

## DO NOT DROP YOUR VEIL

One of the most common risk reduction techniques in operating a real estate brokerage firm is to organize the firm as a corporation or as a limited liability company. It is relatively easy and inexpensive to file articles of incorporation for a corporation or articles of organization for a limited liability company, obtain a real estate brokerage license for the company and begin operations. Generally, the owner as a shareholder of the corporation, or as a member of the limited liability company, will not be liable for the obligations of the corporation or the limited liability company.

As an example, assume that Mary Smith has long operated Smith Realty through a d/b/a she filed with the county in which she resides. Smith Realty operates out of an office which it leases from Jim Brown. As times become difficult, Smith Realty fails to make lease payments to Jim Brown. Jim Brown ultimately sues Mary Smith and Smith Realty for damages due to Smith Realty's failure to pay under the terms of the lease. Mary Smith would have personal liability for the lease obligation since she is operating as a d/b/a and remains personally liable for the obligations of her business.

If, on the other hand, Mary Smith had incorporated Smith Realty and the parties to the lease were Smith Realty, Inc. as tenant and Jim Brown, as landlord; ordinarily Mary Smith would not be personally liable to Jim Brown in the event Smith Realty, Inc. failed to meet its obligations under the lease. Assume that Jim Brown sues Smith Realty, Inc. to recover damages for Smith Realty, Inc.'s breach of the lease. As soon as the lawsuit is filed, Smith Realty, Inc., vacates its leased premises and appears to exist no more. In the meantime, Jim

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Brown continues to see Mary Smith driving around town in a late-model car and living in one of the finest parts of town. He obtains a judgment against Smith Realty, Inc. and ultimately discovers that it has plenty of debts but it has no assets. Conversely, it would appear that Mary Smith has plenty of assets but no debts. Does Jim Brown have any recourse against Mary Smith to get at her personal assets?

Again, Michigan courts typically consider corporations legally distinct from their shareholders, even if a single shareholder owns all the stock. However, in some instances the courts will permit a party, such as Jim Brown in our hypothetical, to “pierce” the corporate veil, *i.e.*, ignore the corporate entity and permit action against the shareholder(s) for the obligations of the corporation.

As a general rule, piercing the corporate veil is permitted where there is evidence of fraud, illegality or injustice. As one court has held:

The fiction of a distinct corporate entity separate from the stockholders is a convenience introduced in the law to serve the ends of justice. When this fiction is invoked to subvert justice, it may be ignored by the courts.

*Allstate Ins Co v Citizens Ins Co*, 118 Mich App 594, 600-01; 325 NW2d 505 (1982).

Three elements must be met to justify piercing the corporate veil so as to impose personal liability on the shareholder(s). First, the corporate entity must be a “mere instrumentality” of another entity or individual. Second, the corporate entity must be used to commit a fraud or wrong. Third, there must have been an unjust loss or injury to the plaintiff. *SCD Chemical Distributors, Inc v Medley*, 203 Mich App 374, 381; 512 NW2d 86 (1994).

There are several factors a court will look at in determining whether a plaintiff will be permitted to pierce the corporate veil and impose personal liability on a shareholder or, in the case of a limited liability company, on a member.

First, was the corporation or limited liability company properly capitalized? For example, if when Mary Smith formed Smith Realty, Inc. and entered into the lease obligation with Jim Brown, she did not contribute any capital to Smith Realty, Inc.; the undercapitalization of her company would be evidence for piercing the corporation veil.

Second, did the corporation or limited liability company maintain appropriate records and bank accounts? If it was determined that Smith Realty, Inc. maintained separate accounts and deposited all funds received by Smith Realty, Inc. in these corporate bank accounts, this would help defeat an attempt to pierce the corporate veil. On the other hand, if evidence demonstrated that at least some revenues received by Smith Realty, Inc. were unaccounted for in its records and/or went directly into the accounts of Mary Smith, this would be evidence helpful to pierce the corporate veil.

Third, were funds which were the property of Smith Realty, Inc. used to pay bills or expenses related more to the private life of Mary Smith than the corporate operations of Smith Realty, Inc? For example, if Mary Smith's automobile was titled in her name but the payments were made from Smith Realty, Inc.'s funds, this would be evidence supporting piercing the corporate veil. As another example, if the tuition for Mary Smith's son's private school was paid with Smith Realty, Inc. funds, this would be evidence to support piercing the corporate veil.

Fourth, was there appropriate documentation for any transactions between Mary Smith and Smith Realty, Inc? For example, if Mary Smith routinely “borrowed” funds from Smith Realty, Inc., were these borrowings evidenced by promissory notes which bore a reasonable rate of interest? Further, did Mary Smith make any payments to repay the funds she had borrowed from her corporation? If the answers to these questions are “no,” then it may be concluded that the loans were shams and that Mary Smith was simply distributing money from her corporation to herself with no obligation to repay. Again, this would be evidence to support piercing the corporate veil.

It is rare in Michigan that a plaintiff is able to effectively pierce the corporate veil of a corporation or limited liability company. This rarity is due to the fact that it is not difficult to maintain the veil if the company follows very basic guidelines. If the company is properly capitalized upon its formation; proper books and records are maintained; all distributions to shareholders are properly documented and made in conformity with Michigan corporate law; and the funds of the shareholders and corporation are not comingled, then there is typically not a case for piercing the corporate veil. On the other hand, if a person simply files articles of incorporation and conducts business without any of the corporate formalities, liability may indeed find him.