

Veil-Piercing Risks for Private Equity Managers Highlighted in Recent Court Decision

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A recent case in a North Dakota district court is a reminder to private equity funds and managers that, under certain conditions, they may be held responsible for actions of a fund's portfolio companies. Courts allow plaintiffs to pierce the corporate veil as a check against improper abuse of the corporate form. When one corporate entity is under such extensive control by another that the first is merely an alter ego of the second, a court may permit a plaintiff to reach through the corporate structure to gain recovery. This is particularly true if the first entity is undercapitalized. Through this mechanism, limited liability does not mean immunity from liability, and under certain circumstances a plaintiff can hold the ultimate shareholders or owners liable for company obligations.

The plaintiffs in [Marchan, et al. v. John Miller, et al.](#) brought such a veil piercing claim against private equity firm KRG Capital Partners, LLC in a products liability action. A major point of contention was how closely connected KRG Capital was to the portfolio companies that made and sold a defective product. KRG Capital had an agreement to manage TerraMarc Industries, Inc., an entity that KRG's principals originally created to make investments in the agricultural industry. KRG Capital itself was not a shareholder in TerraMarc, although its principals remained TerraMarc's shareholders and board members throughout its existence. TerraMarc had been liquidated prior to the lawsuit, but it had previously acquired and operated a portfolio companies that manufactured and sold farm equipment. The plaintiffs were injured by equipment manufactured and sold by those portfolio companies, and sued KRG Capital and TerraMarc, as well as the portfolio companies.

Despite KRG's position that it lacked unity of ownership and unity of interest with TerraMarc, the court denied its motion for summary judgment and determined that under federal law, veil-piercing was a question for the jury to decide. The court went so far as to include a diagram labeling KRG Capital as the owner and operator of TerraMarc in its decision. This case demonstrates courts' concerns about safeguarding plaintiffs' ability to recover from those entities and people that controlled the tortfeasor. The case ultimately settled this spring with the last of the cross claims being dismissed this past summer.

Different courts have developed various factors to determine whether to pierce the corporate veil. [Delaware has a high standard](#) which considers the following: (1) whether the entity was adequately capitalized; (2) whether the entity was solvent; (3) whether corporate formalities were observed; (4) whether the controlling shareholder siphoned company funds; and (5) whether the company generally functioned as a façade for the controlling shareholder. [California has a less rigid set of criteria](#) which does not require a finding of fraud or a "sham" entity. Rather, California has a long non-exhaustive list of factors that courts can look to such as whether the entities commingled funds, employed the same employees, or failed to maintain arm's-length relationships. Overall, California uses the doctrine when the separate existence of the corporation would promote injustice or bring about inequitable results.

While courts may go about assessing veil piercing claims differently, at its core the doctrine is about fairness and holding accountable those in control of an entity's actions. To minimize exposure to such claims funds should:

- Keep separate books and records for both companies.
- Have separate meetings of the board and keep separate minutes.
- Make the board composition of the entities different.
- Keep separate accounts, including bank accounts, for both companies.
- Require the use of separate email addresses and letterhead for any individuals with positions in both entities.
- Where possible, maintain an arm's-length relationship in business dealings between related entities.

- Adequately capitalize any corporation for its line of business.

Funds should avoid:

- Two companies using the same office or business location.
- Diverting assets from a corporation to the detriment of creditors, or manipulating assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another. This is a potential sign of the fraud element that Delaware law requires for veil piercing to apply.
- Having identical equitable ownership in the two entities, especially if the equitable owners have control over both entities.
- The same directors and officers responsible for supervision/management of both entities.
- Employing the same employees/attorney.
- Making the parent liable for the debts of the portfolio company.

If questions arise, it always makes sense to consult with outside counsel.

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