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Connecticut Supreme Court Refines the "Piercing the Corporate Veil" Doctrine

The Connecticut Supreme Court has unanimously ruled that the doctrine of "piercing the corporate veil" cannot apply to a single-owner limited liability company absent a finding that the owner used his control over the entity to perpetrate a fraud. The court applied traditional veil-piercing rules from corporation law to limited liability companies.

In *Naples v. Keystone Bldg. & Dev. Corp.,* 295 Conn. 214, the Supreme Court analyzed veil-piercing arguments in the context of construction of a single-family home. The homeowners alleged that the homebuilder entities -- a corporation and its successor LLC -- were negligent in the construction. The trial court agreed, awarding about $60,000. The homeowners appealed, seeking greater damages and further seeking to hold the sole owner of the homebuilder entities personally liable under the theory of "piercing the corporate veil."

The Supreme Court agreed with the homeowners, sending the case back to the trial court to determine whether to increase the damages award. The court rejected the homeowners' attempt to hold the owner of the entities personally liable, however. The Court found the homeowners' claim deficient under both veil-piercing theories followed in Connecticut.

Connecticut courts employ the so-called instrumentality test and identity test when determining whether to bypass the corporate form and hold the individual owners liable. The instrumentality test requires that an owner exercised complete domination and control over the finances, business policy and business practices of an entity, so that the entity was the mere instrumentality of the owner. But the test also requires that such control must have been used to commit a fraud or wrong in violation of the plaintiffs' legal rights and that the control and breach of duty caused the plaintiffs' injury. The identity test requires proof of such a unity of interest and ownership between the owner and the entity that the entity had in effect ceased (or had never begun) to adhere to a separate legal identity. But again, the identity test requires that the owner use the shell entity as an intermediary "to perpetrate fraud or promote injustice."

Citing an earlier decision by the Connecticut Appellate Court, the Supreme Court identified numerous factors relevant to finding domination or control of an entity. These include, among other factors, (i) the absence of corporate formalities (such as holding annual meetings of stockholders and directors and keeping minutes of meetings); (ii) inadequate capitalization; (iii) whether funds are put in and taken out of the entity for personal rather than corporate purposes; and (iv) overlapping ownership, officers, directors and personnel.

In *Naples*, the Supreme Court affirmed the trial court's finding that, although the corporation and successor LLC had failed to construct the new home in a workmanlike manner, the owner had not created the entities to commit fraud or promote injustice. The owner had clearly exercised control over his wholly owned entities. There was a close relationship between the owner's finances and those of the business, and the owner had failed to comply with corporate formalities by keeping corporate minutes or other records or by preparing an LLC operating agreement.

Nevertheless, the Supreme Court affirmed the lower court's finding that the tests for piercing the veil had not been met. No evidence was found that the LLC did not serve a legitimate business purpose or that failing to pierce the veil would perpetrate a fraud or other injustice, like denying the homeowners damages.

The more subtle takeaway from *Naples* is that the Court did not differentiate veil-piercing actions brought against corporations or LLCs. The doctrine of piercing the corporate veil originated at a time when the dominant entity was the corporation. The advent and rise in popularity of the LLC form of business organization has blurred some of the traditional lines in business law jurisprudence. The *Naples* court, in rendering its decision, did not address whether the use of an LLC influenced its holding in any way. We believe its silence suggests the standard for piercing the veil of an LLC would be the same as for a corporation.

Clients often ask what form of entity best suits their business goals. The answer turns on issues like structural flexibility, requirements of other investors, and exit strategies. In most cases, the LLC is the preferred form of entity. The *Naples* decision underscores that individuals forming a new entity under Connecticut law can choose a single-member LLC or corporation without fear of personal liability for the obligations of the entity, provided the entity is properly structured and funded and there is no intent to perpetrate a fraud or promote injustice. Our business law attorneys would be pleased to discuss choice of entity and veil-piercing risks with you.