To: Conan Smith

From: Michael Stepniak

Date: 7-19-13

Subject: 501(c)(2) formation; liabilities of incorporators, et al.

**Overview**

Law regarding parent-subsidiary relationships can be a blurry thing; much of the outcome of a given tort lawsuit rests with the observance of formalities and the concept of “good faith.” There are however, a few hard-and-fast answers and legal avenues considering the situation of individual officers and incorporators.

**Initial Incorporators**

The initial incorporators have no liability; these individuals have no role in the corporation beyond executing the Articles of Incorporation, and as such have no legal significance. There is one possible concern, which will be discussed below, under **Piercing the Corporate Veil**.

**Initial and Permanent Directors**

As discussed, the Green Anchors Title Holding Corporation will have no paid employees/officers. As such, the Directorship will be volunteer-based. This allows the corporation to provide protection via the Articles of incorporation under the Michigan Nonprofit Corporation Act 162 of 1982, under 450.2209, Sec. 209(c) and/or (d) (which will be posted, with relevant cross-referenced articles and a brief memo to Jungledisk), which “eliminates personal liability of a volunteer director or volunteer officer, its shareholders, or its members for monetary damages for a breach of the director’s or officer’s fiduciary duty,” with certain exceptions. The relevant clause, if added to the Articles of Incorporation certainly protects the directors and officers to an extent; it may still be prudent to purchase indemnification insurance.

**Piercing the Corporate Veil**

In general, a subsidiary corporation is considered a separate legal entity. Certain issues do present themselves. The concept of “piercing the corporate veil” is a legal circumstance which may arise when a legal rule called the “Alter-Ego Doctrine.” When the rule is invoked, the subsidiary’s ostensible individual nature is disregarded and the parent corporation incurs liability.

The application of the Alter-Ego doctrine is considered a last resort; two requirements must be met, which will be discussed below:

1. Unity of Interest.

This is defined as:

such a unity of interest and ownership between the corporation and its shareholders that the individuality of the corporation has ceased.

This definition includes: commingling of the funds and assets of the corporations, failure to observe corporate formalities, inadequate capitalization, sole ownership of all shares, inequitable conduct, lack of arm’s length transactions and manipulation of corporate assets. These components will be discussed in order below.

Commingling of funds and assets

The concept of corporate separate-ness will soon become repetitive, but is an important one. The subsidiary must not, for example, withdraw money from the parent corporation’s bank account; it also must never use the parent corporation’s stationary. Down to the smallest detail, funds and assets separation is necessary.

Failure to Observe Corporate Formalities

Once again, this is about corporate separate-ness. Although meetings of the parent corporation and the subsidiary may be scheduled consecutively at the same location, they must indeed be separate, with separate minutes taken for both, stored in separate places. A separate corporate seal must be used by the subsidiary and conflicts of interest must be disclosed. Up to date corporate documents for the subsidiary must be maintained. In short, the formalities must be observed to show that the subsidiary is actually being operated as a separate entity: Everything Must Be Above Board.

Inadequate Capitalization

With regards to this issue, there are interesting synopses of two court cases (*Macaluso v. Jenkins* & *Ruppa v. American States Insurance Co.*) in “Piercing the Nonprofit Corporate Veil,” which will be on jungledisk in the 501(c)(2) folder under in the folder “reading materials.” Inadequate capitalization once again touches on the separate-ness of the subsidiary corporation; without adequate capital to operate, it is not independent. If not independent, the subsidiary will be treated as if it is a part of the parent corporation, and will incur liabilities.

The Wisconsin Supreme Court ruling in *Ruppa* is perhaps the more relevant to the Green Anchors Title Holding Corporation and its potential liabilities (*Macaluso* dealt with commingling of funds as well as undercapitalization; *Ruppa* brought forth a tort lawsuit.). Nonprofit corporations are often lacking in capitalization; their subsidiaries may have similar circumstances. Although this is one of the conditions that may cause a court to pierce the corporate veil, is not the only criterion. On a cautionary note: the more a nonprofit corporation resembles a for-profitcorporation in its activities, the more likely it is that undercapitalization of a subsidiary will be weighted against the parent corporation.

In *Ruppa* (and in *Macaluso*), the court dismissed claims of undercapitalization. The plaintiff in *Ruppa* had been injured during a horse show sponsored by a club, and sued. The fact that the club’s only asset was its bank account was cited as evidence of undercapitalization; this was not accepted by the court, which went so far as to ignore that the club’s insurance policy did not cover personal injury due to their accident free history.

Much of the law dealing with undercapitalization effects for-profit corporations more than nonprofits. That notwithstanding, the trend nationwide is that nonprofits are conducting business in a manner that resembles for-profit business practices, and are being treated as such by the courts more often. Adequately capitalizing a subsidiary is an essential protection for the parent corporation, and should be discussed with financial advisors.

Sole Ownership

There is nothing to be done; a 501(c)(3) parent corporation is the sole member of a 501(c)(2) subsidiary by law. Sole ownership is not enough to pierce the corporate veil. Much depends on maintaining the formality of corporate separate-ness, the concept of Bad Faith, and the promotion of fraud and injustice, which will be discussed in the next section.

Arm’s Length Transactions & Manipulation of Corporate Assets

Once again, this involves the formalities separate-ness. All of the corporate formalities stated above (letterheads, assets, funds, minutes & meetings, records, etc.) are reiterated. Other formalities to be observed with respect to personnel are worth considering.

To recapitulate: The parent must capitalize the subsidiary. Then the subsidiary must have a separate bank account, separate books and records, correspond with its own letterhead, and observe the strict formality of corporate separate-ness.

The parent appoints the board of directors, but the subsidiary’s board appoints the officers; the board and officers should differ from those of the parent. This must happen in a meeting separate from the parent corporation’s meetings, with separate minutes.

The parent and subsidiary should enter into an official Arm’s Length written agreement on all things pertaining to shared facilities, equipment, employees, etc. With regards to facilities, it is necessary to compute the subsidiary’s portion of office rent, utilities, supplies and equipment. A detailed Arm’s Length agreement is a good protection against piercing the corporate veil.

There should be no common board members between the parent and subsidiary. This is not a law or IRS rule. Rather, it is a prudent measure to avoid liability. Overlap is permitted, but not encouraged. Meetings of the parent corporation’s Board of Directors should limit themselves to the topic of policy when discussing the subsidiary and never management; the minutes will reflect this.

More serious exposure to liability results from shared officers. Officers are involved in the actual managing of the corporations, and if overlap exists, it would become easier for a plaintiff to pierce the corporate veil, arguing that no separation exists between parent and subsidiary.

Employees may be shared (or leased) from the parent corporation to the subsidiary. In the case of Green Anchors, there will be no employees, and the directors and officers are tentatively volunteers. If an Michigan Suburbs Alliance employees are officers of the Green Anchors Title Holding Corporation, and they conduct business, it is prudent that a separate record of their time spent volunteering for the subsidiary be kept, that their time sheet for the MSA not reflect said volunteer hours.

2. Fraud & Injustice

The second part of the “alter ego” rule reads as:

the observance of the entity would sanction a fraud or promote injustice.

Traditionally, this requirement, if met, is enough for a court to pierce the corporate veil. There are no clear guidelines, but much of what exists centers around circumstances in which the conduct of the corporation is inequitable wherein the corporation benefits and the plaintiff is harmed. Courts also consider if respecting corporate separate-ness would endorse fraud or obstruct a legitimate claim for justice.

The issues involved here can be as clear cut as “yes, here is a case of criminal fraud,” or as nebulous as the concepts of “bad faith” and “fairness.” What seems clear is that if the parent and subsidiary avoid all questionable conduct by obtaining the necessary insurance, and by minding the legal p’s and q’s as described, a title-holding corporation may operate for the purpose it exists for without creating a liability for the parent corporation.

**Conclusions**

There is no guarantee to create an absolute immunity for the parent corporation. There are many ways to build up what is referred to in corporate law literature as “a shield against liability.” By observing the recommendations of this memo, the Michigan Suburbs Alliance will become far less susceptible to the alter ego doctrine and the piercing of the corporate veil. A full reading list, a copy of the relevant passages with respect to the immunity of volunteer directors and officers, and (brief) memos on both will follow this and be posted to jungledisk.