Connecticut *Moves to Protect* Business Owners and Investors

By Steve Stafstrom

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This past session, the Connecticut General Assembly has adopted legislation to provide clarity and predictability to business owners and investors regarding when their personal assets could be at risk because of the unpaid debts of a business entity in which they hold an interest. In enacting Public Act 19-181, the legislature has limited the situations in which the doctrine of piercing of the corporate veil can be used to hold a shareholder, member, or partner liable for a judgment against a corporation, LLC, partnership, or other business entity.

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It is generally understood that a business entity is legally distinct from its shareholders, members, or partners and that these individuals are not personally liable for the acts and obligations of the business entity.[1] However, courts have long recognized an ability to disregard the fiction of a separate legal entity to pierce the shield of immunity afforded by the business entity structure in a situation in which the business entity has been so controlled and dominated that justice requires liability to be imposed on the real actor.[2]

Abandoning the Identity Test

Connecticut courts have long grappled with when this equitable remedy of veil piercing is warranted, creating a patchwork of sometimes inconsistent decisions. The courts have created and applied two tests. The first, called the "instrumentality rule," requires proof of three elements: (1) control, not mere majority or complete stock control, but complete domination—not only of finances but of policy and business practice in respect to the transaction attacked—so that the corporate entity as to this transaction had at the time no separate mind, will, or existence of its own; (2) that such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of the plaintiff's legal rights; and (3) that the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.[3]

The second test, called the "identity rule," has generally been stated as follows: "If plaintiff can show that there was such a unity of interest and ownership that the independence of the corporations had in effect ceased or had never begun, an adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise."[4]

The identity test, in particular, has proven vague and thus difficult to apply. It is sometimes subsumed into or confused with the instrumentality test. It also is not clear if "causation" is an element of the identity test,[5] meaning a business owner could potentially be held liable for the debts of the business entity, even if the fact that she and the business had a "unity of interest" was not the reason the debt could not be paid by the business.

Under the new law, this confusion should be resolved as the identity test has been abdicated by the legislature. Under the Act, the instrumentality test is the only means by which a court could pierce a business entity's veil. And, the Act clarifies and codifies the instrumentality test factors. Of particular note, the Act makes clear that the failure of a business entity to observe corporate formalities, such as filing annual reports, is not a ground upon which veil piercing can be based.

No Reverse Veil Piercing

The Act also specifically overrules the doctrine of "reverse veil piercing," which was called into question by a 2012 Supreme Court decision.[6] Reverse veil piercing had been used to hold a business liable for the debts of one of its interest holders.[7] The doctrine of reverse piercing is problematic in that when corporate assets are attached directly for the benefit of the creditors of an individual, it prejudices rightful creditors of the corporation, who relied on the entity's separate corporate existence when extending credit.[8] Also, if a business entity has other non-culpable shareholders, they too will be prejudiced if the entity's assets can be attached directly.[9]

Public Act 19-181 originated with the General Assembly's Judiciary Committee, which has worked in a bi-partisan manner over the past few years to update Connecticut's business incorporation statutes, including the Limited Liability Company Act and the Business Corporations Act. Members of the Business Law Section of the CBA provided valuable input on drafting the final language of the Act.

The veil piercing bill passed both the House and Senate unanimously. It was signed by Governor Lamont on July 9, 2019, and became effective from that date and is applicable to any civil action filed on or after the effective date. ■

Steve Stafstrom *is the House chairman of the Connecticut General Assembly's Judiciary Committee. He introduced and was the principal sponsor of Public Act 19-181. He is a member of Pullman & Comley LLC, practicing in the area of commercial litigation and has defended clients in corporate veil piercing cases.*

NOTES

1. *See e.g.*, *Saphir v. Neustadt*, 177 Conn. 191, 209 (1979).
2. *See e.g.*, *Commissioner of Environmental Protection v. State Five Industrial Park, Inc.*, 304 Conn. 128, 139 (2012).
3. *Angelo Tomasso, Inc. v. Armor Construction & Paving, Inc.*, 187 Conn. 544, 563 (1982).
4. *Id.* at 187 Conn. at 554.
5. *Wells Fargo Bank, N.A. v. Konover*, 2011 WL 1225986, n. 26 (D. Conn. March 28, 2011).
6. State Five, 304 Conn. at 130.
7. *Id.*
8. *Id.* at 140 quoting *Floyd v. Internal Revenue Service*, 151 F.3d 1295, 1299 (10th Cir.1998).
9. *Id.* quoting *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal.App.4th 1510, 1520, 77 Cal. Rptr.3d 96.