

“Piercing the Corporate Veil” of a Limited Liability Company

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Introduction

One of the primary benefits of -- and principal reasons to organize as -- an LLC is the ability to shield the members’ personal assets from claims of outsiders and other members, i.e., the members and managers have the ability, if they so elect, to limit their liability from contract and tort claims of third parties. However, this protection may not be unlimited. At least one court (albeit in an unreported decision) has held that, under the appropriate circumstances, it may “pierce the corporate veil” of the LLC and hold the members personally liable for wrongs done to third parties.

The *Stone v. Hobby* Decision

In *Stone v. Frederick Hobby Associates II, LLC*, 2001 Conn. Super. LEXIS 1853, Superior Court, judicial district of Stamford-Norwalk, at Stamford, Docket No. CV000181620S (July 10, 2001) (Mintz, J.), the court found that the “instrumentality and identity rules” could be applied, under the facts of the case, to “pierce the corporate veil” of an LLC and hold the individual members personally liable. The plaintiffs, husband and wife, were both physicians. The plaintiffs had entered into a sales agreement with the defendant Connecticut LLC (which the court refers to as, and is hereinafter referred to as, “Hobby II”) in December 1999 to purchase a residence in Greenwich, Connecticut, for \$3,300,000. The home had been only partially completed by Hobby II at the time the sales agreement was executed. The sales agreement contained certain express warranties concerning the condition of the premises, and provided for the completion of certain “punch list” items within 60 days of date after the date of the agreement.

The plaintiffs subsequently filed the instant lawsuit, alleging numerous and substantial defects in design, materials and workmanship at the subject property, and alleging further that Hobby II had failed to timely complete all the punch-list work set forth in the sales agreement. The plaintiffs’ complaint further stated that Hobby II had, on or near the January 25, 2001, closing date for the purchase of the premises, transferred substantially all of its assets, including the proceeds from the sale of the subject property, to another Connecticut LLC, Frederick Hobby Associates, LLC (which the court refers to as, and is hereinafter referred to as, “Hobby I”) and to Frederick L. Hobby, III (hereinafter referred to as “Hobby”) and Sally M. Leindecker (hereinafter referred to as “Leindecker”). (Hobby and Leindecker were the sole members of Hobby II). The plaintiffs’ complaint contained nine counts for

relief, including breach of express warranty, breach of contract, violation of the Connecticut Uniform Fraudulent Transfer Act, and piercing the corporate veil of Hobby II so as to hold Hobby I, Hobby, and Leindecker personally liable.

After a court hearing on the merits of the case, the plaintiffs filed a “prejudgment remedy application.” Under Connecticut law, such an action enables the plaintiff in a lawsuit to attach and preserve the assets of the defendant while the matter is being litigated, if the court determines that there is probable cause to sustain the validity of the plaintiff’s claim. The court concluded, after hearing testimony and examining the plaintiffs’ and defendants’ pleadings and proofs, that such probable cause existed and granted the plaintiffs’ application for the statutory prejudgment remedy. In connection with this relief, the court further granted the plaintiffs’ motion for disclosure of the assets of Hobby I, Hobby, and Leindecker.

The court noted that because it found that the plaintiffs were entitled to the prejudgment relief requested, ordinarily it would not need to specifically address their request to “pierce the corporate veil” of Hobby II. However, the court stated that “[t]he issue of whether the assets of Frederick L. Hobby, III, Sally M. Leindecker and Hobby I may be reached upon the theory of piercing Hobby II’s corporate veil is critical to the plaintiffs’ application, especially in light of Frederick L. Hobby, III’s testimony at the prejudgment application hearing indicating that Hobby II currently has no assets.” *Id.* at *24 n. 17.

The court further noted that Connecticut’s LLC statute, Conn. Gen. Stat. § 34-133(a), provides (with certain exceptions) that a member or manager of an LLC is not liable for any debt, obligation or liability of the LLC (or any other member, manager, agent or employee of the LLC) to any third party, whether arising by contract, tort, or otherwise, solely by reason of being a member or manager of the LLC. However, the court stated that “[t]he limitation on liability provided by incorporation or the formation of a limited liability company is not . . . without boundaries.” *Id.* at *26. The court held that the same rationale that applies in connection with piercing the corporate veil also applies in the case of an LLC, but stated that “[t]he veil should . . . only be pierced under extraordinary circumstances.” *Id.* at *28 (citation omitted). The court stated further that “[t]he instrumentality and identity rules may be applied in order to ‘pierce the corporate veil’ of a limited liability company.” *Id.* at *29 (citations omitted).

According to the court, the instrumentality rule requires proof of three elements: 1. complete domination and control of both the entity’s policy and business practices; 2. use of such control to commit fraud or wrong, breach of a legal duty, or a dishonest or unjust act (such as using such control to avoid personal liability previously assumed by an individual); and 3. that the aforesaid control and breach of duty must proximately cause the injury or loss. With respect to the identity rule, the court stated that the “[t]he identity rule is generally employed in a situation where two corporations or companies are, in reality, controlled as one entity because of common owners, officers, directors, members or shareholders, and because of a lack of observance of corporate or company formalities between the two entities.” *Id.* at 30-31 (citation omitted). The court further stated that “in an appropriate case . . . the rule

may also be employed to hold one or more individuals liable,” and that “[o]f paramount concern is *how* the control was *used*, not that it existed. *Id.* at *31-32 (emphasis in text).

Turning to the facts of the instant case, the court found that Hobby and Leiendecker were the sole members of Hobby II, and that Hobby II’s office was located in Hobby’s private home (although Hobby II did not pay any rental for such space). The court also noted that Hobby II never had any assets other than the residential property that the plaintiffs purchased from Hobby II and which was now owned by the plaintiffs. The court also was particularly disturbed by a statement by Mr. Gold, the attorney who formed Hobby II on behalf of Hobby and Leiendecker and continued to act as Hobby II’s attorney. Mr. Gold’s statement was made during a meeting held between the parties in an attempt to resolve their differences in May of 2000 (which meeting the court found was not part of “settlement negotiations,” which would have enabled Mr. Gold to claim the statement was privileged). Mr. Gold told the plaintiffs, at this meeting, to “go ahead and sue us [Hobby II]. There is no money in [Hobby II]. Why do you think we set it up as an LLC in the first place?” According to the court, “[t]his . . . statement evidences an intent on the part of the individual defendants . . . to use the limited liability company as a shield in order to avoid responsibility for contractual obligations owed to the plaintiffs.” *Id.* at *33. The court further found that Hobby II had used a number of other, often confusing, names to describe Hobby II (such as “Frederick Hobby Associates”) and that the Connecticut transfer tax return executed in connection with the sale of the subject property stated that the grantor was not an LLC and was signed by Hobby in his individual capacity.

Based on the totality of the evidence, the court concluded that each of the necessary elements of the instrumentality rule had been established. According to the court, “[t]he plaintiffs have demonstrated that that Frederick L. Hobby, III and Sally M. Leiendecker exercised such domination over Hobby II that in essence, the limited liability company had no mind, will or existence of its own.” *Id.* at *38. The court rejected Hobby II’s argument that a mere breach of contract does not support invocation of the instrumentality rule to pierce the corporate veil of an entity, stating that the rule only requires that the court find “the defendants committed an unjust act in contravention of the plaintiffs’ legal rights,” and stating further that “[i]n this case, probable cause supports the finding that Hobby II committed an unjust act in contravention of the plaintiff’s legal rights by using the privilege of doing business in the limited liability form as a cloak to evade contractual obligations to the plaintiffs.” *Id.* at *38 n.21. The court also rejected Hobby II’s assertion that Hobby I, Hobby, and Leiendecker could not be held liable because the plaintiffs knew they were dealing with an LLC and had not alleged that they were fraudulently induced to enter into the contracts with Hobby II.

The court found that the evidence also demonstrated probable cause for the court to apply the identity rule. This was so, the court ruled, because “Frederick L. Hobby, III and Sally M. Leiendecker used Hobby II interchangeably with their own personal identities and with identities of other entities under their control, and failed to observe formalities for the limited liability company. The names of these other entities,

whether real or fictitious, represent entities which are, in reality, controlled as one entity because of common owners or members and because of a lack of observance of formalities between the entities.” *Id.* at *39. The court reasoned that because there was such a unity of ownership and interest, Hobby II’s existence as a separate entity had never really existed or had been terminated, and the existence of Hobby II as an LLC with a separate identity “would only serve to defeat justice and equity by permitting the individual defendants to escape liability arising out of a ‘shell’ operation conducted for their benefit.” *Id.*

The court held that, under the tests enunciated in both the instrumentality rule and the identity rule, probable cause existed to support the plaintiffs’ breach-of-contract claims and their request to pierce the corporate veil of Hobby II to reach the assets of Hobby I, Hobby, and Leiendecker. The court therefore granted the plaintiffs’ application for the Connecticut prejudgment attachment remedy, in the amount of \$300,000, and further granted the plaintiffs’ motion for disclosure of the assets of Hobby I, Hobby, and Leiendecker.

Conclusion

Although the court in *Stone v. Frederick Hobby Associates II, LLC* believed that the conduct of the individual defendants justified its conclusion that the plaintiffs were entitled to “pierce the corporate veil” of the LLC of which the individual defendants were the sole members, no specific finding of actual fraud on the part of the individual defendants had been made by the court. There probably is no good reason why the “piercing the corporate veil” doctrine should not be applied to LLCs, at least where the particular fact situation warrants its applicability. However, is it really the intention of LLC statutes to abrogate the limited liability feature of an LLC, (which is one of the primary benefits of and reasons for forming an LLC) -- even if the members may have engaged in egregious conduct -- when only a contractual violation has been established and the party alleging misconduct on the part of the LLC members at all times knew that the party it was dealing with was an LLC? Attorneys who are engaged in the practice of forming and advising LLCs should read this decision carefully and determine whether a court in a state other than Connecticut might reach the same conclusion under similar factual circumstances. Other lessons for attorneys from this case: establish a clear and separate identity for the LLC apart from its constituent members (including a separate office, stationery, books, and assets); clearly designate the LLC as the entity entering into and executing (and solely authorized to enter into and execute) business agreements and contracts intended to bind and benefit the LLC; and don’t dare a party dealing with the LLC to sue it by asserting, e.g., that “the LLC doesn’t have any money or assets you can reach, and that’s the reason we formed it.”