic doctrine already has application in that state").

183. Pemco, Inc. v. Kan. Dept. of Revenue, 907 P.2d 863 (Kan. 1995).

184. *Floyd*, 151 F.3d at 1298.

185. C.F. Trust, Inc. v. First Flight L.P., 306 F.3d 126, 137 (4th Cir. 2002).

186. *Id.* (quoting West v. AT&T, 311 U.S. 223, 237 (1940)).

from the highest state court; however, there must be some statement made by the state courts.[187]

Knowledge of how the federal courts treat the doctrine of reverse veil piercing provides an additional mechanism for dealing with pending reverse veil piercing actions. If the federal court in the district where the creditor has filed suit is less likely to pierce than the state court, the corporation can try to remove the action to federal court.[188] There is a 30-day time limit for removal of cases,[189] so it is important to be aware ahead of time whether or not removal will be beneficial. Removal presents two potential problems. First, the federal court may find that the case is not removable and remand it to state court. Second, once the action has been removed to federal court, the plaintiff may attempt to transfer the case to a district with a more favorable attitude towards reverse veil piercing.[190] This risk is minimized since the transferee court must apply the law of the transferor court.[191]

V. CONCLUSION

Reverse veil piercing is an unpredictable, evolving doctrine that can leave corporations' assets open to attachment by third parties and from which it is difficult for corporations to protect themselves. Scholars have proposed a myriad of solutions to the problem. Some scholars have suggested a test that looks past corporate formalities at the actual operation of the corporation and takes into consideration equitable and public policy concerns.[192] Others suggest that the "direct and indirect risks of reverse piercing are significant enough compared to the marginal benefits to judgment creditors to justify complete abandonment of the practice."[193]

Since the doctrine does not appear to be going anywhere in the near future, there are several options available to corporations for dealing with reverse veil piercing, including steps to take before and after an action has commenced. They can make structural changes that will make the courts less likely to pierce by increasing the number of innocent third parties that may be harmed. Shareholders can employ contractual remedies that prohibit the court from piercing. Once an action has been brought, corporations can

187. In *C.F. Trust*, the Fourth Circuit found that the Virginia Court of Appeals had not clearly articulated the standard for reverse veil piercing and so certified the question to the Virginia Supreme Court. *Id.* For the response of the Virginia Supreme Court, see *supra* Part III.B.

188. *See* 28 U.S.C. § 1441.

189. 28 U.S.C. § 1446(b).

190. 28 U.S.C. §1404.

191. *See* Van Dusen v. Barrack, 376 U.S. 612 (1964).

192. *See* Gaertner, *supra* note 26, at 696-98 (outlining an unitary interest test which "requires a court to make a two-step inquiry before it may reverse pierce the corporate veil").

193. Richardson, *supra* note 8, at 1629.

suggest alternative collection remedies that do not involve the corporation or remove the case to federal court in the hope of receiving more favorable treatment.

Regardless of which of the above suggestions a corporation decides to embrace, it must monitor the court decisions in its jurisdiction. Just because a court rejected the doctrine today does not mean that it will do the same tomorrow. Factors that a court had previously considered irrelevant may become an integral part of the analysis. And courts that have not previously addressed the issue may adopt any number of approaches to the doctrine. Monitoring is a crucial prerequisite to all preventive measures available to corporations for a doctrine that creates an "unprincipled hodgepodge of seemingly ad hoc and unpredictable results."[194]

194. Millon, *supra* note 1, at 1311.