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**„How limited is the liability of the members of a corporation?
Piercing the veil in the United States of America and in Hungary”**

Doctoral thesis

Budapest, 2009.

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*„I weigh my words when I say in my judgement
The limited liability corporation is the greatest
Single discovery of modern times... Even steam
And electricity are for less important than the limited
Liability corporation, and they would be reduced
to comparative importance without it.”
(Nicolas Murray Butler 1911.)¹*

I. Summary of the research

„The hallmark of the corporation is limited liability. This is usually the central reason for incorporation”² All states treat a corporation as an individual legal entity separate from its stockholders. The obligations of the corporation is the responsibility of the corporate entity, not the shareholders, who are liable only for the amount they voluntarily put „at risk” in the business venture. The insulation of shareholders is known as „limited liability”. The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting all of their personal wealth to the risks of the business.

Incorporation, while salutary for capital formation and economic development, may serve as a guise with which to perpetrate fraud, violate a law, or circumvent public policy. To remedy the injustice resulting from abuse of the corporate doctrine, the American courts employed „piercing the corporate veil”, an equitable remedy which holds shareholders liable for corporate acts.

The piercing doctrine was developed by the U.S. courts in the 19th century. Since it is an equitable remedy, there is no general formula to fit all cases. Rather the conditions under which a corporate entity will be disregarded vary according to the circumstances of each case. Typical when the corporation is the mere „agent” or „alter ego” of the shareholders and the veil piercing is necessary to prevent fraud or to achieve equity.

At the 19th century this doctrine was unknown in Europe, it assumed it just after the World War II.

From the first cases of the piercing doctrine the commentators tried to explain, how one can disregard from the separate legal entity to make the shareholders

¹ Roger E. Meiners, James S. Mofsky, Robert D. Tollison: Piercing the veil of limited liability [Delaware Journal of Corporate Law 1979] 351.

² Roger E. Meiners, James S. Mofsky, Robert D. Tollison: Piercing the veil of limited liability 352.

liable for the acts of the company. This was the question that I tried to answer in my Dissertation too.

In Hungary the doctrine was settled first in the Companies Act of 1997 (but only for cases where the company was wound up), but – perhaps because of the great respect of the theory of the separate legal entity - the judges do not want to use it. After the legal reforms of 2006 the doctrine is still in the act, although the judges do not use it. But why not? On the other side, there is almost nothing in the Companies Act that protects the creditors of a corporation if the members of the company e.g. undercapitalize the company, and it won't be able to pay the creditors debts or commingles of funds and other assets of the corporation with those of the individual shareholders.

In the first part of my Dissertation I examined the hungarian regulations of limited liability, if the legal instruments of the Companies Act 2006. are able to protect creditors e.g. the chartered accountant, or the minimum capital of the company.

The Companies Act 2006. makes easier to establish a limited liability company or a corporate than the CA 1997. For example: the minimum capital of the limited liability company was 3 million forint, since 2007. it is just 500.000. forint, and now it is possible to establish a company without cash, just with assets.

I think if we make easier the procedure of the incorporation, we have to compensate it to protect the interest of the creditors. I think the use of the piercing doctrine would be a good solution.

I tried to find the answer to the question: Why the hungarian courts do not use the piercing the veil doctrine, although the german courts do. Was it a good idea to take the regulations of the „wrongful trading” from Great Britain to the hungarian Bankruptcy Code? Is it enough to find the director of the company liable for wrongful trading to establish his criminal responsibility too?

The law intervenes in the UK and now in Hungary to protect creditors where fraudulent or wrongful trading by director can be proved. This is an ex post facto exercise and enforcement can be costly and uncertain even if the conditions for liability seem to be satisfied.

I examined not only the Companies Act and Bankruptcy Code, but the provisions of the Criminal Code too.

In 2007. the crime of serving in false value the apport was abolished. Was it a necessary step, when the Companies Act also makes more and more easier the establishing procedure?

We can see that the problem is very complex. It is not enough to know the company law, but we have to examine the provisions of the criminal law and the bankruptcy law too.

Only if we analyze these regulations, we can decide what we have to do: modifying the rules, or the judges have to approach the separate legal entity in another way.

In the second part of the Dissertation I examined the piercing the veil doctrine in the U.S. court practice.

The courts of the American States do not use the piercing doctrine with the same popularity, because every state has different law politics. New York for example uses the doctrine within narrow bounds, Delaware has less than one percent of all reported cases, but California uses it almost in every case. California developed the liability doctrine the best, not only for the domestic corporations, but for those, that were incorporated in other states.

The California corporate unlimited-liability law was considered by the U.S. Supreme Court on several occasions. In *Thomas v. Matthiessen* for example the Court faced an attempt by a citizen of California to recover from a citizen of New York on debts owed by an Arizona corporation in which the New Yorker was a shareholder. Despite the defendant shareholder's explicit agreement with the corporation that he wouldn't be liable for corporate debts and a corporate charter provision to that effect, the California law could be applied. The Court said that „a (corporate charter) provision exempting the shareholder (from liability) alongside of one authorizing the doing of business elsewhere cannot... be deemed an attempt to override the law of the place where the business is to be done.” The American Supreme Court pointed to the shareholder's explicit assent to the corporation's business in California, and held that by that assent the shareholder submitted himself to liability.

Not only the corporation, but the American form of business organization, the limited liability company (LLC) interested me very much.

All fifty states had an opportunity to revisit the question of separate corporate existence when the limited liability company was established in each of the states over a short period ending in the early 1990s. The LLC was driven by a combination of tax considerations and inter-state competition. It has legal entity distinct from its members. A few state statutes were explicit in saying that the separate existence of the new LLC entities was to be established by use of corporate law principles. A few statutes did limit the grounds on which piercing should be proven, usually by saying that informalities would not be a reason to

pierce, but saying nothing about what would be the reason to pierce. When courts have been asked to rule on piercing questions for limited liability companies, they gravitated to corporate piercing principles, sometimes without even acknowledging that the entity in question is not even a corporation. Although there is now some harmonisation by virtue of the Uniform Limited Liability Company Act, variations remain.

The popularity of the LLCs is thanks to that the LLC is a hybrid entity designed to combine the tax advantages of partnership with the benefits of limited liability.

II. **The method of research**

First of all I analyzed the hungarian rules of limited liability and all provisions that are connected with the question of „veil piercing”. In Hungary there is just a few cases connected with veil piercing, and I examined the reasons why the hungarian courts do not use this legal instrument.

I examined the shareholder’s liability for the value of the apport, the rules of instrumentality, the „piercing doctrine” in the hungarian Companies Act, and the „wrongful trading” in the Bankruptcy Code. I compared this new liability form the wrongful trading with the provisions of the Criminal Code.

I have been in the U.S. in 2004. for three weeks at the Ohio State University, where I did research in the field of the liability of the members of a company. Since than I have tried to collect almost all publications since 1912, that elaborates veil piercing. Besides this, I examined the Model Business Corporation Act, the Uniform Limited Liability Company Act, and the influence of these acts to the national legislation and to the practice.

I analyzed the nature of the corporations, the limited liability companies in the U.S. and the reasons given by the courts for piercing or not piercing the corporate veil (like undercapitalization, informalities, shareholder domination, instrumentality).

In the last part of my Dissertation I used the method of comparative law, because it not only shows up the emptiness of legal dogmatism and systematics but, because it is forced to abandon national doctrines and come directly to grips with the demands of life for suitable rules it develops a new and particular system, related to those demands in life and therefore functional and appropriate.

„The basic methodological principle of all comparative law is that of functionality.... Incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfil the same function...The question to which any comparative study is devoted must be posed in purely functional terms; the problem must be stated without any reference to the concepts of one's own legal system.”³

Comparative law doesn't simply criticize what it finds, but can claim to show the way to a better mastery of the legal material, to deeper insights into it, and thus, in the end, to a better law.

Piercing the corporate veil is the most litigated issue in corporate law, and yet it remains among the least understood.

III. Scientific results

As a general principle, corporations are recognized as legal entities separate from their shareholders, officers and directors. Corporate obligations remain the liability of the entity and not of the shareholders, directors, who own and act for the entity. Liability limitation artificially distance individuals from the real life effects of the enterprise in which they invest, thus decreasing their acknowledged personal liability. Piercing the corporate veil refers to the judicially imposed exception to this principle by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholders's own.

The boundaries of this exception are usually stated in broad terms that offer little guidance to judges or litigants in subsequent cases. In 1926, Benjamin Cardozo described this corner of the law as *„enveloped in the mists of metaphor”* and courts and commentators have been even less kind in subsequent years. Legal writers have described judicial decisions to pierce the veil as *„irreconcilable and not entirely comprehensible”* *„defy[ing] any attempt at rational explanation”*.⁴

The main question of my research was: *„How limited is the liability of the members of a corporation in Hungary and in the United States?”*

³ Zweigert, Kötz: An introduction to Comparative Law 34-35.

⁴ Rbert B. Thompson: Piercing the Corporate Veil: An empirical study 1991. 1086-1087.

One of my personal goals is to let the Hungarian scientific life know that the piercing doctrine is able to exist in the Hungarian company law too. If it is necessary I think the Hungarian courts have to pierce the veil in the interests of the creditors and it is not a problem if there is no rule exists in the company act, (because of the general principles of the Code Civil 1959).

1. Undercapitalization

Whenever somebody wants to establish a company with separate legal entity, it have to pay the minimum capital. Since 2006. it is not necessary to pay the hole capital before the incorporation. The minimum capital is a screen if one's decision to participate in the economic life is severe. On the other hand the minimum capital as a guarantee for the creditor too, for example when the company would like to take a credit. I think if the owners want to get the limited liability as a possibility to enter to the business life without personal „risk”, than at least at the moment of the incorporation they should have to put a sum in the company to show that their mind is severe.

I agree with Ödön Kuncz, when he said, that the capital stock of the company is the minimum guarantee of the company's creditors. I would say that the minimum capital is the price of the limited liability.

One apparently measure to prevent small, undercapitalised firms from incorporating with limited liability would seem to be the imposition of a minimum capital requirement, but it is not part of the Anglo-American tradition. In the United States there is just a few states where a minimum sum (\$ 500, or 1000 \$) is necessary to incorporate a corporation, but the most part of the states do not use it. When the limited liability company appeared in the american economic life, there was no state statute that would order a minimum capital. On the other hand, the limited liability of the members is not absolut. The LLC has no minimum capital requirement and may now be formed by one member in many states.

Whenever it is proposed to adopt a foreign solution which is said to be superior, two questions must be asked: first, whether it has proved satisfactory in its country of origin, and secondly, whether it will work in the country where it is proposed to adopt it.

The minimum capital requirement is still seen by some in the continental Europe as an important barrier to incorporation to protect creditors, although there are critics of the requirement in those countries also. In France one can establish a

SARL with 1 euro, but in Germany the minimum capital of the GmbH is still 25.000 euro.

The undercapitalization is a factor frequently cited by commentators as part of a normative standard in piercing cases. Some commentators have gone so far as to conclude that undercapitalization is present in every piercing case, or that every undercapitalization case should lead to piercing. In the U.S. the courts begin with the rule that capitalization must be adequate to cover the reasonably foreseeable risks of the business. This inquiry assumes that, prior to the commencement of the corporate undertaking, prudent businessmen consider the amount of capital required to finance the operations of the business. Presumably, starts-up costs, near term cash flow needs, and long-range financing are all considered in this initial financial planning process. Undercapitalization may exist in at least two forms: (1) the total investment in the corporation in the form of debt and equity is adequate for the reasonably foreseeable risks associated with business, but the debt is excessive when compared to the capital supplied by the shareholders; and (2) the total investment in the corporation in all forms is inadequate for the business.⁵ No general formula has been articulated by the courts in the U.S. for determining adequate capital. A variety of different conceptual approaches with a comparison of their relative merits, are considered.

I presented the German rules of „Haftungsdurchgriff“ and the Proposal for Council Regulation on the Statute for a European private company. The rule of minimum capital is not the only solution to protect the creditors of a company, but without other guarantees it is impractical to abolish it. For example the courts could use the piercing the veil doctrine in case if the members use the company to defeat public convenience, justify wrong, protect fraud or defend crime.

⁵ David H. Barber: Piercing the Corporate Veil [Willamette Law Review 1981.] 391.

2. The misuse of law

Maurice Wormser's analysis of veil piercing in 1912 began as a quest to determine what the corporation is as a „juristic concept”. Although he recognized at the outset that determining the true anatomy of the corporate concept was a „tempting but profitless discussion”. He examined cases of veil piercing, and he laid down what he called the „general rule”. *„When the conception of corporate entity is employed to defraud creditors, to evade an existing obligation, to circumvent a statute, to achieve or perpetuate monopoly or to protect knavery or crime, the courts will draw aside the web of entity, will regard the corporate company as an association of live, up-and-doing, men and women shareholders, and will do justice between real persons.”*⁶

In the U.S. and in Hungary also, the misuse of law conduct to veil piercing. The difference between the two systems are conspicuous. In Hungary the provisions of veil piercing have to apply to companies that are wound up, in the U.S. it can be applied to existing companies. So the piercing doctrine is not a sanction of insolvency in the U.S. like in Hungary. In the U.S. the beginning or the finishing of a winding up procedure is not a condition to make the owners personal liable for the company.

In Hungary the creditor is able to sue the members of a company just after the winding up procedure in condition, that he can prove, that the member misused the law, and with this attitude he caused damages for the creditor. The Companies Act explains what the misuse of law is (a) if the member misuse the legal entity at the creditors expenses, (b) or he used the company's assets or funds to personal gains, and after the winding up the company has not enough money to pay the creditor's claim.

The Proposal of the Courts of Appeal of Szeged is similar to the american piercing theory, when it says, that the member of an existing company could be liable if he misuse the separate legal entity and separate liability of the company, because it conflicts with the principles of the Code Civil. In this case the shareholder is jointly and severable liable with the company. There are some commentators who criticize this approach.

In the U.S. a review of the case law reveals that one or more of the following factors was present in each instance of piercing:

- (a) commingling of funds and other assets of the corporation with those of the individual shareholders

⁶ Maurice Wormser: Piercing the veil of corporate entity [Colum.L.Rev. 1912.] 517.

- (b) diversion of the corporation's funds or assets to noncorporate uses (to the personal uses of the corporation's shareholder)
- (c) failure to maintain the corporate formalities necessary for the issuance or subscription to the corporation's stock, such as formal approval of the stock issue by an independent board of directors
- (d) identity of the directors and officers of two entities who are responsible for supervision and management
- (e) failure to maintain corporate minutes or adequate corporate records
- (f) identical equitable ownership in two entities (Corporation A is owned by the same shareholders and in the same proportions as Corporation B)
- (g) absence of separately held corporate assets
- (h) concealment of misrepresentation of the identity of the ownership, management, or financial interest in the corporation, and concealment of personal business activities of the shareholders
- (i) the formation and use of the corporation to assume the existing liabilities of another person or entity. etc.⁷

3. Instrumentality

Although Frederick Powell examined in the U.S. only the parent and subsidiary corporations, he freely extended his analysis to „one-man” corporations, indicating the rules applied to those entities with equal force. He stated it would be an abuse of privilege or a „fraud upon the law” to allow the separate existence of a corporation to be recognized if the following were true:

- (a) there was control of the corporation,
- (b) used to commit „fraud or wrong” causing
- (c) unjust loss or injury to the complainant.

Powell's three part test is the one now most frequently used as the touchstone for veil-piercing analysis.⁸ Powell's theory is called instrumentality. Many cases use the term agent as the equivalent of instrumentality in piercing test.

Let me introduce the instrumentality theory in an example. In a bankruptcy case, the receiver applied to extend his receivership to the property of a corporation which he alleged to be a mere alter ego of a bankrupt partnership. The members of the partnership firm owned 485 shares of the outstanding stock, the other five shares outstanding were owned by a close relative of the partners. Business

⁷ David H. Barber: Piercing the corporate veil 374.

⁸ Douglas C. Michael: To Know a Veil [The Journal of Corporation Law 2000.] 45-46.

between the corporation and partnership was conducted in such manner that the state of accounts between them was impossible of ascertainment. The court said that, the corporate organization was but an alter ego of the partnership. It was the same pack of tvievish wolves, whether in the „entity” garments of little Red Riding Hood’s grandmother’s or in their own furry coats.⁹

In order to disregard the entity it must clearly appear that one corporation is but the „business conduct” of the other.

In the piercing area „alter ego” and „instrumentality” acquired such conclusory status, describing the result but doing little to explain the reasons for the decisions. „*As a result we are faced with hundreds of decisions that are irreconcilable and not entirely comprehensible.*”¹⁰

All the fifty american states had an opportunity to revisit the question of separate corporate existence when the new form of business organization the limited liability company was established in each of the states over a short period ending in the early 1990s. Those statutes were much more explicit than comparable corporate statutes in addressing limites liability, but these statutes addressed few of the deficiencies of piercing the veil jurisprudence established by the commentators. Instead the clear trend of these statutes was to expand the use of separate corporate entities applying the established principles of corporate law. A few state statutes were explicit in saying that the separate existence of these new entities was to be established by use of corporate law principles. A few statutes did limit the grounds on which piercing should be proven, usually by saying that informalities would not be a reason to pierce, but saying nothing about what would be the reasons to pierce. In any event, when courts have been asked to rule on piercing questions for LLCs, they have gravitated to corporate piercing principles, sometimes without acknowledging that the entity in question is not even a corporation.

⁹ Maurice Wormser: Piercing the veil of corporate entity [Colum.L.Rev. 1912.] 500.

¹⁰ Robert B. Thompson: Piercing the Veil: Is the Common Law the Problem? 624.

IV. Publications of the author:

- The representation of companies (Közjegyzők Közlönye 9/2004. 8-11.)
- The legal relationship of the auditor (Magyar Jog 10/2004. 595-606.)
- Analysis of the legal relationship of the accountant and the book-keeper (Közjegyzők Közlönye 2/2005. 3-8.)
- The most important modifications of the winding-up procedure (Közjegyzők Közlönye 10/2006. 3-8.)
- Protection of interest of creditor- Liability of members of company for contribution in kind (Jogtudományi Közlöny 7-8/2007. 352-360.)
- Piercing the corporate veil in the procedure of liquidation, wrongful trading v. bankruptcy (Magyar Jog 4/2008. 226-237.)
- The liability of the members of a company in Great-Britain (Yearbook of the Department of Commercial Law 2008. 80-92.) under publishing
- Piercing the veil in the interests of creditors (University of Debrecen 2009.) under publishing