Piercing the entity veil: Vertical and horizontal; and the award of attorney fees in a case of first impression

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In a case of first impression, the court, in *Steiner Elec. Co. v. Maniscalco*, 51 N.E.3d 45 (Ill. App. Ct. 2016), which involved piercing the corporate veil of one corporation to hold the sole shareholder (vertical) and a related corporation (horizontal) liable, determined that a provision in the credit agreement between Steiner and Delta, the judgment debtor, was broad enough to encompass post-judgment attorney fees incurred in the subsequent veil-piercing action. The credit agreement imposed liability for “all reasonable costs of collection including attorney fees and expenses,” and contained another provision that provided “[t]he customer shall be responsible for all costs of collection incurred by Company, including without limitation lien costs and all attorney fees and expenses.” Id. at 67.

I. Background

The defendant, Leonard Maniscalco, owned and was the sole director, shareholder, and functioning officer of Delta Equipment Company (Delta) and Sackett Systems, Inc. (Sackett). Id. at 48. Plaintiff, Steiner Electric Company (Steiner), sold electrical products to Maniscalco’s companies on credit beginning in 1989.

Beginning in 2004, Delta began experiencing financial trouble, and the relationship between Steiner and Maniscalco soured, due to nonpayment under their credit agreements. In 2009, Steiner brought a suit against Delta to enforce the credit contract and was awarded $226,686, which encompassed the cost of the products, finance charges, attorney fees, expenses, and costs. Id. at 49. However, Maniscalco closed Delta before the judgment was issued and did not attempt to satisfy the judgment. Id.

Steiner brought the instant action in 2010, asking the circuit court to pierce the entity veil to collect judgment against Delta. The circuit court pierced the entity veil and held Maniscalco and Sackett jointly and severally liable. Id. at 49. Ultimately, the court awarded the finance fees and post-judgment interest, but not the attorney fees. Accordingly, judgment in favor of Steiner was increased to $387,403. Id. at 55-56.

II. Vertically Piercing the Veil from Delta to Maniscalco – Prong 1

In general, corporate officers or directors are insulated from the debts and liabilities of a corporation owned or operated by them. However, Illinois has utilized a two-prong test for determining when to pierce the entity veil: The first prong is met “where the corporation is merely an alter ego or business conduit of the person responsible for the damages,” and the second prong is met where fraud or injustice would result if a separate legal entity were recognized.

In determining whether an alter ego existed, the appellate court analyzed the following factors:

(1) inadequate capitalization; (2) failure to issue stock; (3) failure to observe corporate formalities; (4) nonpayment of dividends; (5) insolvency of the debtor corporation; (6) nonfunctioning of the other officers or directors; (7) absence of corporate records; (8) commingling of funds;
(9) diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors; (10) failure to maintain arm’s-length relationships among related entities; and (11) whether, in fact, the corporation is a mere façade for the operation of the dominant stockholders.”


Maniscalco and Sackett conceded that there was nonpayment of dividends, insolvency of the debtor corporation, and nonfunctioning of the other officers or directors. As such, the appellate court only examined the remaining eight factors. Id. at 58.

First, the appellate court found that Delta was inadequately capitalized since upon its incorporation, Maniscalco did not deposit unencumbered capital sufficient to operate the company and instead gave a $10,000 loan. Id. at 58. The court correctly determined that a loan is not the same as a capital contribution and counsel should be aware of this distinction in counseling their clients. However, the appellate court wrongly put weight on the testimony of Steiner’s financial expert regarding Delta’s “undercapitalization” due to increasingly negative income and retained earnings over the last five years of Delta’s existence. Id. The court came to the correct conclusion on this factor since attempting to capitalize the business only with debt is inadequate capitalization. However, the “increasingly negative income and retained earnings over the last five years of Delta’s existence” should be irrelevant with respect to inadequate capitalization because inadequate capitalization should be determined at the time of organizing the corporation, unless those in control have later taken some actions to “decapitalize” the corporation. Having losses later in the company's existence, (over 25 years later in this instance), should not be considered as a factor in piercing the corporate veil. Every company subject to a piercing claim would fail this test (just like the “insolvency” factor, as discussed supra) because the creditor wouldn’t be attempting to pierce if there were sufficient assets in the company to satisfy the judgment.

As to the second factor, the court found it “neutral” that Delta issued stock, but only to Maniscalco. Id. In reality, it is irrelevant whether a corporation actually delivers a stock certificate, since the certificate is only evidence whether stock has been issued. BCA § 6.35, 805 ILCS 5/6.35. The key is whether the purported shareholder actually transferred consideration to the corporation to pay for the issued shares. There can be no valid issuance of shares if no capital is contributed. See BCA §§ 6.25, 6.30, 805 ILCS 5/6.25-6.30. Since there was no money paid as capitalization for the stock, and only a loan was given to the company, arguably the court could have considered this factor “met” instead of “neutral” as the stock was improperly issued.

On the other hand, the appellate court found that the third factor, observing corporation formalities, was lacking. Id. at 58. There was evidence that Maniscalco made personal loans to Delta with no promissory notes. Additionally, he failed to elect a vice president and functioning officers, despite the bylaw mandate. Id. at 49. The only other corporate officers were Maniscalco’s daughters who had no operational duties. Id. at 49.

Moreover, Maniscalco engaged in a series of six $100,000 money transfers attributed to “management fees” from Maniscalco, to Sackett, to Delta, and back to himself. Id. at 52. These were supposedly “management fees” that Sackett purchased from Delta, but they were provided by Maniscalco as an officer of Delta, to Sackett. However, Maniscalco was also an officer of Sackett and, in that capacity, should have provided the aforesaid services, if they were in fact provided, without payment to Delta. A forensic accountant testified that the purpose was likely to transfer Delta’s net operating loss to Sackett, by creating income to Delta, which was losing money, and a corresponding expense to Sackett, in a cash neutral situation for Sackett, which would yield a substantial tax benefit to Sackett. Id.

The court found this transaction significant under many of the factors, and pointed to the lack of written agreement for transfers as evidence of failure to observe corporate policies. Id. at 59. Moreover, Paul Adank, the general manager of Sackett and Maniscalco’s son-in-law, was unaware of the arrangement. Id. at 58–59. Lastly, when Maniscalco closed Delta in 2009, there was no indication of the decision in the meeting minutes to reflect the closing, winding up, and liquidation of Delta. Id. at 59. Although the corporation maintained a minute book, it was not sufficient. When determining Delta failed to observe corporate formalities, the court also found it instructive that Delta failed to elect a vice president and functioning officers. Thus, there was a lack of corporate formalities, which also tied into the seventh factor, inadequacy of corporate records.

Inadequacy of corporate records differs from the corporate formalities factor as it looks to the documentation supporting company transactions and not board approval of those actions. The court pointed to the lack of promissory notes for loans, the failure to commit the management fee arrangement to writing, and the lack of a formal rental agreement for leasing the building from Maniscalco, in determining this factor was violated. Id. at 59. The lesson here is to make sure that arrangements with owners and affiliated companies are documented to the same extent as they would be with an independent third party.

The eighth factor, commingling of funds, was satisfied because Delta and Sackett shared a joint bank account and engaged in the aforementioned management fee transfers. Money had been shifted between Maniscalco, Sackett, and Delta for no legitimate reason. Id. at 59.

As to the ninth factor, diversion of assets, Maniscalco, in effect, closed Delta and transferred its business to a new company, MPower, formed by Adank and his wife (Maniscalco’s daughter), which sold the same natural gas generators that Delta had sold. Id. at 54. MPower’s success could be attributed, in part, to Adank’s use of Delta’s customer list and data to garner sales. The customers’ list was arguably worth an estimated $200,000. Id. at 54, 60. Maniscalco testified that he was aware of Adank’s use of Delta’s customer data, and
he did not ask Adank for compensation or attempt to stop its use by Adank. In doing so, Maniscalco allowed diversion of a valuable asset to the detriment of creditors, since he could have sought compensation for the use of the valuable customer list to offset Steiner’s debt. Id. at 60.

The tenth factor, failure to maintain an arm’s length relationship among the entities, was demonstrated through the circular management fee transactions and entering into personal loans without promissory notes. Id. at 60. An additional analysis the court could have relied on was the landlord (Maniscalco) ceasing to collect rent from the company, yet still allowing it to stay at the premises, which is not what a landlord would normally do.

Finally, the court found that it was at most neutral whether or not Delta was a mere façade for the operation of Maniscalco. On one hand, Maniscalco maintained his own bank account, separate from Delta and Sackett, and there was no evidence that he used corporate funds for his personal expenses. Id. at 60. Moreover, Delta had employees distinct from Sackett. On the other hand, “Maniscalco appears to have treated his corporations as mere extensions of himself, lending and borrowing money at will and with no corporate documentation.” Id.

Because all of the factors were satisfied or, in a couple of instances, were at least neutral, the first prong, whether the company was an alter ego of Maniscalco, was met with respect to Maniscalco’s liability. Id.

III. Horizontally Piercing the Veil from Delta to Sackett – Prong 1

In the “brother/sister” entity situation, Illinois courts will pierce the corporate veil to reach an affiliate corporation using the same two factor test where the plaintiff can make a substantial showing that there is (1) such unity of interest that one corporation is a dummy or sham for another and (2) that fraud or injustice would occur by maintaining the façade of distinct entities. Id. at 61. Here, the court found that Delta was a mere instrumentality for Sackett.

With respect to the first factor, as with Maniscalco’s liability, the court pointed to the management fee scheme as evidence of Sackett’s unity of interest with Delta. He also paid himself as an employee of Delta to provide management services to Sackett. Furthermore, the companies commingled funds when they shared a joint bank account and in connection with the improper series of transfers between Maniscalco, Sackett, and Delta for management consulting. The court found “[t]he record is replete with examples in which Delta was a mere instrumentality or dummy for Sacket” and “Maniscalco consistently treated both Delta and Sackett in such a manner that both companies were, in practice, Maniscalco’s alter egos.” Id. at 63, 65.

The court also mentioned Maniscalco was the president, shareholder, and director for both companies and that he had the sole decision making authority in both companies. However, Illinois courts have found that the existence of common officers and directors is insufficient to establish an alter ego, especially without more. Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec, 529 F.3d 371, 379 (7th Cir. 2008) (“While having common officers and directors is generally a prerequisite for piercing the corporate veil, this factor is insufficient to justify disregarding the corporate form because it is a “common business practice” that “exist[s] in most parent and subsidiary relationships.”) aff’d in the context of brother/sister entities in Gerk v. CL Med. SARL, No. 15-1145, 2015 WL 7777236, at *4 (C.D. Ill. Dec. 2, 2015) (“The only factual allegation Plaintiff has made is that SARL and CL Medical share common owners and directors” so that plaintiff failed to establish an alter ego under the holding in Judson). Even so, where common authority is not the sole factor, an alter ego may be properly found, as in the present case.

Once again, this time with respect to Sackett’s liability, the first prong was satisfied.

IV. Injustice or Fraud – Prong 2

The court discussed the fairness element jointly in relation to Maniscalco’s liability and Sackett’s liability and stated injustice would prevail if Maniscalco and Sackett were not held liable, when Maniscalco essentially closed Delta as a means to avoid payment to Steiner. Likewise, a finding to the contrary would sanction deception or fraud, as evidenced by the management fee scheme to reduce Sackett’s taxes. Since injustice or fraud would otherwise prevail, the second prong was met with respect to both defendants. As a result, the appellate court upheld piercing the entity veil to impose liability on Maniscalco and Sackett.

Id. at 61-62.

V. Postjudgment Attorney Fees

In a matter of first impression, the court determined that a provision in the credit agreement between Steiner and Delta, which provided liability for “all reasonable costs of collection including attorney fees and expenses,” was broad enough to encompass post-judgment attorney fees incurred in the subsequent veil-piercing claim. Id. at 62. The circuit court had denied enforcement expenses, stating that post-judgment attorney fees are not applicable where they are not specifically provided for in the underlying agreement. Id. at 63.

The appellate court found persuasive Seventh Circuit (Centerpoint Energy Services, Inc. v. Halim, 743 F.3d 503 (7th Cir.2014)) and Colorado decisions (Swinerton Builders v. Nassi, 272 P.3d 1174 (Colo.App.2012) that awarded attorney fees in ancillary veil piercing claims where attorney fees were contractually provided for in collection of the original judgment.

The Centerpoint court found a judgment creditor was able to recover attorney fees for costs incurred in bringing an action to enforce the original judgment, even when the contract provision does not explicitly award enforcement costs for a subsequent action to pierce the veil. Like Steiner, the owners of the debtor company transferred its assets to a new company owned by the owners to ensure the debtor company had no assets by the time of the judgment. The Steiner court echoed Centerpoint and found that the contract language providing for attorney fees in collection of the judgment against the corporation was broad enough to embrace expenses incurred in the veil
piercing action against the owners.

The Swinerton court similarly dealt with a contract that provided for award of attorney fees for the original judgment, but not for enforcement of the judgment in a subsequent veil-piercing action. Since piercing the veil is a procedural mechanism, the prevailing party in the piercing action may recover attorney fees and costs where the underlying contract provides for collections costs of the original judgment. The appellate court relied on these two cases and held:

Here, a fair reading of the contract as well as of Illinois, Federal, and sister state law leads us to determine that Maniscalco and Sackett should be held liable for the attorney fees incurred by judgment creditor Steiner, not only in obtaining a judgment against Delta, but also in seeking to collect that judgment and pursuing its veil-piercing claims in order to enforce the judgment. Id. at 68.

Although not raised by the parties, the court pointed out that the merger doctrine -- that, upon entry of a judgment, a plaintiff’s claims against a defendant are merged into the judgment -- is inapplicable since the rule should not apply to ancillary attorney fees as a matter of fairness. Id. at 54. If such claims merged into the judgment, then the plaintiff could not be made whole because the plaintiff would need to incur all of its attorneys’ fees in collecting the judgment. The concept of fairness and enforcing the parties’ agreement between each other that the wronged party should be made whole can only be effectuated if the plaintiff also recovers all its attorneys’ fees in pursuing collection.

VI. Conclusion

The Court’s analysis as to the unity of interest between Maniscalco and Sackett was detailed and extensive. On the other hand, the analysis with respect to treating Delta and Sackett as a unity was much more limited. Some of the evidence pointed more toward treating Maniscalco and Delta as a unity than it did toward treating Delta and Sackett. As the Court stated, “Maniscalco consistently treated both Delta and Sackett in such a manner that both companies were, in practice, Maniscalco’s alter egos.” Id. at 61.

The two strongest arguments to treat the two companies as one entity were the fact that the two corporations had a joint bank account and that funds were both deposited and withdrawn by both Delta and Sackett, and the questionable and circular transfer of funds pursuant to the “management agreement.” If two corporations do not have separate economic existences, there is little reason to treat them separately for liability purposes.

The Court indicated its concern about the management agreement and the series of circular payments several times in the opinion. Not even a medieval metaphysician could fantasize that, as an officer of Delta, Maniscalco could take off his Delta hat, put on his Sackett hat, and, on behalf of Sackett, bill Delta for his services rendered to Delta. This was not an allocation of Maniscalco’s compensation between Delta and Sacket, but rather an attempt to have his services, if any, that were provided to Delta charged to Sackett which, would give Sacket a cash free tax deduction because the chain started with Maniscalco transferring the same amount of cash to Sacket. Such a charade appropriately cost him the benefit of limited liability.