The Law in Texas Regarding Piercing the Corporate Veil

Section 1. An Overview of the "Corporate Veil"

The Texas corporation, like the corporation in every other state, is a creature of statute and is legally separate and distinct from its officers, directors and shareholders. The general rule of corporate law is that the corporation is a completely separate, legal entity, and, as such, the corporation, and not its shareholders, is liable for its own contracts, debts and torts. In other words, shareholders, directors, officers and employees of a corporation benefit from the doctrine of limited liability, in which none of them are liable for actions taken on behalf of the corporation. This protection from personal liability has traditionally been one of the attractions of the corporate form of organization to its shareholders, officers and directors.

The limited liability characteristic of a corporation is often referred to as the "corporate veil." While the corporate veil normally protects shareholders, officer and directors from liability for corporate debts and obligations, "when these individuals abuse the corporate privilege, courts will disregard the corporate fiction and hold them individually liable." In many cases, determined plaintiffs, feeling that they have been harmed by the corporation or by employees or agents of the corporation, often seek to recover damages personally from the shareholders, directors and officers of the corporation by asking a court to pierce the corporate veil.

Piercing the corporate veil, also known as the doctrine of corporate disregard, is a method used by plaintiffs and courts to impose liability on officers, directors, and shareholders of a corporation. Additionally, plaintiffs will often attempt to pierce the corporate veil in order to impose liability upon a parent corporation for the obligations of a subsidiary. "For the purposes of legal proceedings, subsidiary corporations and parent corporations are separate and distinct "persons" as a matter of law and the separate entity of corporations will be observed by the courts even where one company may dominate or control, or even treat another company as a mere department, instrumentality, or agency." Texas courts are generally willing to disregard the corporate form in this situation only when corporations are not "operated as separate entities, but rather integrate their resources to achieve a common business purpose." Plaintiffs, therefore, often attempt to pierce the corporate veil in order to treat the two corporations as one entity.

Section 2. Theories Used in Corporate Veil Piercing

2.1. The Alter Ego Theory

Prior to the Texas Supreme Court's decision in Castleberry v. Branscum, Texas courts consistently held "that personal liability should be imposed on a [share]holder only in extraordinary circumstances." In Castleberry, however, the Texas Supreme Court pierced the corporate veil by using the "alter ego" theory to allow a promissory note holder to recover against the shareholders of a corporation. The court reasoned that, while shareholders, officers, and directors are generally shielded from personal liability for corporate obligations, when these same people abuse the corporate privilege, courts will disregard the corporate fiction and hold them personally liable. Setting forth the rationale behind the decision, the court stated "if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors."

The alter ego theory permits a court to impose liability upon an individual shareholder, officer, director, or affiliate for the acts of a corporation. This theory may also be used to impose liability upon a parent corporation for the acts of a subsidiary corporation when the subsidiary is "organized or operated as a mere tool or business conduit." A court will look at many factors to determine whether an alter ego relationship exists. When dealing with an individual and a corporation, the court will look at the total dealings of the corporation and the individual, including evidence of the degree to which corporate and individual property have been kept separate; the amount of financial interest, ownership, and control the individual has maintained over the corporation; whether the corporation has been used for personal purposes; and whether the corporation is undercapitalized in light of the nature and risk of its business.

When dealing with a situation in which a plaintiff seeks to pierce the corporate veil in order to impose liability upon a parent corporation for the obligations of a subsidiary, the factors that courts will consider include:

(a) common stock ownership between parent and subsidiary;

(b) common directors and officers between parent and subsidiary;

(c) common business departments between parent and subsidiary;

(d) consolidated financial statements and tax returns filed by parent and subsidiary;

(e) parent's financing of the subsidiary;

(f) parent's incorporation of the subsidiary;

(g) undercapitalization of the subsidiary;

(h) parent's payment of salaries and other expenses of subsidiary;

(i) whether parent is subsidiary's sole source of business;

(j) parent's use of subsidiary's property as its own;

(k) combination of corporations' daily operations;

(l) lack of corporate formalities by the subsidiary;

(m) whether directors and officers of subsidiary are acting independently or in the best interests of the parent; and

(n) whether parent's employee, officer or director was connected to the subsidiary's action that was the basis of the suit.

In Castleberry, the Texas Supreme Court held that Texas courts should take a flexible, fact-specific approach since the purpose of the corporate veil doctrine "is to prevent use of the corporate entity as a cloak for fraud or illegality or to work an injustice, and that purpose should not be thwarted." The Castleberry court held that plaintiffs did not need to show fraud or intent to defraud as a prerequisite to piercing a corporate veil, so long as recognizing the separate corporate existence would bring about an "inequitable result." Therefore, under Castleberry, "tort claimants and contract creditors must show only constructive fraud" to pierce the corporate veil.

In response to this extremely broad interpretation of the doctrine of corporate disregard by the Texas Supreme Court, the Texas legislature amended portions of the Texas Business Corporation Act. In Texas, a shareholder's personal liability for obligations of a Texas corporation is governed by Article 2.21 of the Texas Business Corporation Act [or Sections 21.223, 21.224, and 21.225 of the Texas Business Organizations Code, where that Code is applicable] ("Article 2.21"). After several legislative amendments, Article 2.21 now provides that no personal liability for contractual obligations exists unless the plaintiff can demonstrate that the shareholder, owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the plaintiff primarily for the direct personal benefit of the shareholder, owner, subscriber, or affiliate. Therefore, plaintiffs may no longer rely upon the constructive fraud set forth in Castleberry and must now show that an actual fraud occurred.

Additionally, since amended in 1993, Article 2.21 has provided that, with certain exceptions, Section A of Article 2.21 is the sole method for piercing the corporate veil and imposing liability upon an individual for the obligations of a corporation or upon one corporation for the obligations of another corporation. The current version of Section B of Article 2.21 states:

> The liability of a holder, owner, or subscriber of shares of a corporation or any affiliate thereof or of the corporation for an obligation that is limited by Section A of this article is exclusive and preempts any other liability imposed on a holder, owner, or subscriber of shares of a corporation or any affiliate thereof or of the corporation for that obligation under common law

> or otherwise, except that nothing contained in this article shall limit the obligation of a holder, owner, subscriber, or affiliate to an obligee of the corporation when:
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> > (i) the holder, owner, subscriber, or affiliate has expressly assumed, guaranteed, or agreed to be personally liable to the obligee for the obligation; or
> >
> > (ii) the holder, owner, subscriber, or affiliate is otherwise liable to the obligee under this Act or another applicable statute.

Section A of Article 2.21 governs when an individual may have an obligation with respect to a corporation's contractual obligations or when a corporation may have an obligation with respect to an affiliate's contractual obligations:

> A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate thereof or of the corporation, shall be under no obligation to the corporation or to its obligees with respect to:
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> > (i) such shares other than the obligation, if any, of such person to pay to the corporation the full amount of the consideration, fixed in compliance with Article 2.15 of this Act, for which such shares were or are to be issued;
> >
> > (ii) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, owner, subscriber, or affiliate is or was the alter ego of the corporation, or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud, or other similar theory, unless the obligee demonstrates that the holder, owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, subscriber, or affiliate; or
> >
> > (iii) any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including without limitation: (a) the failure to comply with any requirement of this Act or of the articles of incorporation or bylaws of the corporation; or (b) the failure to observe any requirement prescribed by this Act or by the articles of incorporation or bylaws for acts to be taken by the corporation, its board of directors, or its shareholders.

In other words, corporate shareholders, owners, subscribers, or affiliates may not be held personally liable for the contractual obligations of the corporation under alter ego or another “similar” theory unless actual fraud is shown. Additionally, shareholders, owners, subscribers and affiliates may not be held liable for the obligations of the corporation if the sole basis of a plaintiff’s claim is the failure to observe corporate formalities.

Before the amendments to Tex. Bus. Corp. Act Art. 2.21(A)(2), commentators and courts agreed that all claims that were not contractual were governed by *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986), which required only a showing of constructive fraud in order to pierce the corporate veil under the alter ego theory. Traditionally, Texas cases have attempted to treat contract claims and tort claims differently in determining whether to pierce the corporate veil. *See Lucas v. Texas Indus., Inc.*, 696 S.W.2d 372, 375 (Tex.1984) (pointing out differences between tort and contract alter ego cases). *Id.* However, the 1997 amendments to Article 2.21 of the Business Corporations Act appear to blur the distinction between contractual obligations and other claims. The provision now states that it covers all contractual obligations of the corporation “*or any matter relating to or arising from the obligation.*” *See* Tex. Bus. Corp. Act Art. 2.21(A)(2). For all matters covered by this provision, the corporate veil may not be pierced absent a showing of actual fraud. *Menetti*, 974 S.W.2d at 174. The commentary following the 1996 amendments suggests that the actual fraud requirement should be applied, by analogy, to tort claims, especially those arising from contractual obligations. *Id.* Therefore, it is possible that the Court would require a showing of actual fraud in order to invoke the alter ego theory and pierce the corporate veil for a tort claim.

Even if a showing of actual fraud is not required in a tort case, the courts are reluctant to pierce the corporate veil under an alter ego theory and hold one entity liable for the torts of another or hold the individual shareholders liable. Generally, in a tort case the financial strength or weakness of the corporate tortfeasor is the primary consideration. *Lucas,* 696 S.W.2d 372, 375 (Tex.1984). If the corporation responsible for the plaintiff's injury is capable of paying a judgment upon proof of liability, then no reason would exist to attempt to pierce the corporate veil and have shareholders pay for the injury. *Id.* If, however, the corporation sued is not reasonably capitalized in light of the nature and risk of its business, the need might arise to attempt to pierce the corporate veil and hold the parent corporation liable. *Id.* The Court in *Lucas* chose not to pierce the corporate veil and stated that the fact that the two entities may have had some or all of the same directors or officers, filed consolidated tax returns, shared the same corporate logo, and conducted inter-corporate business was not enough to pierce the corporate veil. *Id.* at 376. Furthermore, the Court reasoned that the blending of activities or interlocking directorship will not give a Court a basis for disregarding the separate identities of corporations, unless such relationship is used to defeat public convenience, justify wrongs, protect fraud, or defend crime. *Id.*

2.2. **The Single Business Enterprise Theory**

The single business enterprise theory is a common law doctrine based in equity that is used to impose partnership-like liability principles when businesses integrate their resources. In order to take advantage of the corporate form of limited liability, parties will often incorporate several different business concerns under the belief that each incorporated entity will protect them from any and all personal liability of each business concern. Courts, however, apply the single business enterprise theory to pierce the corporate veil in situations where two or more corporations are not operated as wholly separate entities, but instead combine their resources to achieve a common business purpose. When courts find that a single business enterprise exists, they will hold each corporation liable for the obligations relating to the common business purpose to avoid an "inequitable outcome."

Basically, when attempting to utilize the single business enterprise theory, the plaintiff desires to pierce the corporate veil in order to reach the assets of a subsidiary's parent corporation or to reach the assets of any other entity involved in the single business enterprise. The single business enterprise theory does not normally allow a successful plaintiff to reach the pockets of an officer, director, or shareholder, but rather allows a successful plaintiff to reach the pockets of an affiliated corporation. While some courts have held that the single business enterprise theory and the alter ego theory are two separate and distinct theories utilized for veil piercing, the purpose and effect of the two theories is identical: to allow a plaintiff to recover from another party when a corporation does not have adequate assets.

The Texas courts have enunciated several factors that are to be considered when determining whether a single business enterprise exists. It appears that a plaintiff need not prove every factor, so a corporation may be held liable even if all of the factors listed below are not present. Unfortunately, the courts have not given any guidance or instruction as to whether any of the listed factors is to be given more weight than the other factors. Factors that have been considered by the Texas courts include:

(a) common employees;

(b) common offices;

(c) centralized accounting;

(d) payment of wages by one corporation to another corporation's employees;

(e) common business name;

(f) services rendered by the employees of one corporation on behalf of another corporation;

(g) undocumented transfers of funds between corporations;

(h) unclear allocations of profits and losses between corporations;

(i) common record-keeping;

(j) common officers;

(k) common shareholders; and

(l) common telephone number.

In recent years, Texas courts have increasingly begun utilizing the single business enterprise theory to pierce the corporate veil. The case law is unclear as to whether the single business enterprise theory is an "other similar theory" under Article 2.21 or whether the theory is completely separate from alter ego. In the case of Southern Union Company v. City of Edinburg, the parties urged the Texas Supreme Court to clarify the law in Texas regarding the "validity and parameters of the single business enterprise theory." The court declined to speak to the issue, however, stating :

> [w]e need not decide today whether a theory of "single business enterprise" is a necessary addition to Texas law regarding the theory of alter ego for disregarding corporate structure and the theories of joint venture, joint enterprise, or partnership for imposing joint and several liability. That is because whatever label might be given to the [plaintiff's] attempt to treat the [defendant] entities as a single entity, article 2.21 of the Texas Business Corporation Act controls. . .

Based upon these comments by the Texas Supreme Court, it would appear that the single business enterprise theory of veil piercing should be treated as an "other similar theory" under Article 2.21 and that a plaintiff should have to prove actual fraud when attempting to pierce the corporate veil by utilizing either the alter ego theory or the single business enterprise theory.

Some Texas courts, however, have recognized the single business enterprise theory as a means of piercing the corporate veil that is separate and distinct from alter ego. One such court announced that an important distinction is that alter ego "generally involves a proof of fraud," whereas the single business enterprise theory does not required proof of fraud, because it relies upon "equity analogies to partnership principles of liability." The plaintiff in that case presented the same evidence to support both the alter ego theory and the single business enterprise theory. The court found that the evidence was insufficient to establish liability under alter ego, but sufficient to establish liability under the single business theory. Based upon the ruling in this case, it appears that some Texas courts may be more willing than others to utilize the single business enterprise theory as a means for piercing the corporate veil that is separate and distinct from alter ego, with the result being an overly broad imposition of liability.

Based upon legislative intent and the comments of the Texas Supreme Court in the Southern Union decision set forth above, however, Texas courts should be reluctant to treat alter ego and single business enterprise as separate and distinct theories for piercing the corporate veil. Both theories have the exact same purpose and effect: to disregard the corporate entity. The single business enterprise theory is obviously an "other similar theory," and any attempt to pierce the corporate veil utilizing this theory should be governed by Article 2.21. The legislature enacted and amended Article 2.21 to "curb the creativity of the bench and the bar as they continued to pierce the corporate veil and disregard the corporate entity." Simply by looking at the original version of Article 2.21 and the subsequent amendments, it is apparent that the legislature intended to preserve the corporate entity and protect shareholders, as well as any other affiliate, from veil-piercing claims in all but the most extraordinary situations. In light of the legislative history behind Article 2.21 and the Texas Supreme Court's comments in Southern Union, Texas courts should not use the single business enterprise theory as a back door to disregard the corporate form and bypass the actual fraud requirement of Article 2.21.

Section 3. Veil Piercing and Limited Liability Companies

The Texas Limited Liability Company Act (the "Act") governs the liability of owners of limited liability companies, or LLCs. "The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms – properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership."

The Act provides that, except as provided for in the LLC regulations, a member or manager is not liable to third parties for the debts, obligations or liabilities of an LLC. Additionally, members may participate in the management of the LLC without losing this shield. Since the Act deals expressly with the liability of members and managers for the obligations of an LLC, corporate veil piercing principles should not apply to LLCs in Texas.

One Texas court, however, has suggested that corporate veil piercing concepts are applicable to LLCs. In Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Association, the Texarkana Court of Appeals assumed that corporate veil piercing rules must apply to LLCs because the LLC is a limited liability entity. The only authority cited by the court, however, was Castleberry, which was decided five years before the Act was passed. Additionally, Castleberry made no reference to the LLC or any entity other than the business corporation. The Pinebrook court then proceeded to analyze the facts before it under Castleberry, which as noted above has been repudiated by the legislature in amendments to Article 2.21, and under Article 2.21, which applies only to corporations and not to LLCs. Ultimately, the court held that veil piercing was not appropriate in the Pinebrook case, which makes the court's opinion in the case neither well reasoned nor of precedential value.