MICHIGAN REAL PROPERTY REVIEW

Vol. 29, No. 1 Spring 2002

CONTENTS

Published by the
Real Property Law Section
State Bar of Michigan

CAVEAT MEMBER: COURTS BEGIN TO "PIERCE THE ENTITY VEIL," IMPOSING PERSONAL LIABILITY ON LLC MEMBERS

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The limited liability company (LLC) form has been embraced by the real estate community, becoming the preeminent organizational vehicle for real estate-owning entities. LLCs are favored because, like partnerships, they are pass-through entities for federal income tax purposes (thereby enabling members to avoid taxation at the entity level) and, also like partnerships, they permit members great flexibility in tailoring management arrangements to their particular transactions.

The enthusiastic acceptance of LLCs is also due in great part to a characteristic they share with corporations, that is, the statutory protection from liability for company acts afforded to LLC members. The Michigan Limited Liability Company Act,[1] at Section 501(2),[2] states that "[u]nless otherwise provided by law or in an operating agreement, a person who is a member or manager, or both, of a limited liability company is not liable for the acts, debts, or obligations of the limited liability company."

Practitioners and their clients should be aware, however, that the limited liability feature of an LLC is not absolute. Although this issue has not yet arisen in a reported appellate decision in Michigan, creditors have successfully challenged the limited liability of LLC members in other jurisdictions. A number of these challenges have been based on the traditional corporate law doctrine of piercing the corporate veil.[3]

This article describes the current Michigan test for piercing the corporate veil and explores how similar veil piercing doctrines have been applied to LLCs in other states. It also suggests measures that members of Michigan real estate LLCs and their counsel might take to avoid the application of the veil piercing doctrine.

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I. Michigan's Corporate Veil-Piercing Law Doctrine

Generally, Michigan law treats a corporation as a separate and distinct entity from its shareholders, even if the stock of the corporation is wholly owned by a few (or even one) individuals. In certain circumstances, though, Michigan courts have ignored the corporate form and held shareholders personally liable for the debts and obligations of a corporation. Although the decisions to pierce the corporate veil have tended to be very fact specific, courts have historically pierced the corporate veil in instances where the corporation has failed to exist as a separate and distinct entity from its shareholders and has been used by its shareholders to commit some type of wrongful or fraudulent act.

In recent years, Michigan courts have utilized a three-step test for piercing the veil of a corporation. The three-step test provides that a court should pierce the corporate veil if *(1)* the corporate entity is a mere instrumentality of another entity or individual, *(2)* the corporate entity is used to commit a fraud or wrong, and *(3)* there has been an unjust loss or injury to the plaintiff. The test, or variations of this test, is also used in other jurisdictions.[4]

Foodland Distributors v. Al-Naimi[5] is one of the best examples of a Michigan court's application of this three-step test. In *Foodland Distributors*, the Michigan Court of Appeals pierced the corporate veil and held the shareholders of a corporation personally liable where the shareholders were found to have committed fraud at the expense of plaintiff Foodland. Foodland sought court assistance in collecting around $800,000 of unpaid grocery bills incurred by Metropolitan Grocery, Inc. (New Metro). Amir Al-Naimi, his wife Sandra Al-Naimi, and Amir Al-Naimi's sister Atour Abro were the three shareholders of New Metro. Although Atour was the president of New Metro, Amir was apparently the actual decision maker and real operator of the business, and Atour did not take an active role. There was evidence that various grocery stores and wholesale operations owned by Amir and his relatives loaned money back and forth to each other with inadequate financial records being kept of the lending transactions. In addition, inventory apparently lost from New Metro's warehouse was later sold at other family grocery stores. Furthermore, New Metro kept inadequate financial records and corporate funds were improperly used for the benefit of shareholders. Finally, Amir restructured certain personal debt owed to Michigan National Bank by causing New Metro to assume a portion of the debt for no consideration, thereby effectively putting New Metro out of business.

The Court of Appeals applied the three-step test and concluded that the corporate veil should be pierced and that the shareholders should be personally liable for New Metro's obligations.

The first step in this test is sometimes referred to as the "instrumentality test" and focuses on whether the corporation is a mere instrumentality of its owners. The *Foodland* court did not specifically identify the factors that had been satisfied in concluding that the first step of the veil-piercing test had been met. However, the evidence showed New Metro's failure to observe corporate formalities, the improper use or siphoning of corporate funds by Amir, the insufficiency of New Metro's funds considering its debt load, the nonfunctioning of the president Atour, the inadequacy of corporate financial records, and, at least in the case of the bank debt restructuring, New Metro's serving as merely a facade for Amir's personal financial dealings. In determining whether the first step has been satisfied, other courts have identified the following factors: *(i)* insufficient capitalization, *(ii)* failure to observe corporate formalities, *(iii)* nonpayment of dividends, *(iv)* insolvency of the debtor corporation at the time of the transaction, *(v)* siphoning of funds by the dominant or controlling shareholder, *(vi)* non-functioning of other officers and directors independent of the dominant or controlling shareholder, *(vii)* absence of corporate records, and *(viii)* existence of the corporation as merely a facade or a sham for individual dealings.[6]

The second and third steps in the veil-piercing test focus on the relationship between the shareholders' actions and the creditors who have been harmed by such actions of the shareholders, and are sometimes jointly referred to as the "equity test." The second step focuses on whether or not the shareholders have used the corporation to commit some type of fraud, wrongdoing or other misuse of the corporation. The third step focuses on whether a creditor has suffered an unjust loss or injury as a result of the shareholders' actions. Michigan courts will generally not pierce the corporate veil to prevent injustice or to reach an equitable result without finding some type of fraud, wrongdoing or misuse of the corporation by the shareholders.

The *Foodland* court's examination of the relevant evidence as to whether or not fraud was committed by New Metro's shareholders (the second test) is thorough and helpful. It lists inventory losses and apparent resales at other stores owned by Amir and his brothers, the lifestyle Amir continued to maintain, the lending transactions among various family grocery stores and wholesale operations, and the bank debt restructuring as evidence that fraud had been committed. Finally, the court points to the loss plaintiff suffered as a consequence of New Metro's failure to pay for its grocery products as determinative of the third test, the existence of an unjust loss or injury.

Foodland is useful both in its exposition of the three part test for piercing the corporate veil, and in its *demonstration of how fact specific the application of* the test is in individual cases.

II. Piercing the LLC Veil

No Michigan appellate courts to date have ruled on whether, and under what circumstances, an LLC veil should be pierced and its members held personally liable for an LLC's obligations. Several courts outside of Michigan, however, have considered this issue. In determining whether to disregard the LLC form and hold members liable for company debts, the courts in these cases have generally based their decisions on their state corporate veil piercing doctrines.[7] Many of these cases have applied a form of, or variants of, the Michigan three part test for piercing the corporate veil.

In ***Hollowell v. Orleans Regional Hospital***,[8] the United States Court of Appeals for the Fifth Circuit refused to overturn a lower court decision that the plaintiff employees in a Worker Adjustment and Retraining Notification Act (WARN) action against their LLC employer could pierce the entity veil to hold the LLC's members liable for losses incurred by the employees. The court looked to Louisiana's corporate piercing standard, a "totality of the circumstances" test not requiring a finding of fraud. It noted the following: the LLC members executed complete dominion and control over the LLC, the representatives of the LLC's members held themselves out as the owners and directors of the LLC, the members controlled the decisions of the LLC, the members profited from the LLC at the expense of its employees, there was commingling of assets and expenses among the LLC members' various enterprises, the members' principals improperly used the LLC for non-company purposes, the LLC was undercapitalized, and, finally, there was an improper distribution to the LLC's members of $1.5 million on the eve of the LLC closing its operations and terminating the employees. The court concluded that, based on this evidence, the jury at the lower court level could have reasonably concluded that the entity veil should be pierced, and refused to overturn the decision.

In re Multimedia Communications Group Wireless Associates of Liberty County, Georgia, L.C.[9] dealt with the trustee's efforts to convince the bankruptcy court that several individuals and commonly owned limited liability companies involved in the transmission of direct programming signals from satellite dishes should be held personally liable for a bankrupt corporation's liabilities. The bankruptcy court, applying the Florida three part test for piercing the corporate veil that is similar to Michigan's, refused to adopt the trustee's position. As to the instrumentality test, it agreed that the various entities were related, and that there is evidence of common management, business location, personnel, computer networking, office equipment and receptionist, as well as the absence of *entity formality.* Nevertheless the court refused to find that the entities were in fact alter egos of the debtor because they did in fact maintain a separate and distinct existence from each other, kept separate books and generally kept investor funds in separate accounts. Finally, it noted that although all of the defendant entities were all involved in the direct satellite transmission market, each of the entities actually had its own distinct piece of the business. The court also felt that the second and third parts of the Florida veil piercing test had not been met because the defendant's purpose of engaging in the direct satellite transmission market through various entities was not a fraudulent or improper purpose and because there was no showing that the use of the LLC form caused injury to the claimants represented by the trustee.

The following two cases considered the appropriateness of the piercing the entity veil test to members of LLCs engaged in real estate operations, with quite different results.

In ***Tom Thumb Food Markets, Inc. v. TLH Properties, LLC***,[10] the Minnesota Court of Appeals refused to impose personal liability on the members of defendant TLH Properties, LLC, the developer and landlord of a proposed shopping center. Tom Thumb and TLH had entered into an agreement for the construction of a grocery store and its lease to Tom Thumb. At the time it negotiated the lease agreement, TLH did not own the land on which the shopping center was to be constructed (although it had an oral commitment from the existing landowner to sell the land). Prior to the start of the lease negotiations, a TLH member had represented to Tom Thumb that TLH did own the land. Ultimately, TLH was unable to obtain adequate financing to construct the shopping center and failed to satisfy its obligations under the lease agreement, and Tom Thumb sued for breach. The trial court had concluded that TLH was liable for the breach and that TLH's members were personally liable for its obligations.

The Court of Appeals affirmed the decision of the trial court regarding the breach of the lease agreement, but reversed the trial court's decision to pierce TLH's entity veil. Applying Minnesota law, which requires that in order for shareholders of a corporation to be personally liable for the actions of the corporation *(1)* the entity must ignore corporate formalities and act as an alter ego or instrumentality of its shareholders and *(2)* the liability limitations of the entity form must result in injustice or be fundamentally unfair, the court determined that the TLH member's misrepresentation regarding the ownership of the land was not intended to be misleading, and that TLH had indeed been created to develop the land into a shopping center, not to perpetrate fraud on Tom Thumb. The court also noted that it would be unjust to hold the members of TLH personally liable because the tenant had failed to timely provide its financial information and reports as required by TLH's lender, leading to the loss of TLH's financing and, consequently, Tom Thumb failed to satisfy the equitable prerequisite that the party seeking the remedy "must come with clean hands."

In ***Stone v. Frederick Hobby Associates II LLC, et al***,[11] the Stones, dissatisfied purchasers of a $3,300,000 residence constructed and sold to them by defendant Frederick Hobby Associates II, LLC claimed, within the context of a prejudgment attachment application, that defendant Hobby II's LLC form should be disregarded so as to reach the assets of Hobby II's two members and a related limited liability company, Hobby I. The plaintiffs' complaint alleged that the defendant builder had failed to complete construction per the parties' agreement and had failed to fulfill its express warranty obligations after construction. They sought to hold Hobby II's two individual members and Hobby I responsible for their losses because, they argued, Hobby II was a shell company with no assets and no ability to pay any potential damage award.[12] After analyzing the situation, the Connecticut Superior Court found there was probable cause to substantiate the breach of contract claim against the members and Hobby I. The court indicated that Connecticut's piercing the corporate veil doctrine would also be applicable to the LLC. In that regard, Connecticut law authorizes individuals to be held personally liable for entity obligations under either the "instrumentality rule" (which is similar to Michigan's three part test) or the identity rule (a slightly different Connecticut test), and the court held that the criteria for application of both rules had been satisfied. With regard to the instrumentality rule, the court noted the following: the LLC's two members each held a 50% ownership interest in Hobby II and had full authority to manage Hobby II's affairs; Hobby II's office was located in one member's home, on a rent-free basis; Hobby II had no assets other than the residence it sold to the plaintiffs; the defendant's attorney had remarked during a meeting that the defendant had no assets;[13] several documents used by Hobby II in connection with the subject premises listed entities or individuals similar to and easily confused with Hobby II as the operative actors (for instance, in the Connecticut real estate conveyance tax return, it is unclear whether the seller is Hobby II or its member Frederick Hobby III). There was also an allegation by plaintiffs that the defendants, shortly following the closing date on the Stones' new residence, had transferred substantially all of Hobby II's assets (including the sale proceeds) to the two members and Hobby I. Based on this evidence, the court concluded that the members had complete control over the LLC, that the control was used as a cloak to evade contractual obligations to plaintiffs and that plaintiffs' losses emanated, at least in part, from the domination the defendant members exercised over Hobby II, and, accordingly, imposed personal liability on the members. Although *Hobby II* is only a Superior Court decision, it is nevertheless illustrative of how the confluence of certain facts can result in a trial court judgment unfavorable to LLC members.

III. Avoiding Piercing the Entity Veil Claims

Due to the lack of Michigan case law regarding piercing the entity veil of LLCs, members of Michigan LLCs have little definitive judicial guidance about how to organize and operate their affairs in order to avoid piercing claims. However, assuming that a Michigan court considering the issue would base its analysis on the state's test for piercing the corporate veil (as courts in other jurisdictions have done), i.e., the three part test described in *Foodland*, the cases described above do provide some illustrations as to what should be avoided and what should be done.

This issue has practical significance to real estate operators, since it is not uncommon for them to organize separate LLCs to own each of their individual real estate properties. These LLCs are often owned by the same members, share the same address and business systems, and are serviced by the same employee group. As noted above, common ownership and operation are two of the elements identified by creditors pursuing piercing claims. Since these elements are not readily modifiable, real estate operators utilizing the LLC form should be cognizant of, and avoid to the extent possible, other elements noted in the piercing cases which, taken together with the existing elements of common ownership, might cause a creditor to claim and a court to conclude that the LLC veil should be pierced, and personal liability imposed.

Based on the above cases, the financial elements to be avoided include commingling of company assets with those of other companies or members, transferring of company assets to related entities without consideration, utilization of company funds to satisfy the obligations of members or related entities, distribution of company funds to members or related entities without making provision for company obligations, inadequate capitalization, failure to maintain complete and accurate financial records of the company's activities, and the delivery of company guarantees for members' or related entities' obligations. Many of these financial characteristics appear to be relevant in determining whether the second and third steps of the Michigan veil piercing test (i.e., whether some type of wrongdoing has occurred resulting in a loss to the creditor) have been satisfied.[14]

In addition to financial elements, the noted cases also indicate that the absence of certain organizational or operational elements within a company is relevant to whether an entity veil should be pierced. For instance, the cases illustrate that the failure of a company owner to identify the capacity in which he acted in his dealings with others and/or in the documentation he prepared or signed is indicative of whether he considered his dealings to be for his own account or on behalf of a separate and independent entity. Although the question of compliance with statutory organizational requirements is generally not an issue in the LLC cases described above, the lack of adherence to statutory requirements (e.g., compliance with meeting and notice requirements) has been noted in some piercing cases within the corporate context. Accordingly, LLC members should take care to clearly identify the capacity in which they are acting when they negotiate on behalf of their company and when they execute documents on its behalf. In addition, the company should be clearly identified in all documents as the titleholder of its real estate and the entity on whose behalf activities are being carried out. Although the Michigan LLC Act imposes few organizational formalities on LLCs, any requirements imposed by the Act (such as, for instance, the requirement of maintaining certain business records) or within the LLC's operating agreement (such as, for instance, any limitations on the LLC's purpose and activities) should be followed.[15] It would also be prudent for members to satisfy any prerequisite to the exercise of any power set forth in their LLC's operating agreement, such as the requirement for prior member consent to particular decisions.

Conclusion

The issue of members' personal liability for LLC obligations is certain to gain in prominence as increasing numbers of LLCs are formed, and creditors are faced with enforcing their rights against underfinanced or overextended LLCs. Practitioners should counsel their clients to properly organize LLC affairs and to avoid activities that would create a basis on which a court could pierce the LLC veil and impose personal liability on its members.

Endnotes

1. MCLA 449.4101 *et seq.*
2. MCLA 450.4501(2).
3. It should be noted that there are other theories, beyond the scope of this article, under which a member may be held individually liable in connection with the activities of an LLC. For instance, members may be held liable for their own negligent acts, for fraud, misrepresentation or conversion of LLC assets, for failure to satisfy an independent contractual undertaking (e.g., a guaranty of LLC debt) or under agency law principles. See Murdock, Charles, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and their Implications for the Future*, 56 The Business Lawyer (February 2001) 499, 504 for an explanation of some of the other grounds upon which an LLC member may be individually liable.
4. The three part test used in Michigan appears to follow the test developed by treatise writer Frederick J. Powell. See Cohen-Wheland, Debra, *Piercing the Veil of an LLC May Become More Common*, 5 Journal of Limited Liability Companies, 80, 83.
5. *Foodland Distributors v. Al-Naimi*, 220 MA 453 (1996), appeal denied 454 M 895 (1997).
6. See *Victoria Elevator Co. v. Meriden Grain Co.*, 283 NW 2d 509 (Minn 1979).
7. See, e.g., *Ditty v. Checkrite, Ltd., Inc.*, 973 F Supp 1320 (D Utah 1997) in which the court determined that the state's corporate veil piercing doctrine should apply to the LLC defendant.
8. 217 F3d 379 (CA 5 2000).
9. 212 BR 1006 (Bkcy MD Fla 1997).

10. No. C9-98-1277, 1999 WL 31168 (Minn App Ct Jan 26, 1999).

11. No. CV 000181620S, Superior Court of Connecticut (July 10, 2001), 2001 WL 861822.

12. Stone 2001 WL 861822, at 7.

13. The court remarks at page 9: "Moreover, during a meeting between the parties in May of 2000, Attorney Gold, while acting on behalf of Hobby II, told the plaintiffs to 'go ahead and sue us [Hobby II]. There is no money in [Hobby II]. Why do you think we set it up as an LLC in the first place?'... This last statement evidences an intent on the part of the individual defendants, Frederick L. Hobby III and Sally M. Leiendecker, to use the limited liability company as a shield in order to avoid responsibility for contractual obligations owed to the plaintiffs."

14. It should be noted that the separation of finances and activities may be particularly challenging to single member LLCs, which are not only owned by a single member, but are often member (rather than manager) managed, and which are treated as sole proprietorships for federal internal revenue code purposes unless the taxpayer/member elects treatment of the LLC as a corporation.

15. It should be noted that some commentators have appropriately expressed concern that the factors used to determine shareholder liability in the corporate veil piercing cases that relate to the maintenance of corporate formalities (such as holding annual meetings and keeping minutes) do not seem appropriate in an LLC setting, since state LLC acts impose few such requirements on LLCs. Practitioners should consider whether, in individual LLC cases, it is necessary to impose non-statutory requirements (such as, for instance, the obligation to hold an annual meeting) in an operating agreement, if it is not a necessary element of the members' arrangement, since it is not inconceivable that a creditor may identify the members' failure to comply with such a contractual organizational requirement as one of its arguments that the entity veil should be pierced.