

Rational Controls to Minimize Veil Piercing

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Authors:

Alan S. Meek

Strong public policy supports the use of business entities such as corporations and LLCs in a wide variety of contexts. Growth and profits, which increase jobs and opportunities, depend on a reasonable allocation of risk. A liability limiting entity allows entrepreneurs to take risks that would be otherwise unacceptable.

Venturers proceed because of the assurance that if a catastrophe occurs or plans fail, liability will be limited to the assets of the entity. That presumes the assets of the entity are reasonable to support the venture. When that is not the case, there is an avenue to hold individual business owners accountable through what is known as piercing the corporate or liability limiting veil.

This article discusses the benefits, fatal factors and structural enhancements and controls to reduce the risk of a pierced veil.

Benefits from Multiple Liability Limiting Entities

There are plenty of benefits, both private and public, to place different business operations into separate entities. Several examples include:

- Allow for capital to be raised for a new and distinct purpose;
- An unregulated business can be operated separately from a regulated one (with proper controls);
- Segregating union activities and associated obligations and liabilities from non-union activities;
- Estate planning objectives can be accomplished;
- Allow for separation of locations and properties to better comply with local law.

Factors Weighing in Favor of Piercing the Veil

The main factor in favor of piercing the veil is direct participation. A liability limiting entity does not shield an individual who was negligent or committed an intentional act. An individual will be held

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accountable for their own negligent driving or fraud, for example. Apart from this, piercing the veil is usually a two-step analysis:

> **(1)** Thin capitalization of the business entity, or blending assets of the business with the personal assets of the individual owner; and
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> **(2)** Some unjust purpose, such as fraud or selfish control that exceeds the bounds of legitimate business judgment or purpose.

Thin capitalization means the business had insufficient capital to meet reasonable expenses and operating liabilities. In cases of short fall, the funds have come from a separate individual account of the owner. Then, in times of abundance, the funds flow back to the individual owner's account without any documentation (such as board declaration of a distribution).

In more recent cases, the second prong does not require actual fraud. Courts are trending in the direction of a more general sense of justice, usually determined by the facts and circumstances. Factors include:

- Common board members and officers in entirely different types of businesses requiring completely different skill sets;
- Inadequate or non-existent corporate records, including financial records to document inter-company flow of funds;
- Use of the same bank account or accounting books and records;
- Financing was grossly inadequate for the purpose/endeavor undertaken;
- Lack of documentation for use of assets owned by an affiliate;
- No inter-company agreements or compensation for inter-company activities (leases, contracts, minutes);
- Use of corporate assets for personal use (automobiles, credit cards, etc.).

Enhancements and Controls to Avoid a Pierced Veil

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The following is a non-exhaustive list of actions a business owner or executive can take to reduce the risk of a pierced liability limiting veil:

- Consider using manager-managed LLCs, and even an entity as the manager;
- Always use a written operating agreement or bylaws to clearly document the authority of controlling persons;
- Issue actual stock or unit certificates to equity owners;
- Convene regular meetings of members, managers, shareholders, and boards of directors. Do not rely regularly on ratification of previous actions (an occasional ratification is sometimes necessary, but routine is a bad precedent);
- Maintain up to date minutes of meetings, and other company records;
- Be wise in placement of liability-prone assets. For example, consider use of a subsidiary for trucking operations separate from sales operations or real estate assets;
- Use arms' length terms for inter-company contracts, and document agreements.
- Avoid administrative dissolution resulting for a late filed annual report. The gap period can in some instances create a window of personal liability;
- Always identify the capacity of individuals signing contracts and formal actions;

Limiting the liability of business owners to the amount of their investment is good policy because it encourages such persons to take risk to produce goods and services, create jobs and generally create value within the community. If one or more business owners take advantage of the business entity for their own selfish purpose, and some injustice results, then a mechanism exists to pierce the entity veil and hold the individual accountable. Accordingly, individual business owners should take note and follow rational and substantive controls to protect not only themselves, but the public as well.

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