# Protection Incorporated

Will you be held personally liable for not respecting the "corporate form"?

By Brian Hunt, JD

The corporate veil forms the bedrock of our capitalist society, allowing an entity's investors to limit their liability and encourage investment risk-taking that otherwise might be avoided.

As a general rule, owners and shareholders aren't held personally liable for corporate obligations. However, the 2012 *Wachovia Securities v. Banco Pan Americano* decision shows that, if the corporate form "is used as a cloak or cover for fraud or illegality, to work an injustice, to defend crime, or to defeat an overriding public policy, or where necessary to achieve equity," then piercing the corporate veil isn't beyond the realm of possibility.

This particular court case involved Lupe Corp. and its three shareholders and officers: Greenblatt (Secretary, 50 percent), Jahelka (President, 30 percent) and Nichols (Treasurer, 20 percent). Through a family trust, Greenblatt also controlled Banco Pan Americano as the sole officer, director and employee. On January 2000, Banco extended Lupe a $10-million line of credit in exchange for a blanket lien over all its assets, which were estimated to exceed $32 million.

In late 2000, Lupe opened an account with Wachovia to purchase shares in HRMI, a NASDAQ-traded entity that later saw its trading halted and share values plunge. This forced Wachovia to issue a margin call on Lupe's account, which, upon liquidation, reflected a $1.9-million debt.

And yet, that debt didn't stop Lupe from accepting another $8-million advance from Banco, moving its real-estate holdings into another vehicle (owned by the same shareholders), investing $500,000 in another venture, repaying $400,000 to Banco among other disbursements, and paying over $200,000 to Nichols and Jahelka as "compensation."

In 2005, pursuant to the terms of the Wachovia brokerage agreement, Wachovia obtained an arbitration award against Lupe that was reduced to a $2.5-million legal judgment, inclusive of interest and costs. Wachovia then pursued claims in federal court, seeking to "pierce the corporate veil" and hold Greenblatt, Jahelka and Nichols personally liable on the judgment.

The Appellate Court began its analysis by noting that Illinois law permits veil piercing when two requirements are met: (1). There must be such a unity of interest and ownership that separate personalities of the corporation and the individual no longer exist, and (2). Circumstances must be such that adherence to the fiction of a separate corporate existence would sanction fraud or promote injustice.

As to the first of these requirements, the Court noted that the trial judge had focused on the essential 11 factors that Illinois courts rely upon, namely, inadequate capitalization, failing to issue stock, failing to observe corporate formalities, failing to pay dividends, corporate insolvency, nonfunctioning corporate officers, missing corporate records, co-mingling funds, diverting assets to an owner or other entity to the creditor's detriment, failing to maintain an arms-length relationship among related entities, and having the corporation act as a mere façade for a dominant owner. No single factor is determinative, and the trial judge is uniquely situated to assess the evidence and evaluate the creditability of witnesses.

Analyzing the pertinent factors, the Court noted that Lupe had only $1,000 of paid-in capital. On the related issue of solvency, the Court noted the trial judge's assessment that Lupe's owners were incapable of competently testifying about its insolvency. Furthermore, the trial judge found that Lupe diverted $1.2 million to insiders and related entities following the HRMI stock collapse, while Greenblatt-controlled Banco held an unenforced lien on all Lupe assets. The Court also found that the assessment of Greenblatt's demeanor supported the trial judge's decision insofar as "[h]is flippant, condescending air in response to legitimate fact-finding questions convinced the trial court that he was intentionally evading the truth."

The Court further noted that Lupe's lack of corporate minutes and accounting records, failure to file or timely file tax returns, and failure to comply with Lupe's bylaws were all uncontested. The Court ultimately concluded that the failure to conform to its own bylaws allowed Greenblatt to dominate Lupe's decision-making and encourage its failure to keep an arms-length relationship with related entities.

As for the second requirement, the Court agreed with the trial judge's conclusion that adhering to Lupe's separate corporate existence would allow its shareholders to leave Wachovia holding the bag for the failed HRMI investment. Therefore, the judgment against Greenblatt, Jahelka and Nichols was affirmed.

Lupe's principals certainly represent an extreme example of a failure to honor the corporate form. The basis for legal action rests on whether the actors acted in good faith. While the failure to maintain corporate records and observe corporate formalities might be dismissed as mere sloppiness, the failure to honor the Wachovia debt while making significant disbursements for other ventures and distributions to insiders is difficult to construe as good faith.

As we know, the vast majority of corporate owners do behave responsibly. By the same token, we can't ignore the occasional bad apple. The best advice any attorney can give corporate owners is to always play fair. □

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