

News & Types: Corporate, Finance & Acquisitions Update

Extreme Example of "Piercing Corporate Veil"

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Practices: Corporate, Finance & Acquisitions, Litigation

It is standard legal advice for business lawyers to tell their clients to avoid claims of "piercing the corporate veil" by respecting the distinction between a business organization and its owners and respecting the distinction between affiliated business organizations. Usually left unsaid, but also true, is that it's not that hard to observe these distinctions. Sometimes a case comes along that not only illustrates the importance of observing corporate formalities, but leaves the reader puzzled about the sheer stupidity of failing to do so. It's as if the owner, in some respects a successful entrepreneur, intentionally took the path of greater resistance to illustrate to future entrepreneurs how not to run a business. (*Steiner Electric Company v. Manisalco and Sackett Systems, Inc.*, 2016 IL App (1st) 132023, March 2, 2016)

Leonard Manisalco was the sole owner of Delta Equipment Company ("Delta") and of Sackett Systems Inc. ("Sackett"). Steiner Electric Company ("Steiner") was one of Delta's suppliers. When Delta failed to pay Steiner, Steiner won a default judgment against Delta. Delta proved to be worthless and judgment proof, so Steiner attempted to pierce the corporate veil by pursuing Sackett and Manisalco individually. Steiner prevailed against both Sackett and Manisalco individually and was also able to obtain an award of attorneys' fees against both, even though it only had an agreement with Delta entitling it to attorneys' fees.

The court's opinion was 39 pages, laying on in detail all of the factors involved in piercing the corporate veil that Manisalco seemed intent on ignoring. These included the following:

- No Capital

Manisalco contributed no capital to Delta when it was incorporated in 1972. Instead, he loaned \$10,000 to Delta on incorporation. As the 7th Circuit Court of Appeals noted in a case we discussed in an earlier update, "Treating debt as in investment is not unheard of, but it is unfavored by courts because by doing so, the lenders cum investors (here, the defendants) give up nothing by way of profits if the corporation succeeds, but have assured themselves the preferred status of creditors if it fails, thus shifting to the legitimate creditors of the corporation a part of the risk that in fairness should be borne by the proprietary interest." Inadequate capitalization is the first, and likely most important, factor in piercing the corporate veil.

- Failure to Observe Corporate Formalities

Here the litany against Manisalco is long. Evidence showed he transferred hundreds of thousands of dollars among Delta, Sackett, and Manisalco. In one extraordinary sequence of transactions in May, 2007, Manisalco deposited \$100,000 into Sackett Systems. Sackett then deposited the \$100,000 into Delta. Delta then returned

the \$100,000 to Manisalco. This occurred no less than six times. Steiner's expert testified that the purpose was to transfer Delta's substantial net operating loss to Sackett (which was then profitable). The expert also testified that Delta's financial statements showed receipt of \$600,000 in management fee income while Sackett's financial statement showed payment of management fees to Delta. Of course, there was no documentation regarding these fees. Eventually the money was returned to Manisalco to reduce a loan from Manisalco to Delta.

There were undocumented money transfers among Manisalco and his entities, such as payment by Delta to Sackett of \$252,949 between January 2005 to December 2008, for which Sackett was able to produce invoices for only \$41,472.

Manisalco testified that he periodically loaned money to Delta, but with no supporting documentation to show where the money came from and where it went to.

In an action by sole director dated May 1, 2002, a mysterious shareholder loan balance of \$425,492 appeared on the corporate records of Delta. There was no prior documentation of such a loan.

In one highly unusual situation, Manisalco even opened a bank account with Delta and Sackett as joint owners. Certainly anyone wanting to show commingling of funds need look no further than this bank account.

- Insolvency and Diversion of Assets

Insolvency, by itself, does not justify piercing the corporate veil. But insolvency increases the temptation to divert assets away from the insolvent company to the detriment of creditors. Manisalco succumbed to this temptation. In November 2008, Delta had stopped paying Steiner. Manisalco claimed he "closed" Delta in December 2008 or January 2009. In February 2009, Manisalco's daughter and son-in-law started a new business called MPower which basically did the same business as had Delta. But MPower had an advantage. It used Delta's sales data and customer list to start its business. Steiner's expert testified that the customer list was worth more than \$200,000. Needless to say, MPower paid nothing for Delta's sales data.

- Nonfunctioning of the Officers and Directors

Initially, Manisalco was Delta's only corporate officer. Then Manisalco's wife became corporate secretary until she died in 1986. At that time Manisalco appointed his three daughters as secretary, treasurer, and assistant treasurer. At the time of their appointment they were 22, 20, and 17 years old respectively. (Delta's bylaws required Delta to have a vice president, but none was elected.) The daughters had no duties other than to attend one annual meeting. It is one thing to mismanage a business organization and put your own individual assets at risk. But it seems extremely irresponsible to put at risk children of this age who no doubt have nothing to do with the business. Later, the court discusses the roles of Manisalco's sons-in-law in the business. But Steiner, the creditor, only pursued Manisalco individually and no other family members.

- Absence of Corporate Records

The court found, as would be expected, that Delta's corporate records were incomplete. Promissory notes were not prepared and executed for the loans between Manisalco and Delta. Intercorporate rental agreements were not documented. And, as noted, the management fees were not supported by documentation.

Given the extreme carelessness that Manisalco handled his business entities, the court's decision should not be a surprise. Any entrepreneur who is looking for a negative example on how not to operate a business and how best to create personal liability should read the court's 39 page *Steiner* opinion.