New Potential for Corporate Liability in Colorado: “Reverse Piercing” of the Corporate Veil

A recent Colorado Supreme Court decision may expose companies incorporated or doing business in Colorado to liability for the actions of their controlling shareholders. Corporations can help shield themselves by carefully separating the affairs of shareholders from those of the corporation and by adhering to common corporate formalities.

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In re Phillips—Colorado Adopts “Reverse Piercing” in a Split 4-3 Decision

On June 26, 2006, the Colorado Supreme Court narrowly adopted the doctrine of “reverse piercing” of the corporate veil, deciding that a corporation may, under certain circumstances, be held liable for the debts of a controlling shareholder or other corporate insider.¹

According to general principles of corporate law, the shareholders of a corporation are generally not personally liable for the acts of the corporation. Similarly, the corporate form has traditionally protected corporate assets from the acts of individual shareholders. In certain narrow circumstances, courts applying Colorado law have recognized traditional “piercing of the corporate veil,” which subjects shareholders to liability for the acts or debts of the corporation.²

Phillip E. Phillips was the majority shareholder of Philsax, Inc., a Colorado corporation (“Philsax”). Phillips’ wife was the only other shareholder of Philsax, and also the majority shareholder of another Colorado corporation, Action Properties, Inc. (“Action”). The trustee of Phillips’ bankruptcy estate sought to prevent transfers of property owned by Phillips and Philsax, arguing that Philsax was the alter ego of Phillips and, therefore, actions taken by Philsax were, in effect, actions taken by Phillips.

The court held that reverse piercing of the corporate veil may be appropriate when there is a clear showing that these three factors are met: (i) the controlling insider and the corporation are alter egos of each other, (ii) justice requires recognizing the substance of the relationship over the form because the corporate fiction is utilized to perpetuate a fraud or defeat a rightful claim, and (iii) an equitable result is achieved by piercing. The court further noted that if innocent shareholders or creditors would be prejudiced, an equitable result would not be achieved and reverse piercing would not be appropriate.

Here, the court accepted the District Court’s use of the reverse piercing doctrine and noted, with respect to the first factor, that Philsax and Phillips appeared to be alter egos of each other because Phillips used corporate funds to pay his personal debts and the creditors of the corporation were also his personal creditors. Moreover, Philsax failed to follow basic corporate formalities; for example, it had no bank account, no written bylaws, and maintained no written financial statements. Philsax also failed to provide written notice of board meetings and Phillips removed and added directors at will. With respect to the second and third factors, the court noted that, because transfers may have been made to and among Philsax and Action with the purpose of avoiding a third party judgment against Phillips, and given that Philsax had no other creditors, reverse piercing would not prejudice innocent creditors.

Three of the seven justices dissented, noting that the decision could significantly alter the value of a shareholder’s investment in a corporation by changing the risks and liabilities to which the investment might be exposed. They also noted that the decision could change the expectations of creditors regarding the risks to and security of their collateral.

¹ See Connolly v. Englewood Post No. 322 Veterans of Foreign Wars of the United States, Inc. (In re Phillips), No. 05SA316 (Colo. June 26, 2006). The case answered a certified question of law posed to the court by the United States District Court for the District of Colorado regarding whether a creditor of a shareholder of a closely held corporation could, under Colorado law, “reverse pierce” the corporate veil to satisfy the shareholder’s debt.

Which Law Applies?

Most often, under the "internal affairs doctrine," the law of the state of incorporation governs issues involving disputes among corporate constituencies. In some jurisdictions, this principle has been applied to veil piercing analysis as well. Under this standard, and as result of the court’s decision in In re Phillips, a company incorporated in Colorado could now face the possibility of reverse veil piercing liability. However, since veil piercing involves disputes beyond the confines of the corporation, in other cases courts have applied the law of the place with the “most significant relationship” to the transaction. For example, in one case, the District of Massachusetts applied Massachusetts veil piercing law in a dispute involving a Rhode Island corporation, noting that the “place of incorporation is only one of several factors that Massachusetts courts consider in deciding what law to apply to piercing the corporate veil involving a contractual dispute.” If Colorado courts were to apply the “most significant relationship” standard, reverse veil piercing liability could apply to Colorado corporations as well as foreign corporations who do business in Colorado.

Reverse Piercing among Parent and Subsidiary Corporations

Although not addressed by In re Phillips, the veil piercing doctrine is also a consideration in the parent-subsidiary context. In traditional veil piercing cases in Colorado, courts have found parent corporations liable for the obligations of their subsidiaries. If the reverse veil piercing doctrine applies to parent-subsidiary relationships, subsidiaries could be held liable for the obligations of the parent.

Factors that courts have found relevant in analyzing whether it is appropriate to pierce the corporate veil and hold a parent corporation liable for the debts or acts of its subsidiary include whether (i) the parent owns all or a majority of the capital stock of the subsidiary, (ii) the parent and subsidiary have common directors or officers, (iii) the parent finances the subsidiary, (iv) the subsidiary has grossly inadequate capital, (v) the parent pays the salaries or expenses of the subsidiary, (vi) the subsidiary has substantially no business except with the parent or no assets except those conveyed to it by the parent, (vii) the subsidiary is referred to as a department or division of the parent, (viii) the directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation, and (ix) the formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Helpful Tips

The divided nature of the court’s decision, coupled with the traditionally narrow circumstances in which the reverse veil piercing doctrine applies, raises questions about its future scope and applicability in Colorado. However, in light of In re Phillips, there are certain corporate governance practices that have taken on greater or renewed importance.

1. **Incorporating (and Perhaps Even Operating in) Colorado May Present Additional Risks.**
   
   In certain limited circumstances, reverse piercing of the corporate veil could be used to obtain funds from a corporation to satisfy the debts or obligations of a controlling shareholder or other corporate insider. The In re Phillips decision may mean that the risk of reverse veil piercing liability is now higher for companies incorporated, and perhaps even operating, in Colorado.

2. **Observe Formalities to Avoid Liability.**
   
   Corporate liability for shareholder debts or obligations can be avoided by maintaining corporate formalities, such as keeping corporate finances wholly separate and maintaining good corporate records. Companies and shareholders should consider, among other things, maintaining a separate corporate bank account; assuring the corporation, and not the controlling shareholder,

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4 Id.
5 Id.
writes and receives checks related to corporate transactions; maintaining written bylaws; maintaining written corporate financial statements; and providing written notice of board and shareholder meetings.

3. **Beware of Identical Sets of Creditors.**

Courts may be more likely to hold a corporation liable for shareholder debts and obligations when the shareholder and corporate creditors are identical.

4. **Foreign Incorporation or Multi-state Operations Present More Complexity.**

Fifteen states, including Colorado, have recognized reverse veil piercing, and a number of federal courts will apply the doctrine unless it explicitly contradicts state law. In some courts, incorporation in one of these jurisdictions will trigger applicability of the reverse veil piercing law. Other courts will look to the law of the jurisdiction with the most significant relationship to the dispute, meaning that reincorporation alone may not be enough to shield a corporation from the liability.

5. **Creditors May Look Beyond Debtors’ Own Assets.**

Reverse veil piercing may now be part of the litigator’s toolbox. Creditors seeking to collect debts may, under certain circumstances, look to the assets of the debtor’s corporations for an enforceable judgment.

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This summary covers general issues that could concern some Colorado businesses. Many companies will not be affected by the recent decision. Other entities may face reverse veil piercing issues not covered in this overview, especially given the range of contexts in which veil piercing can be applied. If you would like to discuss the ruling in more detail, please contact the authors or any other member of the DGS Corporate Finance & Acquisitions Group.

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