

Piercing the Veil of a Michigan Limited Liability Company

By James R. Cambridge

Introduction

In some respects, a limited liability company (LLC) is like a corporation. In others, it is like a partnership. Like a corporation, an LLC (and not its members) is liable for the acts, debts, or obligations of the LLC. Under the Michigan Limited Liability Company Act (Michigan LLCA), a member of an LLC is not liable for the acts, debts, or obligations of the LLC unless otherwise provided by law or in an operating agreement.¹ It is expected, however, that Michigan courts will pierce the veil of an LLC in limited circumstances and hold the members personally liable for the LLC's acts, debts, or obligations. In reaching this conclusion, the courts can be expected to apply the veil-piercing theories normally used to reach the shareholders of a corporation. This article discusses those theories and how Michigan courts, like courts in other parts of the country, might apply the theories to a Michigan LLC and its members.

Traditional Veil-Piercing Theories

In traditional corporate veil-piercing cases, contract and tort creditors typically attempt to disregard the corporate entity in order to obtain recourse against the shareholders. Some creditors have argued that the lack of corporate formality or adequate capital is enough to pierce the corporate veil. Other creditors have argued that the corporate veil should be pierced when the corporation is a mere instrumentality or alter ego of the shareholders, but the Michigan courts seem to say that these factors are not enough. There must be a showing of abuse, fraud, illegality, or injustice before the veil is pierced. See Stephen H. Schulman et al., *Michigan Corporation Law & Practice*,² for a general discussion on piercing the corporate veil.

In *Klager v Robert Meyer Co*,³ the Michigan Supreme Court refused to disregard the cor-

porate entity for purposes of imposing liability on corporate shareholders. In *Klager*, a party that had contracted with an alleged uncapped corporation sought recourse against the shareholders. In reversing the court of appeals decision holding the shareholders liable, the supreme court noted that the circumstances of the case were such that the application of piercing doctrines would violate the terms of the bargain that the parties had struck. The parties were aware that the corporation's assets were nominal and that the corporation was organized to protect the shareholders from personal liability. The supreme court concluded that the plaintiff had willingly accepted the obligation of the allegedly undercapitalized corporation knowing full well that the corporation's assets might be insufficient to satisfy its contract obligations. Regardless of the decision in *Klager*, creditors who are unaware of a corporation's undercapitalization should be able to argue that the undercapitalization and their ignorance of it is a reason for piercing the veil to reach the owners.

The failure to adhere to corporate formalities is often a consideration in piercing cases. However, cases such as *Soloman v Western Hills Dev Co*⁴ and *Maki v Copper Range Co*⁵ seem to indicate that Michigan courts require something more than the mere disregard of organizational formality before the veil may be pierced. In *Soloman*, where an unsuccessful attempt to pierce the corporate veil was made, the court of appeals stated that something more than just failing to follow corporate formalities must exist. The court of appeals was looking for fraud, illegality, or injustice. In *Maki*, the court of appeals held that a subsidiary's separateness from its parent should not be disregarded unless the subsidiary is a mere instrumentality of its parent, the parent exercised control in a manner that defrauded or wronged the plaintiff, and the plaintiff suf-

ferred an unjust loss or injury. *Accord Bodenhamer Bldg Corp v Architectural Research Corp*;⁶ see also *Pizzo v Unicorn Developers & Eng'g, Inc*⁷ (adopting a three-prong *Foodland Distribs* test for piercing and adding that an injustice to be prevented by piercing must relate to the abuse of a corporate form); *Foodland Distribs v Al-Naimi*⁸ (to pierce the corporate veil, a corporate entity must be a mere instrumentality of another person or entity and must be used to commit a fraud or wrong, and the plaintiff must suffer unjust loss or injury as result).

In Michigan, there must be some abuse of the business form before piercing may occur. In determining that piercing would not be appropriate under Michigan law, the Sixth Circuit Court of Appeals, in *United States v Cordova Chem Co*, stated:

Michigan appears to follow the general rule that requires demonstration of patent abuse of the corporate form in order to pierce the corporate veil. There must be such a unity of interest and ownership that the separate personalities of the corporation and its owner cease to exist, and the circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice. Organization of a corporation for the avowed purpose of avoiding personal responsibility does not in itself constitute fraud or reprehensible conduct justifying a disregard of the corporate form.⁹

If the cases where these theories are applied to corporations are any guide, piercing an LLC ordinarily will occur only where organizational formalities have been disregarded and the avoidance of an injustice is a consideration. To the extent that adhering to organizational formalities is an important element in piercing cases, since LLCs have fewer organizational formalities than do corporations, it may be easier for LLCs to satisfy this element and preserve the organizational veil of the LLC.

Piercing the Limited Liability Company Veil

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an LLC. However, it is only a matter of time before such a case is brought before a court. Although the Michigan courts have not had an opportunity to deal with the issue, other courts have.

Wyoming was the first state in the country to adopt the Limited Liability Company Act. In *Kaycee Land & Livestock v Flahive*,¹⁰ the Wyoming supreme court concluded that the remedy of piercing the protective veil of an LLC was an available remedy under the Wyoming Limited Liability Company Act. Courts across the country are dealing with the issue of piercing the LLC and some have come to the same conclusion. Others have not.

In *Gallinger v North Star Hosp Mut Assurance*,¹¹ the Eighth Circuit Court of Appeals found that the veil of an LLC formed in Bermuda should not be pierced. The court held that no element of injustice or fundamental unfairness existed to necessitate piercing the LLC's veil of limited liability; therefore, the members could not be held individually liable for the company's debt. The facts and analysis in *Gallinger* suggest that had a corporation, rather than an LLC, been involved, the result would have been different and the corporate veil would have been pierced. At least in the Eighth Circuit, LLC members must manifest a higher level of egregiousness than corporate stockholders before the limited liability veil will be pierced. See Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, from Sure Bet to Long Shot: Gallinger v North Star Hospital Mutual Assurance, Ltd.*¹²

Since *Gallinger*, courts in other jurisdictions have addressed the issue of piercing. In *Ditty v CheckRite*,¹³ the U.S. District Court for the District of Utah acknowledged that the veil of the LLC may be pierced under the alter ego doctrine, just as a corporation's veil may be pierced. However, the court ultimately did not find the elements necessary to impose liability on the sole member under an alter ego theory. In *Ditty*, the court stated that to pierce the veil, it must be shown that there is such a unity of interest and ownership that the separate personalities of the company and the individual no longer exist but that the company is, instead, the alter ego of the individual. The court also stated

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that it must be shown that the organizational form, if observed, would sanction a fraud, promote injustice, or result in an inequity. The *Ditty* court found none of these elements in the case. See also *Hollowell v Orleans Reg'l Hosp*,¹⁴ where, on a motion for summary disposition, a Louisiana court stated that the veil of an LLC may be pierced if the LLC operates as an alter ego of its members, or if the members commit some fraud or deceit on third parties through the LLC. See Susan Muller Rogge, Casenote, *Hollowell v Orleans Regional Hospital: Piercing the Corporate Veil of a Louisiana Limited Liability Company and Successor Liability*,¹⁵ for a discussion of the *Hollowell* case. In *New Horizons Supply Coop v Haack*,¹⁶ the trial court found the member personally liable because, as the court stated, the parties were acting like a partnership and were being taxed as a partnership. However, on appeal, the appellate court stated that the fact that the LLC was being taxed as a partnership was not conclusive, and it reversed the court on this point. In *Stone v Frederick Hobby Assocs II*,¹⁷ a Connecticut court found that an LLC's veil could be pierced under both the instrumentality theory and the identity theory.

In *Bastan v RJM & Assoc*,¹⁸ the Connecticut Superior Court found that the legislature did not intend the limitation on member liability to be absolute. The court noted that in Connecticut, there are at least two theories on piercing the corporate veil, the instrumentality rule and the identity (or alter ego) rule. The court was willing to apply the alter ego theory to an LLC and reject defendant's claim that there may be no equitable piercing of the veil in member-managed LLCs. (Although Michigan courts have not adopted these two theories by name, Michigan courts have embraced some of the principles of the two theories in the *Maki*, *Bodenhamer*, and *Foodland Distribs* cases, where piercing was successful when a corporate entity was an instrumentality of its owners.)

In *Peinado v Barnett*,¹⁹ the court of appeals of California found that members of a California LLC may be held personally liable for the company's acts under the theory of alter ego liability. The court stated that in order to pierce the protective veil of an LLC, two general requirements must be met: "(1)

that there be such a unity of interest and ownership that the separate personalities of the [LLC] and the individual no longer exist and (2) that, if the acts are treated as those of the [LLC] alone, an inequitable result will follow." The court stated that relevant factors to consider in determining whether to apply the alter ego theory included the disregard of legal formalities, the failure to maintain adequate LLC records, ownership by a single person, the domination or control of the LLC by a single person, the use of a single address for the individual and the LLC, and the use of the LLC as a "mere conduit" for an individual's business.

On the other hand, in *Advanced Tel Sys v Com-Net Prof'l Mobile Radio, LLC*,²⁰ a Pennsylvania court determined that the plaintiff was not entitled to pierce the veil of an LLC under the alter ego theory. In this case, plaintiffs asserted that defendants misused the LLC form so that the LLC became their alter ego. Plaintiffs alleged that the LLC was never adequately capitalized and that the individual members induced plaintiff to enter into the contract with the LLC representing that it was backed by the financial strength of others. The court observed that plaintiff demanded no guarantees for the LLC's obligations. Moreover, the court noted that plaintiff knew it was dealing with an LLC and knew that an LLC's liability is very limited.

The issue of piercing the veil of an LLC was also recently discussed in two unreported Connecticut cases. In *Emma Rosina, LLC v Bilides Bldg & Excavating, LLC*,²¹ an alter ego case, the court recognized that the doctrine of piercing the corporate veil, as applied to corporations, also applies to a limited liability company. The court, however, stated that plaintiff's allegations in the complaint were insufficient to pierce the LLC's veil. In *Nadler v Grayson Constr Co*,²² the Superior Court of Connecticut confirmed that the principle of corporate veil piercing is also applicable to limited liability companies and their members.

For a general discussion of piercing, 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?*²³ Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine Into the Statutory Age*,²⁴ and Warren H. Johnson, Note, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*²⁵

Conclusion

It should be expected that Michigan courts will allow contract and tort creditors to pierce the veil of a Michigan LLC. However, this should occur in only the rarest of instances. Michigan courts should apply to LLCs the same strict standards of piercing that have been traditionally applied to corporations. The general rule is, and should continue to be, that the members of a Michigan LLC are not personally liable for the acts, debts, and obligations of the LLC. There may, however, be very limited instances, as there have been with corporations, where the protective veil of an LLC may be pierced. Piercing should be the rare exception, not the general rule. The veil of a Michigan LLC should be pierced in only the rarest of instances when first, the LLC is a mere instrumentality of its members, and second, there is some compelling abuse, fraud, illegality, or injustice. Michigan courts can continue to look at the undercapitalization of an LLC, but the courts should note that capitalization is a relative term and businesses (LLCs and corporations alike) should not be required to maintain capital sufficient to cover the claims of every possible contract or tort creditor. Undercapitalization, by itself, should not be enough to pierce the protective veil of an LLC. However, if evidence exists that the members of an LLC intentionally undercapitalized the LLC or stripped the LLC of its capital in order to perpetuate some abuse, fraud, or illegality, a Michigan court may appropriately take this into consideration in piercing the LLC veil. In addition, although Michigan courts may consider an LLC's failure to adhere to organizational formalities, the courts should not place too much emphasis on this consideration. LLCs are intended to be very simple and flexible and not be burdened with formality. The lack of organizational formality should not, in and of itself, be viewed negatively.

Lawyers who advise LLCs and their members should be guided by a few important principles. First, because adhering to the organizational formalities of an LLC may still be considered by a Michigan court in a piercing case, organizational formalities not required by the Michigan LLC Act should be kept to an absolute minimum. It may be the inclination of some lawyers to provide, in an operating agreement for example, that there be a very formal process for the meetings of members and managers. If this formality, for example, is not necessary and is not complied with, a Michigan court may take this into account in a piercing case. As a general rule, organizational formalities should be kept to a minimum in an LLC. And, whatever formalities are required, the formalities must be strictly complied with. Second, lawyers should make sure that the business of the LLC is done in the name of the company and not in the name of any individual member. Contracts by an LLC should be in the name of the LLC (which should include the abbreviation "LLC," or better yet, the words "limited liability company"). In addition, whoever executes a contract on behalf of an LLC should do so in the name of the company, and the individual's representative capacity must be made abundantly clear. Third, the LLC should always be operated as a distinct entity, separate from its members. Fourth, an individual member should never give any assurance concerning the financial capacity of the LLC. Fifth, there should be no indication that the members intentionally undercapitalized the LLC or stripped the company of its capital and resources for the express purpose of avoiding the claims of creditors. By following these guidelines, the risk of the organizational veil of a Michigan LLC being pierced can be minimized.

Michigan courts should apply to LLCs the same strict standards of piercing that have been traditionally applied to corporations.

NOTES

1. MCL 450.4501(3).
2. *Michigan Corporation Law & Practice*, § 3.9 (1990).
3. 415 Mich 402, 329 NW2d 721 (1982).
4. 110 Mich App 257, 312 NW2d 428 (1981).
5. 121 Mich App 518, 328 NW2d 430 (1982).
6. 873 F2d 109 (6th Cir 1989), *vacated on other grounds*, 989 F2d 213 (6th Cir 1993).
7. No 230507, 2002 Mich App LEXIS 1538 (Nov 1, 2002) (unpublished).

8. 220 Mich App 453, 559 NW2d 379 (1996).
9. 113 F3d 572, 580 (6th Cir 1997) (en banc) *vacated and remanded on other grounds* sub nom *United States v Bestfoods*, 524 US 51 (1998) (citations omitted).
10. 2002 WY 73, 46 P3d 323 (2002).
11. 64 F3d 422 (8th Cir 1995).
12. 22 Iowa J Corp L 131 (1996).
13. 973 F Supp 1320 (D Utah 1997).
14. No 95-4029, 1998 US Dist LEXIS 8184 (ED LA May 29, 1998), *aff'd*, 217 F3d 379 (5th Cir 2000).
15. 47 Loy L Rev 923 (2001).
16. 224 Wis 2d 644, 590 NW2d 282 (Wis Ct App 1999) (unpublished).
17. No CV000181620S, 2001 Conn Super LEXIS 1853 (July 10, 2001) (unpublished).
18. No CV990593189S, 2001 Conn Super LEXIS 1605 (June 4, 2001) (unpublished).
19. No A093923, 2001 Cal App Unpub LEXIS 1924 (Nov 6, 2001) (unpublished).
20. 59 Pa D&C 4th 286 (2002).
21. No CV020462976, 2003 Conn Super LEXIS 1868 (July 1, 2003) (unpublished).
22. No CV020190015S, 2003 Conn Super LEXIS 1008 (Apr 15, 2003) (unpublished).
23. 51 Okla L Rev 427 (1998).
24. 70 U Cin L Rev 95 (2001).
25. 35 New Eng L Rev 177 (2000).



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