As corporate group structures become more complicated and multi-layered, and as corporate scandals continue to play out, the doctrine of piercing the corporate veil continues to be vital. Historically applied to closely-held organizations, it now applies to parents, subsidiaries, siblings as well as successor corporations.

In general, shareholders are not liable for the debts of corporations in which they own an equity interest. A powerful exception to this general rule is the doctrine of piercing the corporate veil which, under certain circumstances, enables a plaintiff to reach the assets of a wealthy shareholder or parent corporation. Once reserved for situations when a judgment was uncollectible from a corporate defendant, now the doctrine comes into play in the initial stages of a wide variety of litigation, e.g. bankruptcy, fraudulent transfer, etc. From the strategic perspective, a plaintiff may want to pierce the corporate veil to reach deeper pockets, to avoid the consequences of a bankruptcy, or to encourage settlement.

Forensic accountants—brought in at an early stage—are vital to the success of any attempt to pierce the corporate veil. In this article, we will provide a general overview of the law in Pennsylvania and some factors for forensic accountants to consider in their investigation. Oft times, a litigator will engage a forensic accountant to perform a financial investigation which addresses the various veil-piercing factors set forth in relevant case law. Accordingly, the forensic accountant should be familiar with the law of the relevant jurisdiction. [Although the article is based on Pennsylvania decisions and interpretations, the principles are applicable to most other jurisdictions. Ed.]

**Background**

The classic theory for piercing the corporate veil is also referred to as the “alter ego” theory. In Pennsylvania, and in many jurisdictions, the alter ego test comes down to a “totality of the circumstances” test. The ultimate issue for the court to decide is whether the corporation is essentially a shell or a façade for the operations of a sole or dominant shareholder (whether an individual, a partnership, or another corporation). In making this decision, the court will consider evidence dealing with various aspects of the corporate operation including its interaction with its shareholders (i.e. factors). These “factors” include:

1. Undercapitalization;
2. Failure to pay dividends;
3. Commingling of corporate and personal affairs;
4. Disregard of corporate formalities;
5. Failure to maintain corporate records;
6. Non-functioning of other officers and directors;
7. Insolvency; and
8. Use of the corporate form to perpetrate fraud.

This list is not exhaustive. Several of these factors are discussed below in greater detail.

**Undercapitalization**

This element is also referred to as “Insufficient capitalization.” In analyzing whether the corporate veil should be pierced, one must determine whether a corporation is undercapitalized for purposes of the corporate undertaking. See, e.g., *Tr. Of Nat’l Elevator Indus. Pension, Health Benefit & Educ. Funds v. Lutyk*, 140 F. Supp. 2d 407, 412-13 (E.D. Pa. 2001). Adequate capitalization generally describes the ability of a company to meet its capital and operating needs in a manner consistent with its intended business objectives.

The forensic accountant should first analyze whether the corporation was adequately capitalized at its inception. In determining whether the corporation was undercapitalized at inception, the forensic accountant reviews initial corporate records such as shareholder...
records, shareholder certificates, initial balance sheets, income statements, cash flow statements, and documents supporting investments in the corporation. The forensic accountant may also analyze business plans. Those documents that support initial investments in the corporation may include cancelled checks, wire transfer remittances, and invoices/valuations for assets contributed. The forensic accountant utilizes this information to determine whether monetary amounts were truly invested in the corporation and whether any assets claimed as part of capitalization truly exist.

This concept of adequate capitalization is not limited to equity capital contributed to an entity by a shareholder. A shareholder may capitalize an entity with debt (including leases). An analysis of loans to the corporation versus equity investments in the corporation can be very helpful in determining if the corporation was undercapitalized. Factors to consider when determining debt versus equity include:

- The existence of a written agreement evidencing indebtedness;
- A fixed maturity date;
- The source of payments;
- The right to enforce payment of principal and interest;
- Rights to participate in management; and
- The relationship between the lender and the borrower.

Once again, this list is not exhaustive and the forensic accountant may coordinate with counsel to ensure consideration of the appropriate factors. Evidence that accounting documentation has been altered to create the appearance of equity investment at the inception of the entity can be very compelling evidence that the corporation was a sham from the beginning.

To determine whether the corporation was undercapitalized for its stated purposes, the forensic accountant must understand its purposes and try to determine how the corporation views ITSELF in comparison to other companies within its industry. Historical financial statements, business plans, private placement memoranda, and similar documents will assist in this analysis. Industry research can help show how the subject corporation compares to the rest of the industry.

Undercapitalization in not insolvency. In other words, the fact that a business is adequately capitalized at its beginning but later undergoes a decline in its business rendering it insolvent may not be—on its own—a basis for piercing the corporate veil. The common tests for insolvency are:

- The balance sheet test (i.e. liabilities greater than the fair value of its assets); and
- The cash flow test (i.e. the ability to meet obligations as they come due).

### Commingling of Corporate and Personal Affairs

Commingling of personal funds with corporate funds is one of the indicia that can lead to piercing the corporate veil. Commingling occurs when personal or corporate assets are mixed together in a single account or entity. Commingling can occur without the identified expenditure of corporate funds for some personal obligation of a dominant shareholder or some unrelated entity debts and vice-versa. Some defendants may attempt to rebut the finding of commingling by arguing that the transactions are properly accounted for and tracked.

Commingling of funds may also occur between related entities and need not involve the personal accounts of the dominant shareholder. In performing an analysis of commingling, the forensic accountant should analyze the frequency and nature of transfers between related party accounts (both personal and corporate). The forensic accountant should consider whether corporate bank accounts are maintained separately and distinctly from personal accounts and from other related entity accounts.

Commingling can also occur when dominant shareholders cause personal expenses to be paid by the corporation. An entertaining and persuasive trial exhibit might be a listing of all personal expenses paid by the corporation on behalf of the dominant shareholder(s)—especially if those payments list payees such as “Victoria’s Secret” or “Tiffany’s.” The documents required for this undertaking include, but are not limited to, check registers, cash disbursement journals, general ledger expense detail, original cancelled checks, corporate credit card statements, and receipts and expense reports. Courts tend to place great emphasis on the testimony of the forensic accountant regarding his or her findings pertaining to commingling, so this is a natural area of focus.

### Disregard of Corporate Formalities

Failure to observe corporate formalities includes failing to keep meeting minutes, to abide by corporate by-laws, to hold regular elections of officers/directors, and to maintain accounting and banking records. On its own, failure to observe corporate formalities generally may not be sufficient to pierce the corporate veil. Additional evidence is usually required. The forensic accountant should review the corporate records to determine if the
corporate books exist, are maintained, and are current. Analysis should also be done of the documentation pertaining to board of directors meeting minutes and shareholder meeting minutes. Other issues that can be considered are whether key contracts reflect fair market value and whether dividends are paid. Key documents include minute books, exhibits to minutes, shareholder listings, dividend records, and contracts.

Use of the corporate form to perpetrate a fraud

Even though alter ego cases often involve an issue of fraud, fraud is not a necessary element of a veil-piercing claim. See Laborers Combined Funds of W. Pa. v. Ruscitto, 848 F. Supp. 598, 601 (W.D. Pa. 1994). Nevertheless, a forensic accountant should be alert for evidence of potential fraudulent conduct, as it heightens the chances of success in piercing the veil. Among other things, fraudulent conduct might include deceptions or misrepresentations made by the defendant to the plaintiff about the resources of the corporation or siphoning of funds followed by dissolution or merger of the corporation.

Additional factors relevant to whether the corporate veil should be pierced are set forth in Fletcher-Harlee Corp. v. Szymanski, 936 A.2d 87 (Pa. Super. 2007). These factors include:

1. The shareholder’s own vocal disregard of the separate legal status of the corporation,
2. The shareholder’s lack of candor with the tribunal,
3. Shared office space, computer, and employees (the forensic accountant may want to analyze office leases, lease payments, payroll records and 1099 forms to identify which of these factors may apply),
4. Creation of new entities to avoid debts of other entities, and
5. Filing for bankruptcy after a default judgment was entered against the entity.

Practical Pointers for the Forensic Accountant

In performing a “piercing” investigation, the forensic accountant may not be able to establish all the indicia, and that may be fine, but it is critical not to stretch to draw conclusions on factors that simply do not apply. Instead, the better approach is to focus on the strong points of the analyses while maintaining one’s independence with respect to indicia both in favor of and against the client’s position. Likewise, to the extent records do not exist or have been destroyed, consider what type of conclusion can be made from the absence of those corporate records.

If the matter goes as far as report issuance, deposition or trial testimony, a forensic accountant must be mindful to remain independent; his or her testimony and the analysis on which it is based “is what it is.” Wherever possible, utilize corporate documents, checks, charts, and the like as visual summaries of testimony and findings—in these cases, the adage that ‘a picture speaks a thousand words’ holds true. (Relevant examples include contracts reflecting non-market rates between related entities, bank statements with numerous overdrafts, general ledgers that reflect massive related party transactions, etc.). Finally, as a testifying expert, be prepared to be challenged on your credentials. Are you a corporate formalities expert or insolvency expert? Have you ever served as a CEO, CFO, or compliance officer for a corporation? How many corporate boards do you sit on? You get the point.

Conclusion

Piercing the corporate veil is an exception to the general rule regarding shareholder obligation for corporate liabilities. In addition, the legal authorities on the subject do not provide clear guidance, but instead focus on a totality of indicia, only some of which may be present in a given case. Rarely are they all present. Given the complexity of the law on piercing the corporate veil, the forensic accountant serves as a valuable resource to a litigant attempting to utilize the doctrine. Persuasive analysis by an expert can mean the difference between having a valuable or a worthless result. Thus it is critical that the litigator and forensic accountant work together to present the best possible case for why the veil should be pierced.

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