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BUILDERS AND DESIGNERS BEWARE: IT'S GETTING HARDER TO HIDE BEHIND THE CORPORATE VEIL

By: Wendy Testa, Camille Shora, Brigitte Smith, Regan Greenberg, Casie Salvadore

Wilson Elser

When you get the dreaded summons in the mail notifying you of a suit with allegations of negligence and defective design and construction on a recent project, you notify your potential liability insurers and believe it will be addressed appropriately. Then you notice that you along with your business are named as defendants. More and more, plaintiffs' attorneys are naming company owners personally in lawsuits, a strategy wherein counsel for plaintiffs attempt to "pierce the corporate veil."

Piercing the corporate veil, if successful, provides a party an avenue to pass through the protection of corporate structure to hold the owners, shareholders or members of a corporation or LLC personally liable for debts, actions, damages and more. Many contractors, especially those with small corporations or LLCs, think that once they form their corporation, they are protected or "bullet proof" against personal liability. To the contrary, there are many prerequisites, statutory and procedural, that must be met in order for your corporate structure to enjoy insulation from potential individual liability.

Background

We see problems arise most often in small, closely held companies where the owners/officers also are engaged in the day-to-day field operations, and there is very little separation between the corporate structure and the individual owners and/or officers. They are not necessarily thinking about regularly held formal meetings and minutes or drafting and adhering to required business organizational documents such as by laws. This conduct is the very thing that can expose them to personal liability.

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In many jurisdictions while there is a strong presumption against piercing the corporate veil, it does not guarantee that individual owners and/or officers will be able to extricate themselves easily from civil litigation where they are named personally. Be assured that counsel for plaintiffs will not consent to a dismissal when individual defendants can be driven to pressure their liability carriers to resolve claims to prevent individual financial exposure. In the alternative, many owners and officers will contemplate bankruptcy of the company and themselves to protect whatever assets they hold as individuals.

Pennsylvania Example

In a recent construction defect litigation venued in Philadelphia County state court, suit was initiated by a group of homeowners alleging construction defects and deficiencies in their homes against the residential builder/developer and the owners of the development company personally. The homeowners alleged that the owners personally made representations to them regarding the quality and construction of their homes.

In Pennsylvania, the general rule is that a corporation shall be regarded as an independent entity, even if its stock is owned entirely by one person, and the corporate form will be disregarded only when the entity is used to defeat public convenience, justify a wrong, protect fraud or defend crime. *Tunnell-Spangler & Assocs. v. Katz*, 2004 Phila. Ct. Comm. Pl. LEXIS 33 (2004), citing *College Watercolor Group, Inc. v. William H. Newbauer, Inc.*, 468 Pa. 103, 117; 360 A.2d 200, 207 (Pa. 1976); *Good v. Holstein*, 2001 Pa. Super. 320; 787 A.2d 426, 430 (Pa. Super. 2001). The factors Pennsylvania courts generally consider when deciding whether to pierce the corporate veil include undercapitalization, failure to adhere to corporate formalities, substantial intermingling of corporate and personal affairs, and use of the corporate form to perpetrate fraud. *Lumax Industries, Inc. v. Aultman*, 543 Pa. 38, 42; 669 A.2d 893 (1995), citing *Department of Environmental Resources v. Peggs Run Coal Co.*, 55 Pa. Commw. 312; 423 A.2d 765 (1980).

Despite the presumption against piercing the corporate veil, the plaintiffs raised sufficient, but weak, material factual questions to result in the Court's refusal to dismiss the claims against the individuals as a matter of law (by way of motion practice) prior to trial. Specifically, the company was held by two individuals, both of whom also worked in the field on the project that was the basis for the plaintiffs' claims. While they adhered to corporate filing requirements, did not commingle corporate and personal funds, and committed no fraud, the plaintiffs attacked the lack of formal meetings and meeting minutes as well as the fact that the individuals would put their own money into the business from time to time to keep it afloat. The case resolved shortly before trial, but had it not resolved the trial would have proceeded against both the company and the individuals.

Maryland Example

In a recent Maryland case, plaintiffs were the council of unit of a Maryland condominium and its individual members. The basis of the lawsuit was the alleged defective construction of the condominium and misrepresentations by the insured defendant developer and the developer's principal

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shareholder and its parent company. The main claim arose out of an alleged negligently designed masonry veneer that covered the majority of the exterior of the buildings.

In Maryland, a corporation is treated as a separate legal person or entity that is solely responsible for the debts it incurs. However, in rare and unique situations, a court will permit a party seeking redress to “pierce” or “lift” the corporate veil in the act of recovering not just from the corporate entity but also from the corporation’s owners and shareholders personally. Maryland courts have specifically held that “corporate officers or agents are personally liable for those torts which they personally commit, or which they inspire or participate in, even though performed in the name of an artificial body.” *Tedrow v. Deskin*, 265 Md. 546, 550 (1972). Importantly, the courts have explained “that an officer or director is not liable for torts of which he has no knowledge, or to which he has not consented.” *Id.* (citing *Martin v. Wood*, 400 F.2d 310 (3d Cir. 1968)). Knowledge of an allegedly tortious act may be express or implied.

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The Court of Appeals extended its holdings regarding piercing the corporate veil to LLCs in *Allen v. Dackman*, 413 Md. 132 (2010). In *Dackman*, the plaintiffs filed suit against an LLC and its members, alleging that they, as residents of property owned by the LLC, were exposed to lead paint. The Court of Appeals considered whether the LLC’s members could be held liable where they never personally handled matters of the property, and where they only dealt with the property through the LLC. The Court of Appeals held that a reasonable trier of fact could determine that the members were in control of the property and that they personally participated in the alleged tort. With these holdings, the Court effectively extended the principle of piercing the corporate veil to LLCs, permitting the plaintiffs to bring suit against the LLC and its individual members.

It was alleged by the plaintiffs that our client/developer was a “member, officer, agent, and/or representative” of the named defendant LLCs. The plaintiffs sought to pierce the corporate veil and hold our client/developer personally liable because he allegedly “controlled, supervised, accepted, directed and made all decisions regarding the development, design, construction, maintenance, and repair of the Condominium as well as the marketing, negotiation and sale of ownership therein.”

In support of their claims, the plaintiffs cited to the Maryland cases indicating that a corporate officer may be personally liable for torts committed by the corporation if the corporate officer either specifically directed or actively participated or cooperated in the corporation’s negligent conduct. See, e.g., *Tedrow v. Deskin*, 265 Md. 546, 550 (1972). According to the plaintiffs, the corporate veil doctrine does not insulate corporate officers from personal liability in negligence actions if their personal failure to exercise due care results in construction defects. See, e.g., *Fletcher v. Havre de Grace Fireworks, Co.*, 229 Md. 196, 201 (1962); *St. James Constr. v. Morlock*, 89 Md. App. 217, 222-24 (1991).

The plaintiffs alleged that our client/developer failed to exercise due care in failing to retain an independent third-party consultant to review the design

drawings and to observe the installation of the adhered masonry veneer. We argued that the developing entity did enter into contracts with a third-party engineering consultant to perform observations and inspections, but delegated to the general contractor the obligation to bring them to the site at the appropriate intervals. Therefore, any failures were attributable to the general contractor. We further argued that the architect of record was retained to perform construction administration duties and any failure to perform those duties was attributable to the architect. The case settled just prior to trial, but had it proceeded, a case would have been set forth against the individual owners as well as the company.

Virginia Example

In a recent Virginia case, we represented a general contractor that was to build a Leadership in Energy and Environmental Design (LEED) custom home. The process of building soon ran into issues due to the homeowner's demands and constant revisions to the plans. The homeowner filed suit against the company for breach of contract, negligence and breach of warranties. The general contractor handled much of the work himself rather than subcontracting it out, and the carrier sent a reservation of rights letter. Faced with coverage issues, and after the deposition of the general contractor's designee, the homeowner tried to pierce the corporate veil and by adding the sole officer of the corporation as an additional defendant. Facts in support of piercing the corporate veil included that the general contractor officer commingled personal and corporate funds and used his home address as the corporation address.

In Virginia, "Ignoring the separate existence of a corporation and imposing liability on shareholders for debts of the corporation is an extraordinary act to be taken 'only when necessary to promote justice.'" *O'Hazza v. Executive Credit Corp.*, 246 Va. 111, 115 (1993) (quoting *Cheatle v. Rudd's Swimming Pool Supply Co.*, 234 Va. 207, 212 (1987)). An argument to pierce the corporate veil must be accompanied with a factual basis from which it can be inferred that the individual was trying "to evade a personal obligation, perpetrate fraud or a crime, to commit an injustice, or to gain an unfair advantage." *Id.* (citing *Lewis Trucking Corp. v. Commonwealth*, 207 Va. 23, 31 (1966)). "[Evidence that] indicates that corporate formalities may not have been observed by the corporation, [is] one of the indicia of a sham corporation. Disregarding the corporate structure to impose liability on its shareholders or officers, however, is an extraordinary remedy which is undertaken only when necessary to avoid an injustice." See *Sloan v. Thornton*, 249 Va. 492, 498 (1995) (internal citations omitted).

The homeowner argued that the officer operated his company such that "the separate personalities of the corporation and the individual no longer existed." As noted above, the homeowner relied on the fact that the officer failed to observe corporate formalities. However, we argued that the officer did so due to oversight, and not to impose an injustice on the homeowner. In this case, the motion for leave to amend was denied and the court refused to pierce the corporate veil, but once again, it can be seen how important it is for contractors to pay attention to corporate formalities.

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Preserving the Corporate Veil

Even if the court does not permit the piercing of the corporate veil, companies, especially small businesses, need to make sure that the entity and its officers are adhering strictly to all statutory regulations and corporate formalities. Separation of the owners, officers and/or shareholders from the day-to-day field work involved in the design or construction of the projects is necessary to avoid giving the appearance of improper corporate structure. Although there is no guarantee that you will not be sued individually, discovery of the facts surrounding your business entity should enable individuals to pursue and achieve dismissal as a matter of law.

Further, when owners/shareholders of companies also deal directly with customers, they must ensure they are clearly acting in their capacity as a member of the company and not as an individual. While most jurisdictions do not favor piercing the corporate veil, a tactic is gaining traction and succeeding in pressuring companies and its owners, officers and/or shareholders to settle unreasonable construction defect claims in order to avoid paying out of pocket and/or being forced into bankruptcy for inadvertent noncompliance with required corporate structure. With an eye toward risk management, when individuals are forming a corporate entity, it is strongly suggested that they hire a third party to ensure compliance with reporting, tax and internal structural requirements.

Courts are becoming more and more sympathetic to homeowners asserting construction defect claims against residential builders and developers. They want to find relief for homeowners whether or not the claims are meritorious. Construction professionals, contractors and builders need to be on their toes and document properly and frequently the information that will help their counsel help them prevail on corporate veil piercing claims.

About the Authors

This article was a collaboration of case studies authored by Wilson Elser attorneys who practice in the jurisdictions including Pennsylvania, New Jersey, Virginia, West Virginia, Maryland and Washington, D.C. Wilson Elser is a global, full service defense firm with 38 offices nationwide offering legal assistance in various practice areas, including design professional, construction, construction defect, general and products liability.

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COVERAGE CORNER: DISCIPLINARY PROCEEDINGS REIMBURSEMENT

BY: Jessica Grund, A&E Senior Claims Consultant

Receiving a notice that your firm is being investigated by a State Board for professional misconduct can be stressful and time consuming. You may need to provide several documents, answer questions, and attend a hearing before the State Board. The Hartford's Design Professional Liability policy provides reimbursement for costs associated with a disciplinary hearing before a regulatory or governmental disciplinary official or agency.

For example: You receive a letter from the local State Board advising that you are under investigation for possible misconduct. The State Board requests that you provide your complete project file for the project in question and numerous additional documents. They also advise that you may be called to attend a hearing before the board, and they request a response within 14 days.

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