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Piercing the Corporate Veil - A Primer on North Dakota's Piercing Law

Legal Update

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When we talk to clients about forming new business entities, one of their primary goals is to shield themselves and other stakeholders from personal liability as much as possible. As a general rule, corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs and LLLPs) are business entities that are separate and distinct from their shareholders or members, which means the owners' personal liability is limited.

That legal distinction between "entity" and "owner," however, is not absolute and may not always provide the personal liability protection you expect. For example, a business owner cannot escape personal liability for his or her own unlawful acts or for any personal guarantees signed by the owner individually. Moreover, in certain situations, business owners may be held personally liable for company debts and liabilities. When that happens, it is known in the legal world as "piercing the corporate veil."

Piercing claims generally show up when a business entity is functioning as the individual owner's "alter ego," meaning the business entity is acting purely as a front to perpetuate fraud or to dodge creditors. In a classic piercing scenario, the owner operates the business for his or her own personal benefit, using the business entity as a shell. Often the owner controls every aspect of the business organization with no records, no capital, and no functioning entity governance structure. This lack of regard for corporate formalities and undercapitalization can lead to piercing claims and personal liability exposure for individual owners.

Under North Dakota law, several factors are used to determine if a business entity has been acting as an "alter ego" of an individual owner:

- Insufficient capitalization for purposes of corporate undertaking;
- Failure to observe corporate formalities;
- Nonpayment of dividends;
- Insolvency of debtor corporation at time of transaction in question;

- Siphoning of funds by dominant shareholder;
- Nonfunctioning of other officers and directors;
- Absence of corporate records; and
- Existence of corporation as merely a façade for individual dealings.

See *Coughlin Constr. Co. v. Nu-Tec Indus., Inc.*, 2008 ND 163, ¶ 19, 755 N.W.2d 867. In addition to these factors, piercing the corporate veil must be necessary to avoid injustice or fundamental unfairness.

North Dakota Piercing the Corporate Veil Claims

As you might expect, piercing claims are usually the rare exception and not the rule. However, in North Dakota, piercing claims appear to be alive and well, with the North Dakota Supreme Court issuing over nine opinions on the issue since 2008. Indeed, the North Dakota Supreme Court just issued another opinion addressing a piercing claim in late August - *Taszarek v. Welken*, 2016 ND 172 (Aug. 31, 2016). In that case, the plaintiffs brought a piercing claim against the president and sole shareholder of a North Dakota corporation, with little evidence presented on the piercing factors. The trial court allowed the piercing claim to go to the jury, which found that the corporation was the alter ego of the president and sole shareholder. However, the North Dakota Supreme Court reversed and remanded the case for a new trial because the jury instruction on the piercing claim was insufficient. Although the case was remanded back to the trial court for further proceedings on technical grounds, it serves a good reminder to business owners that personal liability protection is not always bulletproof.

Avoiding Potential Piercing Claims and Personal Liability Exposure

To help avoid potential piercing claims and personal liability exposure, owners should, among other things: (1) follow corporate formalities by holding meetings and maintaining proper records; (2) conduct all business activities through the entity and ensure that all contracts, purchase orders, etc. are in the name of the entity and not the owners; (3) maintain solvency for business operations; (4) keep personal finances separate from business finances; (5) ensure sufficient capitalization for business ventures; and (6) maintain appropriate insurance coverage for the entity in order to mitigate the risk of piercing claims. Taking these steps will help reduce your risk of losing the personal liability protection you expect from your business entity.

Recent Fargo, North Dakota Corporate Group Honors

Fredrikson & Byron Fargo attorneys were recently included in *The Best Lawyers in America*® 2017. *Best Lawyers* lists are compiled based on an exhaustive peer-review evaluation. Fargo Corporate attorney, Wayne Carlson, was named the *Best*

Lawyers® 2017 Corporate Law “Lawyer of the Year” in Fargo. Only one attorney in each practice area and designated metropolitan area is honored as the “Lawyer of the Year.” Inclusion in *Best Lawyers* is considered a singular honor. *Chambers USA: America’s Leading Lawyers for Business*, a leading annual legal guide identifying the top attorneys and law firms in the U.S., also ranked a number of Fredrikson & Byron practice areas and individual Fargo attorneys in its 2016 edition. Both Wayne Carlson and Mike Raum were individually ranked in Corporate/Commercial.