Update on Piercing the Corporate Veil

By Shawn M. Flanagan

In *Pertuis v. Front Roe Restaurants, Inc.*, 423 S.C. 640, 817 S.E.2d 273 (2018), the South Carolina Supreme Court has provided important new guidance in the area of "piercing the veil" of brother-sister corporations. All five judges agreed: "[w]e formally recognize today [the] single business enterprise theory." *Id.* at 655, 817 S.E.2d at 280. This new precedent will make it more difficult to pierce the veil of brother-sister corporations.

Single business enterprise theory

The single business enterprise theory ("SBE theory") "is an equitable doctrine applied to reflect *partnership-type liability principles* when corporations integrate their resources and operation to achieve a common business purpose." 1 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Corporations* §43 (perm. ed., rev. vol. 2015) (emphasis added). In other words, a court can pierce the corporate veil of two or more affiliated corporations and treat them as one (1) corporation, which can benefit a plaintiff-creditor.

The South Carolina Court of Appeals has considered the "amalgamation" of two or more corporations several times. In *Pertuis*, the South Carolina Supreme Court recognized the SBE theory for the first time. The SBE theory is comparable to the amalgamation of interest theory ("AOI theory"). However, the new Supreme Court's approach (the SBE theory) is more conservative than the previous Court of Appeals' approach (the AOI theory).

For the SBE theory to apply, there must be "[E]vidence of abuse, or ... injustice and inequity. . . . '[I]njustice' and 'inequity' . . . are used ... as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield—fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity." *Pertuis*, 423 S.C. at 654-655, 817 S.E.2d at 280 (quoting *SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444, 455 (Tex. 2008)). The South Carolina Supreme Court stated: "We agree with the reasoning of the Texas Supreme Court." *Pertuis*, 423 S.C. at 655, 817 S.E.2d at 280.

Piercing the corporate veil

"Piercing the corporate veil is a common law doctrine by which courts disregard the separate corporate entity in particular circumstances and impose liability on the participants behind the entity's veil." Robert B. Thompson, *Piercing The Veil Within Corporate Groups: Corporate Shareholders As Mere Investors*, 13 Conn. J. Int'l L. 379, 383 (1999). *See generally* Shawn M. Flanagan, *Piercing the Corporate Veil in South Carolina*, S.C. Law, Nov. 2006, at 35. (discussing piercing the corporate veil in South Carolina); Stephen B. Presser, *Piercing the Corporate Veil*, (West 2013) (discussing a nationwide study of piercing the corporate veil).

Facts of the case

Mark and Larkin Hammond

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built and operated three restaurants. The Hammonds hired Kyle Pertuis ("Pertuis") to manage the three restaurants. As part of his compensation, Pertuis acquired minority ownership interests in the corporations that owned the restaurants. The dispute primarily concerns the percentage and valuation of Pertuis's ownership interests in the three corporations. The trial court found the three corporate entities should be amalgamated into one legal entity. The Court of Appeals affirmed. The Supreme Court reversed on the issue of "amalgamation." As a result of the guidance provided by the Supreme Court in *Pertuis*, this author suggests using "single business enterprise theory" in place of "amalgamation of interests theory" to distinguish the new test from the old test.

Lake Point

In 1998, the Hammonds formed Lake Point Restaurants, Inc. ("Lake Point") in North Carolina. Lake Point purchased a restaurant operated as Larkin's on the Lake. The Hammonds were the initial shareholders with equal ownership in Lake Point. In 2000, the Hammonds hired Pertuis as a manager of the restaurant. As part of Pertuis's compensation package, the parties agreed Pertuis would earn (a) a base salary plus bonuses based on profitability benchmarks and (b) a 10% share in the business over the course of a five-year period at an agreed vesting schedule. The vesting schedule was time-based to incentivize Pertuis to remain with the company for a period of time. In accordance with the vesting schedule, by 2007, Pertuis owned a 10% share in Lake Point.

Beachfront

In 2001, the Hammonds formed Beachfront Foods, Inc. ("Beachfront") in North Carolina. As with Lake Point, the Hammonds were the initial shareholders with equal ownership interests, and the parties agreed upon a five-year vesting schedule for Pertuis to attain a 10% ownership interest. Pertuis' duties included oversight of both restaurants. As with Lake Point, by 2007, Pertuis owned a 10% share in Beachfront. Beachfront first operated a restaurant named MaLarKie's, which was not as successful as Larkin's on the Lake and was eventually sold. Beachfront then began operating a restaurant named Larkin's Carolina Grill, which was the least profitable of the three restaurants at the time of trial, with a negative net income reported each year from 2008–2012.

Front Roe

In 2005, the Hammonds formed Front Roe Restaurants, Inc. ("Front Roe") in South Carolina. As with the other two corporations at the time of their formation, the Hammonds were the sole shareholders of Front Roe with equal ownership interests. Front Roe operated Larkin's on the River in Greenville, South Carolina. At the time of trial, Front Roe was the most profitable of the three corporations.

Although the parties agreed upon a vesting schedule for Pertuis to acquire up to a 10% interest in Front Roe, this agreement, unlike the others, was based on restaurant profitability benchmarks – rather than length of service. Mark Hammond testified the agreement was for Pertuis to receive a 1% interest the year Front Roe first became profitable and an additional 9% once the company achieved a net operating profit of $500,000. By 2007, Pertuis owned a 1% share of Front Roe. However, at the time of trial, Front Roe had never reached the $500,000 net profit benchmark.

Pertuis never made any capital contributions or personal loans to the corporations, either during or after his employment.

Lawsuit

It appears that Pertuis' employment terminated in late 2009, although it is unclear from the record whether it was Pertuis' decision, the Hammonds' decision or a mutual decision. After the parties' unsuccessful attempts to negotiate the Hammonds' purchase of Pertuis's shares of the corporations, suit was filed. Pertuis argued he owned a 10% share in Front Roe. The trial court found the three corporate entities—Lake Point (NC), Beachfront (NC), and Front Roe (SC)—should be amalgamated into a single business enterprise located in and operating out of Greenville, South Carolina. The trial court awarded Pertuis a 7.2% ownership interest in Front Roe. The trial court valued each of the three corporations and ordered a buyout of Pertuis's shares. The South Carolina Court of Appeals affirmed. *Pertuis v. Front Roe Restaurants, Inc.*, No. 2016-UP-091, 2016 WL 757503, at *8 (S.C. Ct. App. Feb. 24, 2016). The South Carolina Supreme Court agreed with the Hammonds' claim that the Court of Appeals erred in affirming the trial court's finding that amalgamation of the three corporate entities was warranted. *Pertuis v. Front Roe Restaurants, Inc.*, 423 S.C. 640, 817 S.E.2d 273 (2018).

Choice of law: N.C. law vs. S.C. law

The Supreme Court concluded the application of South Carolina law was appropriate. "The choice of law rule generally applied to corporate law issues is the internal affairs doctrine, which provides that the internal matters of corporate governance are governed by the law of the state of incorporation." *Id.* at 649, 817 S.E.2d at 277. The "amalgamation issue is not as much a question of the inner-workings of foreign corporations as it is an assessment of whether these entities actually operate as a single business enterprise, and thus should be treated as a single entity." *Id.* at 650, 817 S.E.2d at 278. Front Roe was a South Carolina corporation and its restaurant was located in Greenville, South Carolina. Much of the conduct at issue occurred in Greenville, South Carolina. Pertuis was a South Carolina resident. "Accordingly, we conclude the application of South Carolina law is appropriate and that the internal affairs doctrine does not bar our review of this issue." *Id.*

Amalgamation / single business enterprise theory

The seminal case in South

Carolina is *Kincaid v. Landing Development Corp.*, 289 S.C. 89, 344 S.E.2d 869 (Ct. App. 1986). The statement of facts and the discussion of law in *Kincaid* is limited. *Kincaid* involved three brother-sister corporations involved in the development of a subdivision. One corporation owned the land. A second corporation handled sales and marketing. A third corporation constructed homes. The plaintiffs' lawsuit was based on negligent construction. The plaintiffs sought recovery from the sales and marketing corporation as well as the other two corporations. The Court of Appeals recited facts that the three corporations had common shareholders and common officers, and that they shared corporate offices and business letterhead, but not much more. The Court of Appeals was perfunctory in its affirmation of the trial court's finding that all three corporations were liable for the damages:

> The trial court ruled the evidence revealed "an amalgamation of corporate interests, entities, and activities so as to blur the legal distinction between the corporations and their activities." We agree.

Id. at 96, 344 S.E.2d at 874. For unknown reasons, the Court of Appeals in *Kincaid* did not cite its two year-old decision in *Sturkie v. Sifly*, 280 S.C. 453, 313 S.E.2d 316 (Ct. App. 1984) as authority.

Pertuis is the first time the South Carolina Supreme Court examined the Court of Appeals' "amalgamation of interests theory" in detail.

> [U]nder this theory, as it has been recognized in other states, where multiple corporations have unified their business operations and resources to achieve a common business purpose *and where adherence to the fiction of separate corporate identities would defeat justice*, courts have refused to recognize the corporations' separateness, instead regarding them as a single enterprise-in-fact, to the extent the specific facts of a particular situation warrant."

Pertuis, 423 S.C. at 652-653, 817 S.E.2d at 279 (emphasis added).

The highlighted language in the previous paragraph was the deciding point in *Pertuis*. In footnote 5 of *Pertuis*, the Supreme Court cited with favor three cases from California, Louisiana and Texas and included specific quotes from those cases. The South Carolina Supreme Court quoted from the Texas case in the body of the *Pertuis* decision, as well as in the footnote. Given the Court's approval of these three cases, they may be good sources of information regarding the application of the single business enterprise theory in South Carolina. The most important language from the Supreme Court in *Pertuis* is as follows:

> [A]t least fourteen states around the country recognize some sort of single business enterprise theory. It also appears virtually all of these states

require evidence of some sort of injustice or abuse of the corporate form to warrant disregarding the distinct corporate entities and treating the businesses as a single enterprise. As the Texas Supreme Court has put it:

> Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances. *There must also be evidence of abuse, or ... injustice and inequity. By "injustice" and "inequity" we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used ... as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield—fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity.* Any other rule would seriously compromise what we have called a "bedrock principle of corporate law"—that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's obligations.
>
> Disregarding the corporate structure involves two considerations. One is the relationship between two entities .... *The other consideration is whether the entities' use of limited liability was illegitimate.*

SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 455 (Tex. 2008) (emphasis added). *We agree with the reasoning of the Texas Supreme Court.*

We formally recognize today this single business enterprise theory, and in doing so, we acknowledge that corporations are often formed for the purpose of shielding shareholders from individual liability; there is nothing remotely nefarious in doing that. For this reason, the single business enterprise theory requires a showing of more than the various entities' operations are intertwined. *Combining multiple corporate entities into a single business enterprise requires further evidence of bad faith, abuse, fraud, wrongdoing, or injustice resulting from the blurring of the entities' legal distinctions.*

As with other methods of piercing the corporate form that have previously been recognized in South Carolina, equitable principles govern the application of the single business enterprise remedy, and this doctrine "is not to be applied without substantial reflection." *Drury Dev. Corp. v. Found. Ins. Co.*, 380 S.C. 97, 101, 668 S.E.2d 798, 800 (2008) (quoting *Sturkie v. Sifly*, 280 S.C. 453, 457, 313 S.E.2d 316, 318 (Ct. App. 1984)). "If any general rule can be laid down, it is that a corporation will be looked upon as a legal entity until sufficient reason to the contrary appears; but when the notion of legal entity is used to protect fraud, justify wrong, or defeat public policy, the law will regard the corporation as an association of persons." *Id.* "The party seeking to pierce the corporate veil has the burden of proving that the doctrine should be applied." *Id.*

Pertuis, 423 S.C. at 653-655, 817 S.E.2d at 280-281 (emphases added) (citations omitted). *See generally Magnolia North Property Owners' Association v. Heritage Communities, Inc.*, 397 S.C. 348, 725 S.E.2d 112 (Ct. App. 2012) (discussing the Court of Appeals' amalgamation interest theory; i.e. the "old test").

The Supreme Court's holding in *Pertuis* would make the application of the "old test" less likely today.

Application of law to the facts in *Pertuis*

Recognizing the single business enterprise theory (i.e., the "new test"), the Supreme Court applied the new test to the facts in *Pertuis* and held that the SBE theory did not apply.

> "The Hammonds' failure to strictly comply with corporate formalities was expressly authorized by statute, and *our thorough review of the extensive record yields no evidence of bad faith by the Hammonds*. Thus, it was error to consider these three distinct corporations as a single business enterprise."

Pertuis, 423 S.C. at 657, 817 S.E.2d at 281 (emphasis added).

Harmless error

The Supreme Court's decision includes a mistake, but the mistake did not alter the outcome. According to the opinion, the three corporations in *Pertuis* were S-Corporations for tax purposes. The Supreme Court said the trial court "overlooked the corporations' status as S-Corporations, which are statutorily permitted to disregard the very corporate formalities identified by the trial court as lacking. *See, e.g.*, S.C. CODE ANN. § 33-18-200 to -210 (authorizing elimination of the requirement of a board of directors); *Id.* § 33-18-220 (authorizing an S-Corporation not to adopt bylaws); *Id.* § 33-18-230 (authorizing an S-Corporation not to hold an annual meeting)." *Pertuis*, 423 S.C. at 656-657, 817 S.E.2d at 281. The Supreme Court is confusing S-Corporations for South Carolina statutory close corporations. The state corporate statutes cited by the Court do not have anything to do with whether or not an "S" corporation tax election has been made.

Title 33, chapter 18 of the South Carolina Code of Laws is the "Statutory Close Corporation Supplement." Being (1) a statutory close corporation under corporate law and (2) an S-Corporation under tax law are two different things. The Supreme Court in *Pertuis* mistakenly equated these two things. It is true that many S-Corporations are also statutory close corporations. But that was not the case in *Pertuis*. The author has reviewed the S.C. Articles of Incorporation filed for Front Roe Restaurants, Inc., and Front Roe did not elect statutory close corporation status.

The Supreme Court's mistake did not alter the outcome in *Pertuis* because of the lack of "evidence of bad faith, abuse, fraud, wrongdoing, or injustice resulting from the blurring of the entities' legal distinctions." *Pertuis*, 423 S.C. at 655, 817 S.E.2d at 281. A fairly serious type of "wrongdoing" is required under the new single business enterprise theory.

It seems to this author that reference to the "amalgamation of interests theory" should be "put on the shelf." As you will see later in this article, however, the Court of Appeals thinks otherwise.

The new test: two prongs

Like the *Sturkie* piercing the veil test, it appears South Carolina will use a two-prong test to determine whether legal entities should be disregarded under the SBE theory. The first prong will be a review of factors regarding the relationship between the corporations. The second prong, applying equitable principles, will require evidence of abuse, or injustice and inequity.

The first prong

For guidance regarding the first prong of the single business enterprise test, it seems appropriate to look to the Texas case which the South Carolina Supreme Court leaned on so heavy in *Pertuis*.

> Factors to be considered in determining whether the constituent corporations have not been maintained as separate entities include but are not limited to the following: common employees; common offices; centralized accounting; payment of wages by one corporation to another corporation's employees; common business name; services rendered by the employees of one corporation on behalf of another corporation; undocumented transfers of funds between corporations; and unclear allocation of profits and losses between corporations ...

Id. at 652, 817 S.E.2d at 279, n.5 (quoting *SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444, 450–51 (Tex. 2008)).

The second prong

Regarding the second prong of the SBE test, the South Carolina Supreme Court has set the bar high. In addition to the language from *Pertuis* already stated above in this article, consider the following: "the limitation on liability afforded by the corporate structure can be ignored only when the corporate form has been used as part of a basically unfair device to achieve an inequitable result." *Id.*

The South Carolina Court of Appeals

The Court of Appeals had an opportunity to apply the single business enterprise theory in *Walbeck v. The I'On Company, LLC*, Opinion No. 5588, 2018 WL 3748668 (SC Ct. App. Aug. 8, 2018). In *Walbeck*, the plaintiffs alleged a developer promised to convey a dock and park to a homeowner's association, but instead sold the recreational facilities to a third party. The Court of Appeals in *Walbeck* discussed with favor its "amalgamation of interests theory." Even though "no other jurisdiction seems to use the term 'amalgamation'" *Pertuis*, 423 S.C. at 640, 817 S.E.2d at 279, the Court of Appeals is sticking with the name it adopted in 1986.

To the Court of Appeals in *Walbeck*, the SBE theory is not a new test, but merely the addition of another element to its amalgamation of interests theory:

> "In *Pertuis*, the court formally recognized the amalgamation of interests theory for the first time and indicated a preference for the term "single business enterprise theory. ... the [single business enterprise] theory dovetails with the second prong of the *Sturkie* test, i.e., an element of injustice or fundamental unfairness, to place accountability where it belongs."

Walbeck, 2018 WL 3748668, at *18.

In *Walbeck*, the Court of Appeals affirmed "the circuit court's conclusion that Appellants were amalgamated." *Id.* at *19. The Court of Appeals noted "fundamental unfairness," "evidence of ... bad faith," a "secret sale" and a "surprise sale." *Id.* All of this may be true, but it does not seem as though the facts in *Walbeck* rose to the appropriate level of abuse, injustice or inequity as described in the Texas case adopted by the Supreme Court in *Pertuis*.

In *Stoneledge at Lake Keowee Owners' Association, Inc. v. IMK Development Co., LLC*, 425 SC. 276, 821 S.E.2d 509 (Ct. App. 2018), the Court of Appeals had another recent opportunity to apply the SBE theory. *Stoneledge* was a construction defect case. The Court of Appeals affirmed the trial court's decision to amalgamate interests. Although the Court of Appeals in *Stoneledge* referenced "single business enterprise" three times, this author counted 10 uses of the word "amalgamation" (or a form thereof) in the opinion. And as it did in *Walbeck*, the Court of Appeals in *Stoneledge* chose to quote milder language from the *Pertuis* decision than was available to it. In *Walbeck* and *Stoneledge*, the Court of Appeals did not use any of the language from *SSP Partners v. Gladstrong Invs. (USA) Corp.*, 275 S.W.3d 444, 455 (Tex. 2008) quoted in *Pertuis*.

Remember that the South Carolina Supreme Court "agree[s] with the reasoning of the Texas Supreme Court." *Pertuis*, 423 S.C. at 655, 817 S.E.2d at 280. The "second prong" standard set forth by the Texas Supreme Court in *SSP Partners* (and quoted with favor by the South Carolina Supreme Court) was "fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like." *Id.* at 654-655, 817 S.E.2d at 280. The Court of Appeals' decision to quote milder language from *Pertuis* may be a deliberate attempt to "water down" the SBE theory. What this author refers as the "first prong" of the new SBE test is referred to by the Court of Appeals in *Stoneledge* as the "threshold amalgamation issue."

Conclusion

Business men and women should be aware of "piercing the veil" principles and take steps to avoid falling prey to the judicial doctrine. The guidance set forth in *Hunting v. Elders*, 359 S.C. 217, 597 S.E.2d 803 (Ct. App. 2004) makes it more difficult to pierce the veil of a statutory close corporation and a subchapter "S" corporation. Now with *Pertuis*, it is more difficult to treat several corporations as one corporation. Both cases are welcome guidance from our judiciary.

Shawn Flanagan practices business, tax, trusts and estates at Womble Bond Dickinson.