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## Piercing the Corporate Veil of a New York Not-For-Profit Corporation

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# PIERCING THE CORPORATE VEIL OF A NEW YORK NOT-FOR-PROFIT CORPORATION

Matthew D. Caudill\*

*“For every human problem, there is a neat, simple solution; and it is always wrong.”<sup>1</sup>*

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1. Henry L. Mencken, *Mencken’s Metalaw*, at [http://www.olympicpc.com/quotes/menckens\\_metalaw.html](http://www.olympicpc.com/quotes/menckens_metalaw.html) (last visited Mar. 10, 2003).

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#### INTRODUCTION

The S.H. and Helen R. Scheuer Family Foundation (the “Foundation”), a New York not-for-profit corporation, organized largely from revenues under the estate of Helen R. Scheuer, engaged in philanthropic activities, generally donating funds to other charitable organizations.<sup>2</sup> In 1989 alone, the Foundation made charitable donations of \$9,000,000.<sup>3</sup> In that year, Steven H. Scheuer (“Scheuer”) on his own behalf, as well as on behalf of the Foundation, sued eight directors (the “Directors”), 61 Associates, and 61 Associates Corp. (collectively, “61 Associates”) for imprudent and negligent investment activity resulting in lost revenues to the Foundation.<sup>4</sup>

Scheuer served on the board of directors and was a member of the Foundation.<sup>5</sup> 61 Associates served as the investment advisor to the Foundation and the Directors purportedly controlled 61 Associates.<sup>6</sup>

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2. S.H. & Helen R. Scheuer Family Found, Inc. v. 61 Assocs., 582 N.Y.S.2d 662, 663–64 (App. Div. 1992).

3. *Id.*

4. *Id.* at 663. Scheuer served as one of the twelve directors and members of the Foundation from 1984 until 1989. *Id.* A short time after filing the lawsuit, Scheuer was removed Scheuer as a director. *Id.*

5. *Id.*

6. *Id.* at 668.

Scheuer's amended complaint alleged six causes of action against the Directors for engaging in various activities which resulted in the loss of substantial assets to the Foundation.<sup>7</sup> Scheuer sought recovery of the Foundation's lost assets (totaling \$5,650,442)<sup>8</sup> and removal of the Directors from the Foundation.<sup>9</sup> He also sought to permanently bar the Directors from exercising any power on behalf of the Foundation.<sup>10</sup> Finally, Scheuer petitioned the court for recovery of those assets which 61 Associates allegedly lost as a result of negligent investment decisions.<sup>11</sup>

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7. *Id.* at 664–65. The first cause of action alleged that the Directors “breached their duty of loyalty to the Foundation by engaging in an illegal cover-up scheme designed to forestall investigation of an improper relationship between the Foundation and 61 Associates.” *Id.* at 665. The second cause of action alleged that the Directors mismanaged the investments of the Foundation. *Id.* The third cause of action alleged that the Directors “negligently selected, supervised, and monitored 61 Associates as its delegee with the authority to invest, reinvest, and manage the funds of the Foundation.” *Id.* at 666. The fourth cause of action alleged that the Directors improperly charged the Foundation \$581,200 for office space. *Id.* at 664. The fifth cause of action alleged that the Directors caused the Foundation to loan a partnership certain funds, when two of the Directors were general partners of said partnership. *Id.* The sixth cause of action alleged that 61 Associates made negligent decisions in investing the funds of the Foundation. *Id.* at 666. Scheuer amended his complaint to consolidate the seventh, eighth and ninth causes of action into the first cause of action. *Id.* at 665.

8. See Plaintiffs' Amended Complaint at 9–10, 21, 23, *61 Assocs.*, 582 N.Y.S.2d at 662 [hereinafter Amended Complaint] (stating allegations of wrongdoing, rather than proven facts, since the dispute never proceeded to trial). The Amended Complaint estimated the following losses:

(i) \$802,317 in loans to 61 Associates on November 30, 1988; (ii) \$581,200 improperly charged to the Foundation for office space from 1985–88; (iii) aggregated losses of \$1,371,425 from the improper investment of Foundation funds in “undercapitalized, illiquid, thinly-traded securities of speculative quality, manifestly improper for investments by a foundation;” (iv) \$1,018,500 in improper commissions charged to the Foundation for an absurd number of trades in the portfolio of the Foundation in the 1987–88 period alone; and (v) \$1,877,000 for the loss of 30% of the value of the Foundation's shares of Southdown stock when the Directors refused to sell the shares at the recommendation of independent analysts.

Amended Complaint at 9–10, 21, 23.

9. *61 Assocs.*, 582 N.Y.S.2d at 662–63.

10. *Id.*

11. *Id.* at 666 (noting that Scheuer's third cause of action attempts to

Scheuer alleged that the Directors engaged in unethical business practices that resulted in substantial losses to the Foundation in an attempt to realize personal financial gain.<sup>12</sup> The Directors purportedly blocked Scheuer's attempts to investigate the services provided by 61 Associates.<sup>13</sup> Specifically, Scheuer alleged that the Directors attempted to bribe Scheuer, revoke Scheuer's donation designation power,<sup>14</sup> blackmail Scheuer,<sup>15</sup> and improperly "released each other from claims held by the Foundation against each of them as individuals."<sup>16</sup> In addition, the Directors also allegedly concealed independent consultant reports concerning those investments from which the Directors personally

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establish the Directors' liability for their alleged negligent investing).

12. *Id.* at 665.

13. *Id.*

14. *Id.* The Directors revoked Scheuer's power to designate donees of the Foundation in \$75,000 increments. *Id.* The Directors then offered to reinstate the power and raise the amount to \$400,000 if Scheuer agreed to vote to release claims by the Foundation against the Directors. *Id.*

15. *Id.* The Directors threatened to publicize "damaging allegations concerning [Scheuer] and his brother" and claimed that it was because of those allegations that the Directors withheld certain financial information. *Id.* On January 18, 1989, the Directors allegedly threatened that, if Scheuer, and his brother James, did not immediately cease investigations, the Directors would conspire to ruin James's congressional career by publicizing statements:

(i) that he had improperly made Foundation donations to groups and individuals in his congressional district in order to "buy" their support and votes;

(ii) that James had improperly participated in the management of valuable California real estate held for his benefit in a blind trust; and

(iii) that James had engaged in illegal conduct with the late Donald Manes, former Queens Borough President.

Plaintiffs' Memorandum in Law in Opposition to Defendants' Motion to Dismiss Amended Complaint at 14, *61 Assocs.*, 582 N.Y.S.2d at 662 [hereinafter Opposition Brief].

Representative James Scheuer (D-NY) represented District 8 in Manhattan and Brooklyn in the U.S. House of Representatives from 1965-1973 and 1975-1993. See <http://profiles.numbersusa.com/improfile.php3?DistSend=NY&VIPID=581> (last visited Feb. 28, 2003). The Directors allegedly threatened Scheuer with destroying his career by publicizing statements that he had improperly paid certain Foundation donations to an employee. See Opposition Brief at 14.

16. *61 Assocs.*, 582 N.Y.S.2d at 665. One element of the alleged indemnification compelled binding confidential arbitration of future claims. See Opposition Brief at 15-16.

benefited.<sup>17</sup>

One particularly troubling accusation involved the refusal to sell the Foundation's shares of Southdown, Inc. ("Southdown"), a publicly traded company, despite the reports of Goldman Sachs & Co. ("Goldman") stating that the shares were unlikely to increase in value.<sup>18</sup> Scheuer alleged that both the Directors and 61 Associates were improperly affiliated with Southdown,<sup>19</sup> concealed the recommendations of Goldman,<sup>20</sup> and caused the Foundation to sell the shares at a later date at a "substantially reduced amount."<sup>21</sup> Presumptively, the Foundation "held the bag" while other equity holders sold their shares for around \$50/share, causing the Southdown shares to decrease in value. Sometime afterwards, the Foundation sold its shares, and lost nearly \$2 million in the interim. The Directors also allegedly blocked efforts to investigate the trading activity of 61 Associates during this period.<sup>22</sup>

The New York Supreme Court dismissed the claims against the Directors as protected transactions, governed by the business judgment rule, which precludes a court from inquiring into corporate decision-making, so long as the decisions made were honest and disinterested.<sup>23</sup> On appeal, Scheuer argued that the alleged transactions involved self-dealing and were thereby exceptions to the business judgment rule.<sup>24</sup> The Appellate Division

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17. *61 Assocs.*, 582 N.Y.S.2d at 665-66.

18. *Id.* at 665.

19. *Id.* ("[R]epresentatives of 61 Associates served as principal officers [of Southdown] and a large percentage of which was owned by separate Scheuer family interests also represented by 61 Associates . . .").

20. *Id.*

21. *Id.* According to the Amended Complaint, by June 5, 1980, the Foundation owned 28% of the outstanding shares of Southdown. *See* Amended Complaint at 22-23. For six years thereafter, the Foundation was the controlling shareholder of Southdown. *Id.* In February 1987, Goldman advised the Directors to sell the shares of Southdown for \$50/share. *Id.* Instead, the Directors concealed the Goldman report, waited and sold the shares at a later date for \$34.89/share. *Id.*

22. *Id.* at 665. Interestingly, the accounting reports submitted to the board over a three-year period were the product of an accounting company controlled by one of the Directors. *Id.*

23. *Id.* at 664; *see also infra* notes 60-63 and accompanying text.

24. *61 Assocs.*, 582 N.Y.S.2d at 664.

agreed with Scheuer and reinstated the claims against the Directors and 61 Associates.<sup>25</sup>

While the remaining events in this dispute are not a matter of public record<sup>26</sup> even if Scheuer prevails on each of the causes of action and recovers the maximum damage award, that award would not adequately compensate for the purported wrongdoing. The alleged causes of action<sup>27</sup> would entitle the Foundation to an accounting by the Directors only for the assets of *the Foundation* that the Directors mismanaged and that 61 Associates negligently invested.<sup>28</sup> Furthermore, under the removal remedy,<sup>29</sup> the Directors could be permanently barred from exercising power on behalf of the Foundation.<sup>30</sup> While these determinations could restore the Foundation to its prior standing in a strict financial sense<sup>31</sup> and protect the Foundation from future wrongdoing by the Directors, these remedies fail: (i) to hold the Directors and 61 Associates responsible for the abuse of the Foundation entity;<sup>32</sup> (ii) to compensate the beneficiaries of the Foundation for lost services and donations;<sup>33</sup> and (iii) to deter future wrongdoing.<sup>34</sup>

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25. *Id.*

26. There are no further entries listed in the on-line databases of Westlaw or Lexis.

27. *61 Assocs.*, 582 N.Y.S.2d at 664–66 (describing the six causes of action alleged).

28. *See* N.Y. NOT-FOR-PROFIT CORP. LAW §§ 720 (a)(1)(A)–(B) (McKinney 2001); *see also* Amended Complaint at 9–10, 21, 23 and *supra* note 8 (detailing the alleged losses totaling \$5,650,442).

29. *See infra* notes 39–42 and accompanying text (describing removal action of an officer or director of a non-profit corporation as authorized by New York law).

30. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 706(d).

31. The Foundation could reclaim the position it had prior to the financial mismanagement, but still lose years of potentially successful operations and, ultimately, potential revenue.

32. *See* N.Y. NOT-FOR-PROFIT CORP. LAW §§ 720 (a)(1)(A)–(B); *see also* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 568 (1981) (arguing that the current mechanism for enforcing the fiduciary obligations of nonprofit directors and officers is insufficient); *infra* notes 115–22 and accompanying text.

33. *See* Michele Cotton, *Back with a Vengeance: The Resilience of Retribution As an Articulated Purpose of Criminal Punishment*, 37 AM. CRIM. L. REV. 1313, 1316 (2000) (stating that no punishment justification theories are concerned with

The equitable remedy of piercing the corporate veil empowers an aggrieved plaintiff to disregard the separateness provided by a limited liability entity and hold responsible individual members of that entity for its acts or obligations.<sup>35</sup> Under New York law,<sup>36</sup> piercing is a common law remedy available to plaintiffs pursuing a business corporation (“BC”),<sup>37</sup> but not for plaintiffs pursuing a not-for-profit corporation<sup>38</sup> under similar circumstances. This Article will analyze the purposes behind this distinction, including the development of piercing, the policies underlying BCs and not-for-profit corporations, and the possible application of piercing to a not-for-profit corporation.

Part I will review the causes of action currently available under New York not-for-profit law. Part II will provide an overview of piercing, including the underlying rationale, theories, corollary doctrines, and the piercing approach in New York. Part III will examine the not-for-profit corporation and the distinctions between it and the BC. Part IV will outline other jurisdictions that allow piercing to apply to a not-for-profit entity, consider the appropriateness of such a remedy under New York Law, and conclude that allowing the plaintiff to pierce the corporate veil of a not-for-profit corporation would complement the current statutory framework. The Conclusion will then return to the Foundation, discuss the proposed piercing elements under New York law and demonstrate the need and usefulness of this remedy in the context of not-for-profit corporations.

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reimbursement); *see also* Hansmann, *supra* note 32, at 505.

34. *See infra* text accompanying notes 241–45.

35. N.Y. BUS. CORP. LAW §§ 109(b)(5), 720 (McKinney 2001).

36. A not-for-profit entity is subject to the laws of the state of New York if it is a domestic corporation or a foreign corporation that is authorized or conducts activities in New York. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 103.

37. A BC is subject to the New York Business Corporation Law. *See* N.Y. BUS. CORP. LAW §§ 101–1603.

38. For purposes of this Article, the considerations involving not-for-profit (or non-profit) entities shall be limited to those entities organized as corporations. Therefore, those entities organized as trusts shall be outside the scope of this Article.



I. CAUSES OF ACTION AVAILABLE UNDER NEW YORK NOT-FOR-PROFIT LAW

New York enacted the Not-for-Profit Corporation Law (“N-PCL”) in 1970, the first of its kind in the United States.<sup>39</sup> The N-PCL sets forth the duties, liabilities, and remedies applicable to the not-for-profit corporation board of directors, officers, and members.<sup>40</sup>

A. Action for Removal or Suspension of Officer or Director

The Attorney General (“AG”), or ten percent of the members of a not-for-profit corporation may bring an action to remove a director.<sup>41</sup> In a similar matter, the N-PCL provides:

An action to procure a judgment removing *an officer* for cause may be brought by the [AG], by any director, by ten percent of the members, whether or not entitled to vote, or by the holders of ten percent of the face value of the outstanding capital certificates, subvention certificates or bonds having voting rights.<sup>42</sup>

In the removal action of either a director or officer, the court has discretion to fix the time of the removal period.<sup>43</sup>

B. Misconduct Action Against Officer or Director

The AG, an officer or director of the not-for-profit corporation, the not-for-profit corporation itself, a member thereof

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39. See generally N.Y. NOT-FOR-PROFIT CORP. LAW §§ 101–1411; WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 12-1(c) (6th ed. 1998).

40. N.Y. NOT-FOR-PROFIT CORP. LAW §§ 101–1411.

41. See *id.* § 706(d). Ten percent of the members may bring the action, whether or not the not-for-profit corporation entitles its members to vote for the board of directors. See *id.*

42. *Id.* § 714(c) (emphasis added).

43. See *id.* §§ 706(d), 714(c). In either circumstance, the N-PCL also provides for the removal of an officer or director by the board of directors with or without cause. *Id.* §§ 706, 714.

in a derivative action,<sup>44</sup> a receiver, trustee in bankruptcy, or a judgment creditor thereof may bring an action of misconduct against an officer or director.<sup>45</sup> An officer or director of a not-for-profit corporation may be held liable for breaching his or her fiduciary duties of care, loyalty, and obedience.<sup>46</sup>

The duty of care requires officers and directors to use reasonable care in performing their duties, as described in section 717(a) of the N-PCL: “[d]irectors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.”<sup>47</sup> The N-PCL allows officers and directors to rely upon certain experts in performing their duties in good faith.<sup>48</sup>

Under the duty of loyalty, officers and directors must pursue the interests and mission of the not-for-profit corporation with undivided allegiance, placing the interests of the entity above any

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44. See *id.* § 623(a) (stating that 5% of a corporation’s members, holders of capital certificates or owners of a beneficial interest may bring an action against an officer).

45. See *id.* § 720(b). In addition, “[i]f the certificate of incorporation or the by-laws [of the not-for-profit corporation] so provide . . . any holder of a subvention certificate or any other contributor to the [not-for-profit corporation] of cash or property of the value of \$1,000 or more” may also procure such an action. *Id.* § 720(b)(4). In the event of a not-for-profit corporation with no members, a director may bring an action against third parties to obtain a judgment in favor of the not-for-profit corporation. See *id.* § 720(c). In such circumstances:

The complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reason for not making such efforts. The court in its discretion shall determine whether it is in the interest of the corporation that the action be maintained, and if the action is successful in whole or in part, what reimbursement if any should be made out of the corporate treasury to the plaintiff for his reasonable expenses including attorney’s fees, incurred in the prosecution of the action.

*Id.*

46. See generally *id.* §§ 717, 720.

47. *Id.* § 717(a).

48. *Id.* § 717(b) (stating that as long as the reliance is in good faith, an officer or director may rely on either another corporate employee whom he or she believes to be competent and reliable in such matters, an outsider whom the officer or director believes to be an expert in such matters, or a committee of the board on which such officer or director does not serve).

private interests.<sup>49</sup> The N-PCL provides that officers and directors: (i) must act in good faith;<sup>50</sup> (ii) must not receive loans from the entity;<sup>51</sup> and (iii) must not engage in self-dealing transactions.<sup>52</sup> Pursuing the interest of a third person above that of the not-for-profit corporation also violates this duty.<sup>53</sup>

Under the common law duty of obedience, officers and directors must adhere to the purposes of the not-for-profit corporation and pursue its mission.<sup>54</sup> While the N-PCL does not explicitly refer to this duty,<sup>55</sup> certain N-PCL provisions allude to it.<sup>56</sup> The N-PCL limits the activities of a not-for-profit corporation to those set forth in the purpose clause of the certificate of incorporation.<sup>57</sup> The N-PCL also provides that officers and directors serve as the corporate managers of the not-for-profit corporation and carry forth its purpose.<sup>58</sup> As a corollary to this

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49. *See* S.H. & Helen R. Scheuer Family Found, Inc. v. 61 Assocs., 582 N.Y.S.2d 662, 665 (App. Div. 1992) (“[I]t is well established that, as fiduciaries, board members bear a duty of loyalty to the corporation and ‘may not profit improperly at the expense of their corporation.’”) (citing *Turner v. Am. Metal Co.*, 50 N.Y.S.2d 800, 831 (1944), *appeal dismissed* 295 N.Y. 822 (1946)).

50. N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a).

51. *Id.* § 716 (stating that other than the purchase of bonds, debentures or similar obligations customarily sold in public offerings, no loans should be made by a not-for-profit corporation to its directors, officers, or any entity in which one of its officers or members has a substantial financial interest).

52. *Id.* §§ 406(a)(2), 715. Section 406 of the N-PCL provides that a not-for-profit corporation “shall not engage in any act or self-dealing which is subject to tax under section 4941 [of the U.S. Internal Revenue Code].” *Id.* § 406. Section 406 applies to those not-for-profit corporations classified as “private foundations” under section 509 of the U.S. Internal Revenue Code. *Id.*

53. *Collins v. Beinecke*, 67 N.Y.2d 479, 483 (1986).

54. *See generally* *Alco Gravure, Inc. v. The Knapp Found.*, 479 N.E.2d 752 (N.Y. 1985) (stating that the board has a duty to apply funds within the framework of the N-PCL).

55. Office of the New York State Attorney General Eliot Spitzer, *The Regulatory Role of the Attorney General’s Charity Bureau*, at <http://www.oag.state.ny.us/charities/role.html> (last visited Feb. 9, 2003).

56. N.Y. NOT-FOR-PROFIT CORP. LAW §§ 201, 202. Section 201 sets forth the types and purposes of not-for-profit corporations. Section 202 provides that not-for-profit corporations “shall have power in furtherance of its corporate purposes” and sets forth such default powers. *Id.* § 202(a).

57. *Id.*

58. *Id.* §§ 701, 713. Section 701 provides that a not-for-profit corporation

duty, officers and directors must also ensure the entity conducts its activities in a lawful manner.<sup>59</sup>

Although the N-PCL does not expressly refer to the business judgment rule, courts nonetheless apply the business judgment rule to the decisions of not-for-profit corporation officers and directors.<sup>60</sup> The business judgment rule forecloses a court from inquiring into the decisions of corporate actors, so long as such actions were disinterested and honest.<sup>61</sup> The purpose of this rule is to allow officers and directors to take legitimate business risks without subjecting their decision-making to judicial scrutiny.<sup>62</sup> Thus, when an officer or director “fail[s] to possess the independence and disinterested status which is a prerequisite to insulation from liability by virtue of the business judgment rule,” such protection is unavailable.<sup>63</sup>

The N-PCL provides that an aggrieved plaintiff may pursue the remedies of accounting, rescission, and an injunction in a

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“shall be managed by its board of directors.” *Id.* § 701(a). Furthermore:

If the certificate of incorporation vests the management of the [not-for-profit corporation], in whole or in part, in one or more persons other than the board, individually or collectively, such other person or persons shall be subject to the same obligations and the same liabilities for managerial acts or omissions as are imposed upon directors . . . .

*Id.* § 701(b). Section 713 governs the authority of officers, stating:

All officers as between themselves and the corporation shall have such authority and perform such duties in the management of the [not-for-profit corporation] as may be provided in the by-laws or, to the extent not so provided, by the board. The board may require any officer to give security for the faithful performance of his duties.

*Id.* § 713(e).

59. See, e.g., *Carter v. United States*, 717 F. Supp. 188, 194–95 (S.D.N.Y. 1989) (holding officers and directors of not-for-profit corporation liable for unpaid withholding taxes as responsible persons involved in day-to-day business operations).

60. See *S.H. & Helen R. Scheuer Family Found, Inc. v. 61 Assocs.*, 582 N.Y.S.2d 662, 664 (App. Div. 1992) (“[T]he rule will govern only where such decision making, although perhaps misguided, has been honest and disinterested and the doctrine will not be enforced when the good faith or oppressive conduct of the officers and directors is in issue.”).

61. See *61 Assocs.*, 582 N.Y.S.2d at 669; see also *Koral v. Savory, Inc.*, 276 N.Y. 215, 220 (1937).

62. See *61 Assocs.*, 582 N.Y.S.2d at 669.

63. *Id.* at 663.

misconduct action against an officer or director.<sup>64</sup> A plaintiff may compel an accounting if an officer or director neglected, failed to perform, or otherwise violated his or her “duties in the management . . . of [the not-for-profit corporation] assets,” or if such person acquired, transferred, lost, or wasted entity assets due to a derogation of duty.<sup>65</sup> If the plaintiff demonstrates the officer or director *knew of the unlawfulness* of a conveyance, assignment, or transfer of corporate assets, a court may set aside that unlawful act.<sup>66</sup> Finally, a court may also enjoin a prospective conveyance, assignment, or transfer of not-for-profit corporation assets if there are reasonable grounds that an unlawful transfer will be made.<sup>67</sup>

In certain circumstances, the N-PCL provides immunity for officers and directors. An unpaid officer or director of a not-for-profit corporation that qualifies as a 501(c)(3) organization under the U.S. Internal Revenue Code may raise an immunity defense.<sup>68</sup> The purpose of this qualified immunity is to reduce the burden of expensive liability insurance by shielding persons serving qualifying not-for-profit corporations without compensation.<sup>69</sup> Such officers or directors must raise this defense before the service of answers.<sup>70</sup> Nonetheless, this immunity is not available if the officer or director acts in a manner that is grossly negligent or intended to cause the harm to the complaining party.<sup>71</sup>

### C. Criminal Penalties

In cases involving particularly egregious conduct or specific

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64. See *supra* notes 44–45 and accompanying text.

65. N.Y. NOT-FOR-PROFIT CORP. LAW §§ 720 (a)(1)(A)–(B) (McKinney 2001).

66. See *id.* § 720(a)(2).

67. See *id.* § 720(a)(3).

68. See *id.* § 720(a); see also I.R.C. § 501(c)(3) (2002) (defining 501(c)(3) corporations as organizations operated solely for, among other specified aims, religious and charitable purposes).

69. See N.Y. NOT-FOR-PROFIT CORP. LAW § 720(a).

70. See *Woodford v. Benedict Cmty. Health Ctr.*, 575 N.Y.S.2d 415, 416 (App. Div. 1991) (holding that defendants cannot claim immunity from liability under Internal Revenue Code section 501 unless they raised it prior to their answers).

71. See N.Y. NOT-FOR-PROFIT CORP. LAW § 720(a).

statutory violations, law enforcement agencies may bring criminal actions against officers or directors of not-for-profit corporations.<sup>72</sup> For example, on February 6, 2002, AG Eliot Spitzer announced the indictments of Lorraine Hale and her husband, Jesse DeVore, for stealing over \$700,000 from the Hale House Foundation.<sup>73</sup> The seventy-count indictment included charges of grand larceny, forgery, criminal possession of stolen property, and criminal possession of a forged instrument.<sup>74</sup> Spitzer also obtained a court order freezing the assets of Hale and DeVore.<sup>75</sup> The indictment alleges:

Money raised under the well-respected Hale House name to fulfill its mission of caring for children born addicted to illegal drugs and/or afflicted with AIDS was instead used to pay Hale's property taxes, to install a Jacuzzi in her home, to pay her brother's legal expenses and to fund her husband's theatrical production.<sup>76</sup>

Spitzer also commenced a civil forfeiture action to recover \$1 million alleged to have been stolen.<sup>77</sup> Spitzer settled with Hale and DeVore for \$766,000 and five years probation.<sup>78</sup>

Certain regulatory schemes also penalize officers and directors for the unlawful acts of the not-for-profit corporation.<sup>79</sup> For

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72. See *infra* note 73 and accompanying text.

73. See Press Release, Office of New York State Attorney General Eliot Spitzer, Lorraine Hale and Husband Indicted for Stealing Hale House Funds (Feb. 6, 2002) (on file with author) [hereinafter Hale Press Release]; see also Heidi Evans & Dave Saltonstall, *Indictments in Hale Scandal Ex-Chief, Hubby Charged with Theft, Forgery*, N.Y. DAILY NEWS, Feb. 6, 2002, at 2 [hereinafter Hale Article].

74. See Hale Press Release, *supra* note 73.

75. See Hale Article *supra* note 73.

76. See Hale Press Release, *supra* note 73.

77. See *id.*

78. *Shelter Founder's Daughter Sentenced*, CHI. TRIB., Oct. 25, 2002, at 14. The couple faced up to fifteen years in prison if convicted on all charges. See Darch Gregorian, *No Jail for Hale in Charity Rip-Off*, N.Y. POST Oct. 25, 2002, at 21 (“[T]he husband and wife have returned about \$125,000 to Hale House so far, which is their life savings, and are trying to come up with the rest of the cash.”).

79. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1036–37 (1991).

example, in *People v. Pymm*, the New York Court of Appeals affirmed the convictions of officers of a corporation for criminal activity related to the mercury contamination of the workplace.<sup>80</sup> Officers and directors of not-for-profit corporations, as well as BCs, are also vulnerable to criminal and other penalties with regard to employment,<sup>81</sup> environmental,<sup>82</sup> antitrust,<sup>83</sup> and intellectual property<sup>84</sup> laws and regulations.

## II. PIERCING THE CORPORATE VEIL

Among the most litigated and least understood issues in corporate law, piercing is an equitable remedy developed by courts to hold individuals responsible for acts commissioned by a corporation.<sup>85</sup> Justice Cardozo, writing for the New York Court of Appeals in 1927, lamented that piercing is “enveloped in the mists of metaphor. Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.”<sup>86</sup> Commentators have since echoed this sentiment, as phrases such as “Alter Ego” and “Instrumentality” developed to describe piercing tests.<sup>87</sup> All too frequently, however, these “tests” prove to

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80. *People v. Pymm*, 76 N.Y.2d 511, 525 (1991). Although the court upheld the convictions of the officers of for-profit entities, it does not appear that the result would have been different if the entity were not-for-profit. *Id.* The Occupational Safety and Health Act was enacted “to assure so far as possible that every working man and woman in the Nation [have access to] safe and healthful working conditions.” *Id.* at 517 (citation omitted) (emphasis added). Violations of this act leading to criminal penalties typically involve the serious injury or death of an employee. *Id.*

81. See N.Y. LABOR LAW §§ 198(a), 198(c) (McKinney 2001).

82. See generally Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. § 9613(b) (1994).

83. See *NCAA v. Bd. of Regents of Univ. of Okla.*, 468 U.S. 85, 101 n.22 (1984) (“There is no doubt that the sweeping language of Section 1 [of the Sherman Act] applies to nonprofit entities.”) (emphasis added).

84. See *Symbol Techs., Inc. v. Metrological Instruments, Inc.*, 771 F. Supp. 1390, 1402 (D.N.J. 1991) (holding corporate officers liable for their torts even while acting officially).

85. See Thompson, *supra* note 79, at 1036–37 (1991).

86. See Thompson, *supra* note 79, at 1036 (citing *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926)).

87. Professor Blumberg described the litany of piercing cases as

be result-oriented and offer little in the form of constructive analysis.<sup>88</sup>

### A. Rationale

A corporation exists independent of its owners as a separate legal entity.<sup>89</sup> A corporation's distinct legal existence insulates its shareholders from liability: shareholders of a corporation are liable only for the amount of their investments and not for the debts of the corporation itself.<sup>90</sup> Courts will only pierce in the unusual circumstance, to prevent fraud, achieve equity or avert the violation of a statute or public policy.<sup>91</sup> Under the piercing doctrine, courts may hold liable corporate actors who misuse the corporate form in such a manner as to accomplish their own personal affairs rather than that of the business of the corporation.<sup>92</sup>

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"irreconcilable and not entirely comprehensible." *Id.* at 1037 (citing PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* 8 (1983)). Professor Landers characterized the case law as "def[y]ing] any attempt at rational explanation." *Id.* (citing Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary & Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 620 (1975)). Finally, Judge Easterbrook remarked that piercing decisions occur "freakishly." *Id.* (citing Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability & the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985)). With such welcoming introductions to the field from some of the most respected figures therein, this Article will attempt, nonetheless, to rationally explain such a freakish, irreconcilable and overly metaphoric doctrine.

88. See Thompson, *supra* note 79, at 1036-38.

89. See Mark S. Cohen, *Grounds for Disregarding the Corporate Entity and Piercing the Corporate Veil*, in 45 AMERICAN JURISPRUDENCE PROOF OF FACTS 3d § 1 (1998).

90. *Id.* § 2.

91. See JOHN BLYTH ET AL., 14 NEW YORK JURISPRUDENCE 2D BUSINESS RELATIONSHIPS § 37 (2nd ed. 1996). It should be noted that a plaintiff typically has several alternative grounds for imposing substantive liability upon individuals or corporations in the piercing context, including civil conspiracy, estoppel, fraud, agency, the trust fund doctrine, fraudulent transfer, the denuding theory, breach of fiduciary duty and unjust enrichment. See Cohen, *supra* note 89, § 1. This Article will address only the piercing remedy.

92. See, e.g., *Semigran Enters. v. Noren*, 730 N.Y.S.2d 586 (App. Div. 2001)



Piercing most frequently occurs in the context of a close corporation, due to the usually small number of shareholders.<sup>93</sup> Courts rarely pierce the corporate veil against a large corporation and, even then, generally do so only to reach the parent corporation of a defendant subsidiary.<sup>94</sup>

### B. Tests

Courts have developed many tests<sup>95</sup> to determine piercing liability, primarily focusing upon the relationship between the controlling person(s) of the corporation and the corporation itself.<sup>96</sup>

#### 1. Alter Ego

Under the Alter Ego test, the separate existence of the corporation shall be disregarded if: (i) the corporation is so influenced by the controlling person(s) that there is such unity of both ownership and interest that the separateness of the corporation has ceased and (ii) adherence to the separate corporate existence would perpetuate a fraud or promote

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(relieving defendant Lawrence B. Semigran from individual liability since the claim against him contained no particularized allegations regarding his use of Semigran Enterprises as his corporate alter ego and, therefore, failed to set forth a basis on which Semigran could be held individually liable).

93. Thompson, *supra* note 79, at 1038–39.

94. *Id.* (noting “[piercing] is contextual. Most significantly, piercing occurs only in close corporations or within corporate groups; it does not occur in public corporations.”).

95. Commentators and courts alike utilize the terms “tests” and “theories” interchangeably to refer to the factors or considerations employed in determining whether to pierce. *See, e.g.*, Cohen, *supra* note 89, § 6(B) (“Most jurisdictions employ a number of *theories or multi-pronged tests* in analyzing piercing situations and have articulated specific factors in determining whether a particular prong has been satisfied.”) (emphasis added). Professor Cohen then lists the major “tests” employed by various jurisdictions, illustrating “[t]he decision to present . . . these *theories is somewhat arbitrary because the line between what is a theory and what is merely a factor is somewhat nebulous.*” *Id.* (emphasis added). Nonetheless, for the purposes of clarity, this Article will refer to the alternate methods of piercing as tests rather than theories.

96. Thompson, *supra* note 79, at 1071.

injustice.<sup>97</sup> The rationale of the Alter Ego test is: “if the shareholders themselves disregard the separation of the corporate enterprise, the law will also disregard it so far as necessary to protect individual and corporate creditors.”<sup>98</sup>

## 2. Instrumentality

Under the Instrumentality test, the distinct corporate existence of a subsidiary in relation to its parent entity shall be disregarded if: (i) complete domination existed in respect to the attacked transaction so that the distinct corporate entity had no separate mind, will, or existence of its own [*instrumentality element*]; (ii) defendant used such that domination to commit fraud or wrong [*improper purpose element*]; and (iii) such domination and breach of duty must proximately cause the loss or unjust injury [*proximate*

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97. Cohen, *supra* note 89, § 7; *see also* Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986) (indicating alter ego liability “is shown from the total dealings of the corporation and the individual, including [i] the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, [ii] the amount of financial interest, ownership and control the individual maintains over the corporation, and [iii] whether the corporation has been used for personal purposes.”). The particularly liberal piercing application of the Texas Supreme Court in *Castleberry* spurred the Texas Legislature to enact limitations to a shareholder’s liability for fraud due to a corporation’s contractual obligations “unless the obligee demonstrates that the [shareholder] caused the corporation to be used [for] actual fraud . . . primarily for the direct personal benefit of the [shareholder].” Thompson, *supra* note 79, at 1042 (citing TEX. BUS. CORP. ACT ANN. art. 2.21A(2) (Vernon 1991)). Nonetheless, courts commonly consider such factors in the Alter Ego test. *See, e.g.*, Cohen, *supra* note 89, § 7. Federal common law follows an alternative Alter Ego test, the unity-of-interest test. *See* White v. Midwest Office Tech., 5 F. Supp. 2d 936, 956–57 (D. Kan. 1998) (ruling in favor of defendant as plaintiff failed to show that the personalities and assets of the corporation and shareholder were sufficiently blurred or that the defendant misused the corporate form in order to perpetrate fraud, evade existing allegations, or circumvent the law). The unity-of-interest test provides that the corporate fiction should be ignored if: (i) there was such a unity of interest given to the separate identity of the corporation by its shareholders that the assets and personality of the corporation and such individuals are indistinct and (ii) adherence to such corporate fiction would promote fraud, injustice or lead to an evasion of legal obligations. *Id.*

98. *Castleberry*, 721 S.W.2d at 272 (quoting BALLANTINE, CORPORATIONS 294 (1946)).

*cause element*].<sup>99</sup> Since the dominant corporation misused the subservient corporation as a corporate fiction for its own purposes, the rationale of the Instrumentality test is to hold the dominant corporation responsible for such conduct.<sup>100</sup>

### 3. Equity

Courts dissatisfied with both the Alter Ego and Instrumentality tests have fashioned their own equitable tests that focus upon the distinct factors in a given case.<sup>101</sup> Courts consider several factors,<sup>102</sup> including: (i) undercapitalization; (ii) failure to observe the formalities of corporate existence; (iii) nonpayment or overpayment of dividends; (iv) siphoning off of funds by the dominant shareholder; and (v) guarantee of corporate liabilities by a majority of shareholders.<sup>103</sup>

### 4. Public Policy

Some courts will pierce when the defendant utilized the corporate form to violate a statute, perpetuate a fraud, or violate other public policy.<sup>104</sup> The improper conduct may involve discharging unwanted obligations by creating new business entities with the same controlling persons while hindering the ability of the previous entity to pay off its debts.<sup>105</sup> Another likely application of this test involves attempts to avoid compliance with environmental, employment, and antitrust regulations.<sup>106</sup> Typically, a company facing liability for violation of a regulatory statute attempts to avoid it by liquidating and the regulatory entity will pursue the

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99. Cohen, *supra* note 89, § 8.

100. *Id.*

101. *See id.* § 9.

102. Although proponents of this Equity test disfavor the Alter Ego theory, the factors considered under both tests are very similar. *Cf.* sources cited *supra* note 97 and accompanying text.

103. *Cf. supra* note 97.

104. *See* Cohen, *supra* note 89, §§ 9–10.

105. *Id.*

106. *Id.*

controlling individual(s).<sup>107</sup>

Although these four alternative piercing tests are phrased differently and have different elements, each test focuses upon essentially similar conduct to achieve an equitable result.<sup>108</sup> The tests also assume, thus far, that the liability flows from the corporation to the controlling person(s) (or entities).<sup>109</sup> However, under other circumstances equity may require that liability flow in the opposite direction.<sup>110</sup>

### C. Inter-Affiliate Liability

Suppose an individual shields his assets in a corporation to avoid personal liability.<sup>111</sup> The piercing remedy empowers an aggrieved plaintiff to hold the individual responsible for the obligations of the corporation; notwithstanding, here, the creditor needs to reach the assets of the corporation to satisfy the debts of an individual and the piercing remedial claim is insufficient to reach the assets shielded by the corporation.<sup>112</sup> Reverse piercing and triangular piercing allow the creditor to reach those assets of the corporation or even other affiliated corporations.<sup>113</sup>

#### 1. Reverse Piercing

Reverse piercing occurs when a court holds a controlled corporation, which has been misused as the alter ego or instrumentality of a shareholder, liable for the debts of that controlling shareholder.<sup>114</sup> In *C.F. Trust, Inc. v. First Flight Ltd. Partnership*, the U.S. District Court for the Eastern District of

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107. *Id.* § 9.

108. *Id.* §§ 7–11.

109. *Id.*

110. *Id.* § 6 (allowing plaintiff to reverse pierce in order to reach assets that individuals have sheltered in a corporation).

111. *See C.F. Trust, Inc. v. First Flight LP*, 111 F. Supp. 2d 734, 742 (E.D. Va. 2000).

112. *Id.* at 740.

113. *Id.*

114. Gary J. Mennitt, *Reverse & Triangular Piercing of the Corporate Veil*, 223 N.Y. L.J. 53 (2000) (discussing applications of reverse piercing).

Virginia considered the applicability of the reverse piercing remedy.<sup>115</sup> There, the plaintiff sought to enforce a debt against the limited partnership<sup>116</sup> of an individual defendant and his general partners<sup>117</sup> and argued that both the limited partnership and its general partners were alter egos of the defendant.<sup>118</sup> Citing the acceptance of reverse piercing cases throughout the country, Judge Ellis observed, “the rationale for traditional piercing operates with equal force in support of reverse piercing.”<sup>119</sup> The court thereby allowed plaintiff’s piercing claim to proceed.<sup>120</sup>

Allowing the piercing to reach from the corporation to the controlling person, but not from the controlling person to the corporation<sup>121</sup> would hinder commercial activity.<sup>122</sup> If reverse piercing claims are not recognized, “an individual could abuse the

115. *C.F. Trust*, 111 F. Supp. 2d at 734.

116. *See id.* at 740 n.11 (noting that although piercing “typically focuses on the corporate form, it is settled that the doctrine also applies to limited partnerships.”).

117. *See id.* at 744 (refusing to apply the alter ego analysis to other individuals and stating, “it is clear that an individual cannot be the alter ego of another individual.”). *But see In re Bohrer*, 145 F.3d 1323, 1998 WL 228198 at \*4 (4th Cir. 1998) (holding that an individual was an alter ego of another individual).

118. *C.F. Trust*, 111 F. Supp. 2d at 734. U.S. District Court Judge Ellis stated: This case is by no means the first suit by the plaintiffs claiming [the defendant] has taken steps to evade the payment [of his debts] and to defraud his creditors. To the contrary, this case is *merely the latest chapter in an ongoing saga*. So voluminous is the litigation involving these parties that only a summary is presented in the margins.

*Id.* (emphasis added) (citations to eleven reported cases omitted).

119. *Id.* at 741.

120. *Id.* at 744.

121. *Id.* at 740. Judge Ellis described two types of reverse piercing claims. Outsider reverse piercing actions involve an attempt by an outside creditor to reach the assets of a corporation to satisfy the debts of a corporate insider. *Id.* Insider reverse piercing claims are an attempt by a dominant shareholder to disregard the corporate fiction so as to permit such insider to raise corporate claims against a third party. *Id.* at 740 n.12.

122. *See id.* at 741. The court maintained:

When [the corporate] form is abused, courts, in appropriate circumstances, may disregard the fiction. And, in these circumstances, this should be so, on principle, whether the fiction is misused to shield the owner’s assets from claims against the corporation [piercing] or to shield the corporation’s assets from claims against the owner [reverse piercing].

*Id.*

corporate or limited partnership forms with impunity so as to evade personal obligations and to hinder the collection of valid judgments.”<sup>123</sup> The court noted, however, the only time such an application would result in an inequitable result is in the context of a corporation with multiple shareholders because, as non-culpable parties, such shareholders would suffer for the action of another shareholder.<sup>124</sup>

## 2. Triangular Piercing

Triangular piercing occurs when a controlled corporation is held liable for the debts of an affiliated corporation, through an intermediary controlling shareholder.<sup>125</sup> The liability flows in a triangle, first from the controlled corporation to the controlling shareholder, then from the controlling shareholder to the affiliated corporation.<sup>126</sup> The following diagram depicts the remedial claims of piercing, reverse piercing and triangular piercing.

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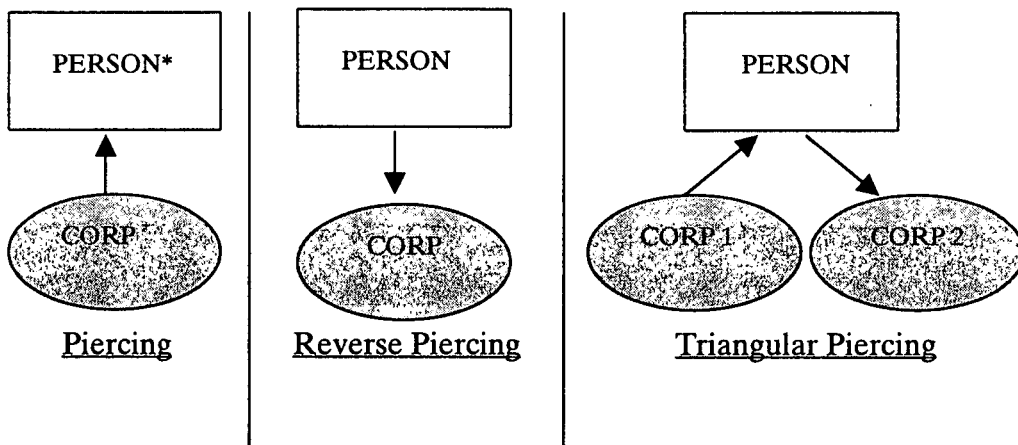
123. *Id.* at 741.

124. *Id.* at 741 n.16; *cf. supra* notes 93–94 and accompanying text (discussing the primary application of the piercing remedy in actions against closely held corporations).

125. Mennitt, *supra* note 114.

126. *Id.*

3. Diagram: Piercing the Corporate Veil—Reverse and Triangular Piercing



\* **PERSON** signifies the controlling shareholder or entity.

+ **CORP** signifies the controlled entity.

The **ARROWS** signify the flow of liability.

**Piercing:** liability flows from the controlled entity to the controlling individual.

**Reverse Piercing:** liability flows from the controlling individual to the controlled entity.

**Triangular Piercing:** liability flows from the first controlled entity to the controlling individual, then from the controlling individual to the second controlled entity.

**Triangular Piercing = Piercing + Reverse Piercing**

4. Critical Observations

Judge Posner suggested that reverse and triangular piercing claims should apply essentially to cases of misrepresentation.<sup>127</sup> He

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127. Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 520 (1976); see also Mennitt, *supra* note 114 and accompanying text (discussing Judge Posner's analysis of reverse and triangular piercing remedies).

provided an example in which a bank holding company chooses a similar name for its real estate subsidiary.<sup>128</sup> The real estate subsidiary leases office space in the bank, so that it appears to be within the office of the bank.<sup>129</sup> Assuming they are dealing with the bank, unsuspecting creditors extend generous terms to the real estate company.<sup>130</sup> It would thus be appropriate to forbid the bank from denying that it is the entity to which the creditors extended credit.<sup>131</sup>

However, Judge Posner cautioned that reverse (and triangular) piercing claims should be allowed discriminately. In this scenario, a taxi company incorporates each taxicab separately for the purpose of limiting its exposure to tort liability from accident victims.<sup>132</sup> Separate incorporation serves to externalize the costs of taxicab service.<sup>133</sup> Permitting accident victims to pierce here would create an inefficiency: investors would not be able to limit their liability.<sup>134</sup> Therefore, investment in taxi service thereby would be unattractive and the affiliated entities of the taxi service would suffer increased information costs.<sup>135</sup> Implicitly, investment

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128. Posner, *supra* note 127, at 521.

129. *Id.*

130. *Id.*

131. *Id.* (observing that “[t]o protect the legal separateness of affiliated corporations in this case would lead creditors as a class to invest a socially excessive amount in determining the true corporate status of the entity to which they were asked to extend credit.”)

132. *Id.*

133. *Id.* Judge Posner maintained:

The separate incorporation of the taxicabs increases the risk that the taxi company will default on its tort obligations. If this were a negotiated obligation the creditor-victim would charge a higher interest rate to reflect the increased risk, but it is not, negotiations between the taxi company and the accident victims before the accident being infeasible.

*Id.*

134. *Id.* at 520.

135. *Id.* at 521. Judge Posner considered the alternative of insurance coverage, but the insurance company could become insolvent, exclude particular torts in coverage policies, etc. *Id.* In this particular circumstance, the most viable solution appeared to be preserving the limited liability of the taxi company but requiring it to post a bond in the amount of the highest tort recovery estimate. *Id.* Under this solution, “[s]hareholders would be protected; accident costs would be internalized; and the information costs of the creditors of affiliated corporations



in taxi service would become a speculative venture and the price of taxi service would necessarily increase.

Judge Posner distinguished these scenarios above and explained that the creditors of the bank through contract were voluntary creditors and the creditors of the taxi cab through tort were involuntary creditors and then suggested an alternative method to pierce.<sup>136</sup> Posner would implement an objective test and look to what a reasonable person in place of the aggrieved creditor would have thought.<sup>137</sup> Considering information costs would differentiate the more sophisticated creditors from involuntary creditors.<sup>138</sup> If “creditors are [reasonably] misled by the proliferation of affiliated corporations, the misrepresentation principle affords them a remedy. If they are not [reasonably] misled, the proliferation of corporations is harmless and should be ignored.”<sup>139</sup>

#### *D. Piercing Approach in New York*

In *State v. Easton*, the New York Supreme Court acknowledged many of these critical observations regarding the overly formalistic language of the piercing tests and articulated a potential new direction for New York case law.<sup>140</sup> There, Karl Easton (“Easton”) served as the President of Cobble Hill Center Corp. and 3 Lafayette Avenue (collectively, “Easton Corps.”) and as Medical Director of Brooklyn Psychosocial Rehabilitation Institute (“BPRI”), a New York not-for-profit corporation.<sup>141</sup> Easton’s infant children owned all the shares of Easton Corps.<sup>142</sup>

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would be minimized.” *Id.*

136. *Id.* at 522–24.

137. *Id.* at 522; *cf.* sources cited *supra* notes 94–113 and accompanying text (focusing upon the actions of the debtor and the degree of egregiousness in his or her conduct).

138. Posner, *supra* note 127, at 522–23 (“[a] financial creditor, such as a consortium of banks, can discover the true financial situation of the debtor at a lower cost than the trade creditor, and the latter in turn at lower cost than the non-business creditor.”).

139. *Id.* at 524.

140. *State v. Easton*, 647 N.Y.S.2d 904 (Sup. Ct. 1995).

141. *Id.* at 906.

142. *Id.* Easton’s children owned all the shares of Cobble Hill Center Corp.,

Easton Corps. leased properties to BPRI, which ran facilities for the mentally ill funded by Medicaid and Social Security.<sup>143</sup> In 1986, the state of New York charged BPRI and the Easton Corps. with defrauding Medicaid.<sup>144</sup> After a non-jury trial and appeal, the state entered judgment against Easton for \$7,573,703.<sup>145</sup> The Second Department dismissed all other charges against BPRI and the Easton Corps.<sup>146</sup>

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which in turn owned all the shares of 3 Lafayette Avenue. *Id.*

143. *Id.*

144. *Id.* The State charged that BPRI, Easton and the Easton Corps. defrauded Medicaid by “improperly billing for ‘home visit’ services that were not reimbursable under the regulations of the New York State Office of Mental Health, or not performed.” *Id.*

145. *Id.* The sum represented the Medicaid fraud proceeds plus treble damages. *Id.*

146. *Id.* at 907. The Second Department held Easton liable, apart from BPRI and the Easton Corps., on a fraud theory, as Judge Joseph Harris of the Supreme Court narrated:

The claims against [BPRI and the Easton Corps.] for the fraudulent “home visit” payments were dismissed. This is an *obvious result* of the fact that the initial fraud perpetuated by Easton—the “home visit” fraud—was what might be determined an “operating” fraud, designed and supervised by Easton and implemented by the operating company BPRI. In this initial fraud, [the Easton Corps.] did not participate. It was a subsequent or secondary fraud that the realty corporations participated in—the concealment and laundering of the fraudulent proceeds obtained by the “home visit” fraud, and the shielding of these proceeds, as well as the personal assets of [Easton] and his wife, from recoupment from the State. Not only were [the Easton Corps.] a laundry for “dirty” proceeds, they were a bank in which to hide these proceeds during the cleansing process.

*Id.* (emphasis added). This is quite a creative way to explain how the Second Department, without resorting to a piercing analysis, held Easton personally liable and then Easton Corps. liable.

The Second Department held Easton personally liable under Social Services Law, Section 145(b)(2), which places personal liability on an individual who “knowingly by means of a false statement or representation, or by deliberate concealment of any material fact” obtains public funds, “on behalf of himself or others.” *People v. BPRI*, 585 N.Y.S.2d 776, 779 (App. Div. 1992). The court commented that “this fraud inured to the benefit of Easton and his family . . . because Easton himself was controlling the bargaining on both sides of the bargaining table, in his not-for-profit capacity as Medical Director of BPRI, and his for-profit role as [equitable] owner of [the Easton Corps.]” *Id.*

Although neither Judge Harris nor the Second Department expressly characterized the relief as a triangular pierce, *Easton* involved a triangular pierce

The State then procured an action in the Supreme Court to enforce the judgment against the Easton Corps. through Easton.<sup>147</sup> The enforcement action involved a reverse piercing claim because the State attempted to hold the Easton Corps. liable for the debts of Easton.<sup>148</sup> Judge Harris began by prudently ascertaining “[t]here appears to be a consensus that the [piercing] analysis does not differ as between a [piercing] claim framed on an instrumentality [test] and one framed on an alter ego [test].”<sup>149</sup>

The court next stated that it would be inequitable not to allow a reverse pierce, even though Easton did not himself have equity in Easton Corps.<sup>150</sup> The court concluded by holding Easton Corps. liable for the debts of Easton and explained— “[n]either the corporate concept nor the corporate form was ever intended to enable the commission of the ‘perfect crime.’”<sup>151</sup> *Easton* summarizes the New York approach with the piercing doctrine and anticipates the application so proposed in this Article.

As the leading commercial center in the United States, New York produces the most piercing cases.<sup>152</sup> New York piercing cases are somewhat more restrictive than such cases from the rest of the country.<sup>153</sup> New York employs what some commentators view as a

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because the liability flowed from BPRI to Easton, then from Easton to the Easton Corps.

147. *Easton*, 647 N.Y.S.2d at 905.

148. *Id.* It is interesting that Judge Harris acknowledged the reverse piercing analysis that led to the reverse piercing claim. That is, the liability initiated with BPRI and flowed to Easton. *See* cases cited *supra* note 146 (comparing Judge Harris’ “levels of fraud” analysis to the apparent triangular piercing claim).

149. *Easton*, 647 N.Y.S.2d at 908.

150. *Id.* at 909. The court did not dwell on the concept of equitable ownership, except to mention in passing that “[c]omplete domination of the corporation is the key to [piercing], especially when the owners, *legal or equitable*, use the corporation as a mere device for their personal rather than legitimate corporate business.” *Id.* (emphasis added). *But see infra* notes 161–63 and accompanying text.

151. *Easton*, 647 N.Y.S.2d at 910.

152. *See* Thompson, *supra* note 79, at 1052.

153. *Id.* Of 212 reported piercing cases through 1985, New York courts pierced in seventy-four cases (34.91% of the time), compared with a national average of 40.18%. *Id.* at 1051. Out of eleven piercing cases, Delaware did not pierce a single time, while Kansas pierced fifteen out of nineteen piercing cases. *Id.*

stringent standard to pierce.<sup>154</sup>

The New York Court of Appeals set forth the modern piercing standard in *Morris v. New York State Dep't of Taxation and Finance*.<sup>155</sup> The court began to elicit the standard by first recognizing that "because a decision whether to [pierce] in a given instance will necessarily depend on the attendant facts and equities, the New York cases may not be reduced to definitive rules governing the varying circumstances when the power may be exercised."<sup>156</sup> Piercing, nonetheless, requires a showing that, "(i) the owners exercised complete domination of the corporation in respect to the attacked transaction; and (ii) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury."<sup>157</sup>

Under the first element, the complaining party must demonstrate complete domination, indicating that the controlling person(s) used the corporation as a mere mechanism to further personal rather than corporate interests.<sup>158</sup> The complaining party

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154. See, e.g., Richard H. Wagner, *Parsing New York's Stringent Rules on Piercing the Corporate Veil*, N.Y. L.J., May 13, 1991 (Outside Counsel), at 1 (discussing the heavy requirements that must be met in New York before a court will apply the piercing doctrine).

155. *Morris v. N.Y. State Dep't of Taxation & Fin.*, 603 N.Y.S.2d 807 (N.Y. 1993) (stating that piercing requires a showing that plaintiff's injury resulted from owners' use of their complete control of the corporation with respect to the transaction to commit a wrong against the plaintiff).

156. *Id.* at 810.

157. *Id.* at 810–11. Such formulation contains language of the Alter Ego and Instrumentality tests. See *supra* notes 97–100 and accompanying text.

158. *Morris*, 603 N.Y.S.2d at 807. A court will consider the following factors in ascertaining complete control:

- (1) disregard of the corporate formalities; (2) inadequate capitalization; (3) intermingling of funds; (4) overlap in ownership, officers, directors, and personnel; (5) common office space, address and telephone numbers of corporate entities; (6) the degree of discretion shown by the allegedly dominated corporation; (7) whether the dealings between the entities are at arms length; (7) whether the corporations are treated as independent profit centers; (9) payment or guarantee of the corporation debts by the dominating entity; and (10) intermingling of property between the entities.

*Freeman v. Complex Computing Co.*, 119 F.3d 1044, 1053 (2d Cir. 1997) (discussing the factors considered in precedent to evaluate the existence of complete control); cf. sources cited *supra* notes 97, 99–103 and accompanying text (reviewing other methods of evaluating "complete control").

must then establish that the controlling person(s) perpetuated an injustice or wrong against that party using such domination to the extent that a court in equity should intervene.<sup>159</sup> The same factors which govern a traditional piercing case also govern a reverse piercing case.<sup>160</sup>

The only means by which a non-shareholder may be liable for a piercing remedial claim is under the doctrine of equitable ownership, by which a court may hold a person liable who does not actually own equity in a controlled corporation.<sup>161</sup> Courts consider a number of factors to determine whether a non-shareholder is an equitable owner for piercing purposes, including *de facto* control over the assets and affairs of the corporation, involvement of other persons in the affairs of the corporation and representations the non-shareholder made to the public and third parties regarding ownership of assets and control of the corporation.<sup>162</sup> A court will typically deem an individual to be an equitable owner when the individual once had equity, but transferred it to a relative,<sup>163</sup> or when a creditor is overly involved in a corporation's activities.<sup>164</sup>

The relevant portions of the New York Business Corporation Law ("BCL"), governing the duties and liabilities of officers and

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159. *Morris*, 603 N.Y.S.2d at 811.

160. *In re Vebeliunas*, 2002 WL 115656 (S.D.N.Y. Jan. 28, 2002). Thereby, the same standard would apply to a triangular piercing claim. In *Vebeliunas*, Judge Preska considered the applicability of piercing to trusts. *Id.* at \*5. Citing to authority in other jurisdictions, the court determined that New York law would likely allow a piercing action against a trust. *Id.*

161. *Lally v. Catskill Airways, Inc.*, 603 N.Y.S.2d 619, 621 (App. Div. 1993) (explaining how a defendant with no remaining equity interest in a corporation might yet maintain sufficient control to be deemed the equitable owner); *Freeman*, 119 F.3d at 1051–52 (noting that an individual with sufficient control over a corporation may be considered an "equitable owner"); *see also supra* note 124 (indicating that the *Easton* court considering a piercing claim against Easton even though he did not own equity in the Easton Corps.).

162. *Freeman*, 119 F.3d at 1051–52.

163. *See State v. Easton*, 647 N.Y.S.2d 904, 906 (Sup. Ct. 1995); *see also supra* note 142 and accompanying text.

164. *Freeman*, 119 F.3d at 1051. In *Freeman*, the defendant creditor operated the corporate entity as if it were his personal bank account, ignoring corporate formalities—its shareholders and board of directors—and held himself out as the controlling person of the corporation. *Id.*

directors,<sup>165</sup> do not refer to the piercing remedy. Similarly, the New York piercing case law seldom reference the BCL.<sup>166</sup> Therefore, the statutory scheme would not necessarily foreclose the application of piercing to not-for-profit corporations. Absent some characteristic of a not-for-profit corporation that so differentiates it from a BC,<sup>167</sup> piercing should apply to a not-for-profit corporation as to a for-profit corporation.

### III. NOT-FOR-PROFIT CONSIDERATIONS

The prefix “not-for-profit” refers to the non-distribution constraint of an entity. Not-for-profit entities may not distribute dividends directly or through subterfuge; nonetheless, may distribute reasonable compensation to members, officers and directors for services rendered.<sup>168</sup> All profit derived from

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165. N.Y. BUS. CORP. LAW § 717 (McKinney 2001) (governing the duties of directors of a BCL); *cf.* N.Y. NOT-FOR-PROFIT CORP. LAW § 717 (McKinney 2001); *supra* notes 48–50 and accompanying text (explaining the duties governing the directors of directors of a not-for-profit corporation); N.Y. BUS. CORP. LAW § 719 (governing the liability of directors of a BCL); *Id.* § 720 (governing misconduct actions against directors and officers of a BCL); *cf.* N.Y. NOT-FOR-PROFIT CORP. LAW § 720; *supra* notes 52, 65–68, 71 and accompanying text (governing misconduct actions against directors and officers of a not-for-profit corporation).

Interestingly, the last portion of each of the afore-referenced BCL sections includes a statement indicating that “[t]his section shall not affect any liability otherwise imposed by law . . .” N.Y. BUS. CORP. LAW §§ 717(b)(v), 719(4)(f), 720(c); *see also* N.Y. NOT-FOR-PROFIT CORP. LAW § 719(f) (containing similar language that “[t]his section shall not affect any liability otherwise imposed by law upon any officer or director.”).

166. *Supra* note 37. On March 10, 2003 a Westlaw on-line “NY-CS-ALL” database search retrieved only seventeen documents with the following inquiry: “FT(PIERC! & “CORPORATE VEIL”) & FT(“BCL”).” All seventeen documents contained both terms for references to alternative causes of action, procedural devices, etc. Only one of these documents referred to either BCL Sections 717, 719 or 720. *See infra* note 165. It did not refer to the BCL section, however, to limit the scope of the piercing remedy. The inquiry: “FT(PIERCE! & “CORPORATE VEIL”)” produced over 400 documents. While the inquiry: “FT(“BCL §”)” produced 211 documents.

167. Courts have not only applied piercing to BCs, but to partnerships and trusts. *See cases cited supra* notes 115–16, 160 and accompanying text.

168. *See KNEPPER & BAILEY, supra* note 39, § 12-1(a).

operations must be used for the purposes as set forth in the articles of incorporation.<sup>169</sup> Furthermore, not-for-profit corporations do not have equity holders in the same manner as BCs, partnerships or other limited liability entities.<sup>170</sup>

Notwithstanding this non-distribution constraint, not-for-profit entities comprise a significant amount of the workforce and generate significant revenues.<sup>171</sup> More than 1.2 million not-for-profit entities are exempt from federal income taxes,<sup>172</sup> such entities also generate an estimated \$1.1 trillion in revenues,<sup>173</sup> account for over fifteen million people in the workplace<sup>174</sup> and are a significant force in the business of the country.<sup>175</sup>

Not-for-profit entities run the gamut from churches, sports leagues, charities, social clubs, schools, and hospitals.<sup>176</sup> Charitable organizations such as the American Red Cross, the Salvation Army, the United Way, as well as special interest groups such as the Federalist Society and the Star Trek Fan Club all count themselves among the many not-for-profit entities.<sup>177</sup> Not-for-profit entities provide many services and functions in society, most notably serving as philanthropic vehicles.

Many not-for-profit entities facilitate the charitable character of the human spirit by providing a means to organize, collect donations, assemble volunteers, and provide charitable services.<sup>178</sup> The vast majority of charitable organizations organize as not-for-

169. See HOWARD L. OLECK, *NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS* 5–6 (5th ed. 1988).

170. See *id.* at 5 (mentioning the “[p]resence or absence of *equity shares* is the single clear feature distinguishing a [BC] from a [not-for-profit-corporation].”) (internal quotations omitted) (emphasis in original).

171. See James J. Fishman, *The Development of Nonprofit Corporation Law and An Agenda for Reform*, 34 *EMORY L.J.* 617, 683 n.4 (1985).

172. See KNEPPER & BAILEY, *supra* note 39, § 12-1(a).

173. See *id.*

174. See *id.*

175. Fishman, *supra* note 171, at 657.

176. KNEPPER & BAILEY, *supra* note 39, § 12-1(a). Not-for-profit entities “range in size from organizations with billions of dollars of assets, such as foundations and universities, to groups with virtually no resources, such as three-person dance companies or Little Leagues.” Fishman, *supra* note 178, at 618.

177. KNEPPER & BAILEY, *supra* note 39, § 12-1(a).

178. Fishman, *supra* note 171, at 622.

profit entities.<sup>179</sup> Indeed the budgets of U.S. philanthropic organizations exceed the budgets of many nations.<sup>180</sup> To facilitate the provision of such services, federal, state, and local governments provide tax exemption to not-for-profit corporations under certain circumstances.<sup>181</sup>

If a not-for-profit corporation satisfies certain criteria under the U.S. Internal Revenue Code, it may be exempt from federal income taxes and be eligible to receive tax deductible donations.<sup>182</sup> Further, if a not-for-profit corporation satisfies other standards under state and local provisions, it may also qualify for exemption from property, sales, use, income, and licensing taxes on the state and local level.<sup>183</sup> Some commentators suggest that if tax-exempt not-for-profit entities ceased to exist, the government would have to spend tax dollars to fill the void left by their absence.<sup>184</sup>

#### A. Types of Not-for-Profit Corporations Organized Under New York Law

Not-for-profit entities must first accede to the organizational requirements set forth under state law.<sup>185</sup> New York organizes not-for-profit corporations according to their function and purpose.<sup>186</sup> The four types of not-for-profit corporations under New York law are subject to varying degrees of regulation.<sup>187</sup> Type A

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179. See, e.g., OLECK, *supra* note 169, at 7 (noting that a charitable corporation is necessarily a nonprofit corporation).

180. *Id.* at 4.

181. Fishman, *supra* note 171, at 637–38.

182. See generally *id.* at 212–35 (explaining the various ways these types of entities can obtain tax-exemption and other tax benefits).

183. See generally *id.* at 345–72 (listing the state taxes from which these organizations may be exempt generally and in specific states).

184. See OLECK, *supra* note 169, at 227 (opining that not-for-profit entities “perform functions which would fall squarely on the government if private volunteers were not willing to devote their time and energies to them. Thus, if the exempt organizations ceased to exist, the government would have to spend more tax dollars in order to fill the void left in society by their absence.”).

185. See Fishman, *supra* note 171, at 659–60.

186. See N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b) (McKinney 2001).

187. See Fishman, *supra* note 171, at 660. For general considerations on the New York not-for-profit corporation statutory framework, see Hansmann, *supra*



corporations are the least regulated type of not-for-profit corporations and consist of members who are the primary beneficiaries of these entities.<sup>188</sup> Type A not-for-profit corporations consist of those corporations formed for lawful non-pecuniary purposes, including “civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, and for a professional, commercial, industrial, trade or service association.”<sup>189</sup>

Type B corporations are the most regulated entities and consist of those entities most likely to be tax exempt under the U.S. Internal Revenue Code.<sup>190</sup> Type B not-for-profit corporations consist of those entities formed for non-business purposes, including “charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals.”<sup>191</sup> If a corporation is formed for purposes contained within the provisions of both Type A and Type B, the N-PCL classifies the not-for-profit corporation as a Type B corporation.<sup>192</sup>

Type C corporations are less regulated than Type B entities and consist of those not-for-profit corporations formed “for any lawful *business* purpose to achieve a lawful public or quasi-public objective.”<sup>193</sup> An example of a Type C organization is a food cooperative operating in a low-income community.<sup>194</sup> Any not-for-profit corporation with a purpose listed under Type C shall be a Type C entity.<sup>195</sup>

Finally, Type D corporations consist of those not-for-profit corporations whose power of formation derives from another enabling statute.<sup>196</sup> These entities are eligible for financing from local and state funds, such as those provided by the New York Private Housing Finance Law.<sup>197</sup> Type D not-for-profit

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note 32, at 530–35.

188. See Fishman, *supra* note 171, at 661.

189. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b).

190. Fishman, *supra* note 171, at 661.

191. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(b).

192. *Id.* § 201(c).

193. *Id.* § 201(b) (emphasis added); Fishman, *supra* note 171, at 661.

194. Fishman, *supra* note 171, at 661.

195. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(c).

196. *Id.* § 201(b).

197. Fishman, *supra* note 171, at 662–63.

corporations are subject to the regulation-level of Type B entities.<sup>198</sup> While New York classifies not-for-profit corporations under four separate categories, the board of directors remains a common element amongst these organizations.<sup>199</sup>

### B. Not-for-Profit Corporate Board

The governing entity of a not-for-profit corporation, the board of directors, is in charge of the day-to-day activities of the organization.<sup>200</sup> A board may be self-perpetuating or elected from the membership of the entity.<sup>201</sup> In either respect, the board of a not-for-profit corporation differs from that of the BC.<sup>202</sup>

Traditionally, not-for-profit board practices are much looser than those of the BC.<sup>203</sup> There are no analogous reporting requirements to outside agencies, such as is the case with public corporations.<sup>204</sup> Several checks aim to assure the fair practice of BC boards, including the threat of derivative lawsuits combined with an active plaintiff's bar, scrutiny of the financial press, oversight by the U.S. Securities and Exchange Commission and other securities industry agencies and the responsibility of the board to the shareholders.<sup>205</sup> In the not-for-profit corporation, there are few if any such procedural safeguards.<sup>206</sup>

Outside monitoring of not-for-profit corporations is largely performed by the mainstream media, but stories tend to surface only in extreme cases.<sup>207</sup> The Charities Bureau of the New York

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198. N.Y. NOT-FOR-PROFIT CORP. LAW § 201(c).

199. *See id.* § 201.

200. OLECK, *supra* note 169, at 743.

201. 18 NEW YORK JURISPRUDENCE 2D CHARITIES § 74 (2d ed. 1999).

202. *See Fishman, supra* note 171, at 674–78.

203. *See id.* at 675.

204. *See id.* at 674–75.

205. *See id.*

206. *See id.* at 674.

207. *See* Interview by Bill O'Reilly with Randy Daniels, New York Secretary of State, *The O'Reilly Factor* (Fox News television broadcast, Oct. 23, 2001), available at 2001 WL 5081827 (commenting that “[l]ess than 10 percent of the \$1.4 billion raised [by the combined 160 9-11 charities] has been paid out.”); Heidi Evans & Dave Saltonstall, *Hale Blew \$500G on Hubby's Play[,] Lied About Loan, Said It Was Used to Fix Up House*, N.Y. DAILY NEWS, May 8, 2001,

AG's office has limited resources to devote to over 40,000 entities under its watch.<sup>208</sup> Therefore, the level of conduct necessary to trigger an investigation with the AG is typically egregious.<sup>209</sup>

While board positions in both not-for-profit corporations and BCs may be prestigious, not-for-profit corporation board members typically have no experience, are unpaid, and are unaware of their duties and responsibilities.<sup>210</sup> Not-for-profit board memberships are prestigious due to contacts made with prominent individuals and a general interest in the provision of charitable services.<sup>211</sup> Many members of the board serve at the behest of in-house director employees.<sup>212</sup> Such directors serve as tokens, with little experience or conception of the duties and expectations of their positions.<sup>213</sup> The frequent lack of sufficient oversight and the inherent structural flaws of the not-for-profit corporation may present opportunities for not-for-profit board members to abuse their positions.<sup>214</sup>

#### IV. PIERCING APPLIED TO NOT-FOR-PROFIT ENTITIES

A number of jurisdictions allow an aggrieved party to apply the equitable remedy of piercing to a not-for-profit entity.<sup>215</sup> The experiences of these jurisdictions provide insight into the suitability of the piercing remedy in the not-for-profit corporation context.

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available at 2001 WL 17950407. For other notable scandals reported by the press, see Nina J. Crimm, *Why All Is Not Quiet on the "Home Front" for Charitable Organizations*, 29 N.M. L. REV. 1, 26-27 (1999).

208. Thomas Adcock, *Charities Bureau Caught in Spotlight*, 227 N.Y. L.J. 16 (2002) (mentioning the Bureau has only seventeen attorneys and six accountants).

209. *Id.* (quoting Attorney General Eliot Spitzer, who said "[w]ith more than 40,000 charities filing with us, six accountants can hardly do even rudimentary analysis, or even a cursory examination to look for red flags.").

210. Fishman, *supra* note 171, at 674-75.

211. *Id.* at 674.

212. *Id.* at 674-75.

213. *Id.*

214. See sources cited *supra* notes 207-12.

215. See discussion *infra* Part IV.A.

A. Jurisdictions Recognizing Piercing in Not-for-Profit Context

In *Macaluso v. Jenkins*, an Illinois appellate court held that the status of an entity as not-for-profit does not foreclose the application of piercing as an equitable remedy.<sup>216</sup> There, the defendant utilized a non-profit corporation for his own personal gain by drawing its funds for his personal and business use, commingled its assets with his own and contracted under the non-profit organization to supply services to his for-profit business and did so despite his status as merely one of six directors of the non-profit entity.<sup>217</sup> The court dismissed the argument that piercing could not apply because Illinois statutory law does not authorize the remedy.<sup>218</sup> The court reasoned piercing is an equitable remedy, which “completely disregards th[e] statutory network creating and supporting corporate structures.”<sup>219</sup> The Illinois court effectively discerned that what works for the corporation should also work for the not-for-profit entity.<sup>220</sup> The court then held the defendant personally liable for the debts of the non-profit corporation.<sup>221</sup>

In *Public Interest Bounty Hunters v. Board of Governors of the Federal Reserve System*, the U.S. District Court for the Northern District of Georgia held that piercing applied to a private foundation.<sup>222</sup> In the case, the plaintiff brought a lawsuit against the federal government to encourage the enforcement of unfair banking laws.<sup>223</sup> The federal government moved for attorneys fees under the False Claims Act.<sup>224</sup> The plaintiff formed a not-for-profit foundation because he had been personally barred from suing personally, under the doctrine of *res judicata*.<sup>225</sup> The judge noted that “a ‘foundation’ and its ‘trustee’ are . . . legal fictions whose

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216. *Macaluso v. Jenkins*, 420 N.E.2d 251, 255 (Ill. App. Ct. 1981).

217. *Id.* at 254-57.

218. *Id.* at 255.

219. *Id.*

220. *Id.*

221. *Id.* at 257.

222. *Publ. Interest Bounty Hunters v. Bd. of Governors of the Fed. Reserve Sys.*, 548 F. Supp. 157, 162-63 (N.D. Ga. 1982).

223. *Id.* at 159.

224. *Id.*

225. *Id.* at 162.

protective shells can be pierced under appropriate circumstances in order to expose the individual persons responsible for the entity's actions."<sup>226</sup> The court further stated that the noble mission and public spirit contained within the foundation's charter should not preclude common sense from revealing that the trustee utilized such an instrumentality to avoid liability.<sup>227</sup> The court thereby discerned that the plaintiff was the real party because the foundation had no real assets and plaintiff was the sole shareholder and then awarded attorneys fees to the government.<sup>228</sup>

In *Barineau v. Barineau*, the District Court of Appeals of Florida held that an entity's non-profit status does not preclude the application of the piercing remedy.<sup>229</sup> The trial court ruled as a matter of law that a non-profit corporation could not be the alter ego of an individual.<sup>230</sup> In a *per curiam* opinion, the appellate court observed that although one cannot exercise control of a not-for-profit entity in the same legal manner as a corporation—for example, as a shareholder—"a person can be held personally liable . . . if the evidence shows that the person . . . did *in fact* exercise control [of the not-for-profit entity]."<sup>231</sup> The court indicated that a sufficient factual showing might deem a not-for-profit entity as the alter ego of an individual.<sup>232</sup> The appeals court thereby reversed the ruling of the trial court and held that a non-profit corporation could be the alter ego of an individual.<sup>233</sup>

A number of other jurisdictions considering this question, while not finding a sufficient factual basis to pierce a not-for-profit entity, have suggested that the doctrine should be available.<sup>234</sup>

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226. *Id.*

227. *Id.*

228. *Id.* at 165.

229. *Barineau v. Barineau*, 662 So.2d 1008, 1009 (Fla. Dist. Ct. App. 1995).

230. *Id.* at 1008.

231. *Id.* (emphasis added) (citing 1 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.75 (perm. ed., rev. vol. 1999)).

232. *Id.* at 1009. This court would seem to have no problem with reverse or triangular piercing as well.

233. *Id.*

234. See *Lycoming County Nursing Home Ass'n v. Commonwealth*, 627 A.2d 238, 291 (Pa. Commw. Ct. 1993) (allowing plaintiff to pierce a nursing home to reach the assets of a public entity); *DeMartino v. Monroe Little League, Inc.*, 471

Many of the courts that have allowed this remedy to apply to a not-for-profit entity did so despite the lack of the remedy appearing in the state statutory framework.<sup>235</sup> These developments suggest the propriety of this remedy.

B. Need for Piercing in Context of New York Not-for-Profit Corporations

Piercing fills a gap in current New York law regarding not-for-profit corporations.<sup>236</sup> The piercing remedy holds accountable those who abuse the entity of a not-for-profit corporation for personal benefit. The remedy compensates the entity for the losses incurred by the wrongful activity of its officers or directors, and thereby rewards the beneficiaries of the not-for-profit corporation.

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A.2d 638, 641 (Conn. 1984) (holding a corporation liable for debts of a not-for-profit entity under piercing remedy); *Lake Otis Clinic, Inc. v. State*, 650 P.2d 388, 396 (Alaska 1982) (holding a not-for-profit entity liable for the debts of an individual under a reverse piercing claim with no specific consideration on whether the entity status as non-profit precluded the remedy); *cf. Christofferson v. Church of Scientology of Portland*, 644 P.2d 577, 596 (Or. Ct. App. 1981) (holding facts did not suffice to pierce an entity, but court did not preclude the application of piercing to a not-for-profit entity); *Jabczenski v. S. Pac. Mem'l Hosps., Inc.*, 579 P.2d 53, 59 (Ariz. Ct. App. 1978) (holding factual record did not indicate disregarding corporate fiction, not-for-profit entity issue not discussed); *Jones v. Briley*, 593 So.2d 391, 397 (La. Ct. App. 1991) (denying piercing claim as applied to a not-for-profit entity on factual rather than legal basis); *United States v. Funds Held in the Name or for the Benefit of Wetterer*, 210 F.3d 96, 107–11 (2d Cir. 2000) (applying federal and Guatemalan law and considering whether piercing claim applied to a not-for-profit entity, but deciding against the application on factual analysis).

235. See generally ALASKA STAT. §§ 09.65.170, 10.06.478, 10.06.480 (Michie 2001); FLA. STAT. ANN. §§ 607.0830, 607.0832, 607.0834, 617.0830, 617.0832, 617.0834 (West 2001); GA. CODE ANN. §§ 14-2-830, 14-2-842, 14-2-860, 14-8-30-31, 14-3-842, 14-3-860, 14-3-865 (2001); LA. REV. STAT. ANN. §§ 12:91-95, 12:219-221, 12:226 (West 2001); PA. STAT. ANN. tit. 15, §§ 512, 5712-13 (West 2002). Cf. N.Y. BUS. CORP. LAW §§ 717, 719-20 (McKinney 2001); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 713-77, 720, 720(a) (McKinney 2001); see also sources cited *supra* notes 36-37, 39-69, 163-67 and accompanying text.

236. See sources cited *supra* notes 39-84 and accompanying text. The remedy also serves the intermediate situation that is not so egregious so as to involve action from the AG, but which conduct is noticeable by persons affiliated with such not-for-profit corporation.

Finally, piercing provides deterrence against future wrongdoing against the organization.

While the accounting remedy available under section 720 of the N-PCL serves to compensate the not-for-profit corporation for its lost assets, it does not compensate the entity for the abuse of the not-for-profit status as a vehicle for personal gain.<sup>237</sup> Under the piercing doctrine, a plaintiff with standing chooses a substantive cause of action against alleged wrongdoers. Once the plaintiff establishes liability, the enforcement of such judgment begins. Without the remedy, a liable individual may be able to escape liability through various means.<sup>238</sup> Under the piercing doctrine, a plaintiff can attack the defendants' personal assets, or those of affiliated entities through reverse and triangular piercing. Thereby, there would be no place to run and hide for someone who chooses to cloak their assets.

Just as a judgment against a director of a BC for alleged wrongdoing benefits the shareholders of the corporation, a judgment for a not-for-profit corporation serves the beneficiaries of the services that entity provides.<sup>239</sup> This is particularly true for those organizations engaged in true charitable activities, that is, where the donors and the beneficiaries are distinct.<sup>240</sup> Suppose, for instance, a not-for-profit corporation promises its donors that for every one hundred dollars donated, the entity will deliver twenty pounds of food to needy families. If, in the interim, certain controlling persons divert millions of dollars of the not-for-profit corporation assets, the real victims are the families to whom such donations were to benefit. Allowing the not-for-profit corporation to pursue such wrongdoers and to ignore corporate fiction serves to vindicate the real beneficiaries and restore a damaged entity to its noble purposes.

Piercing deters future wrongdoing by both: (i) the specific corporate actors involved in not-for-profit corporation fraud and (ii) those prospective persons who serve or will serve in positions of trust at these organizations. Deterrence, a criminal law doctrine,

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237. *Supra* note 65 and accompanying text.

238. *See, e.g.*, sources cited *supra* notes 115–24 and accompanying text.

239. *See* Hansmann, *supra* note 32, at 568.

240. *See id.* at 505.

views punishment as a means of social control and prevention of crime.<sup>241</sup> Ideally, those persons punished for a particular crime should be deterred from committing the same offense again [*specific deterrence*].<sup>242</sup> In addition, the punishment of those individuals sends a message to society not to act in that manner [*general deterrence*].<sup>243</sup> Piercing, if applied to the numerous cases of not-for-profit corporate fraud, could serve to prevent future abuse of the entity and encourage responsible service in positions of authority within the organization.<sup>244</sup>

While the piercing remedial claim produces a wealth of litigation with regards to the BC,<sup>245</sup> the corresponding dearth of litigation in the not-for-profit corporation context merits consideration. The litigiousness of the piercing remedy involving BCs necessarily involves debatable instances wherein the remedy may be appropriate. While shareholders, creditors, and directors are enforcing the rights of a BC to prevent individuals from perpetuating fraud, such persons at a not-for-profit corporation typically must rely upon the services of the AG to achieve the same result.<sup>246</sup> Certainly, the lack of corresponding litigation on the not-for-profit front is not a result of these officers and directors acting more responsibly than their BC counterparts.<sup>247</sup> Although increased litigation may result, the goal of responsible management is a result surely worth the price of applying the piercing remedy to not-for-profit corporations.

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241. Cotton, *supra* note 33, at 1316.

242. *Id.*

243. *Id.*

244. Cf. Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 245 n.70. Professor Manne noted:

Many who consider whether or not to join a board of a [not-for-profit corporation] worry about exposing themselves to the risk of personal liability lawsuits as a result of their becoming board members. Furthermore, the wealthier potential board members may be, the more they are likely to worry that their wealth alone will attract lawsuits. And yet, for a variety of reasons, it is just this class of persons that [not-for-profit entities] like to attract to their boards.

*Id.*

245. See *supra* note 85 and accompanying text.

246. See sources cited *supra* notes 207–09 and accompanying text.

247. See *supra* notes 202–05 and accompanying text.



*C. Piercing Applied to New York Not-for-Profit Corporations*

Piercing would complement the current framework governing not-for-profit corporations under New York law. The current N-PCL provisions on standing,<sup>248</sup> fiduciary duties,<sup>249</sup> remedies,<sup>250</sup> and qualified immunity<sup>251</sup> would remain in a piercing analysis. Once a plaintiff establishes a substantive violation,<sup>252</sup> the piercing remedy would allow that plaintiff to pursue the defendant.

The plaintiff must first demonstrate that the defendant was an equitable owner of the not-for-profit corporation.<sup>253</sup> While no person can legally control a not-for-profit corporation in the same manner that a controlling shareholder exercises control over a BC, the plaintiff may establish that the defendant was a *de facto* owner of the entity.<sup>254</sup> Once the plaintiff demonstrates equitable ownership, s/he must then show that, “(1) the owners exercised complete domination of the corporation in respect to the attacked transaction; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff’s injury.”<sup>255</sup> A plaintiff would then repeat this analysis for any

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248. See *supra* notes 43–45 and accompanying text. Interestingly, the N-PCL standing provisions taken in conjunction with the piercing remedy would serve to relieve the already burdened AG’s office. See *supra* notes 207–08 and accompanying text. The AG’s office could then focus upon criminal charges in the most extreme cases of not-for-profit corporation fraud and abuse.

249. See *supra* notes 46–55 and accompanying text.

250. See *supra* notes 65–67 and accompanying text.

251. See sources cited *supra* notes 68–69 and accompanying text.

252. Such substantive liability may arise from the provisions of the N-PCL—breach of fiduciary duties—or other laws. See, e.g., *supra* notes 59, 71–80, 140–49 and accompanying text.

253. See *supra* notes 161–64 and accompanying text.

254. See *supra* notes 161–64 and accompanying text.

255. *Morris v. N.Y. State Dep’t. of Taxation & Fin.*, 603 N.Y.S.2d 807, 810–11 (N.Y. 1993); see sources cited *supra* notes 154–55 and accompanying text. Of course, if the not-for-profit corporation were a 501(c)(3) organization and the director served the entity without pay, the qualified immunity provisions of N-PCL, Section 720(a), would apply. See *supra* notes 68–69 and accompanying text. If the defendant put forth such affirmative defense before the service of answers, only grossly negligent or fraudulent activity would be subject to attack. See *supra* notes 68–69 and accompanying text. Thereby, volunteer service provided to charitable organizations would be virtually unaffected. The plaintiff would have

subsequent piercing or reverse piercing analysis necessary to satisfy the judgment.

#### CONCLUSION

If Scheuer obtained a verdict for the Foundation against the Directors and 61 Associates, the piercing remedy would allow the enforcement of the judgment. Scheuer would probably have to pursue reverse piercing remedial claims against the Directors and piercing remedial claims against 61 Associates. In any event, Scheuer would have to first prove equitable ownership of the Foundation by the Directors.

The Directors, while not equity holders of the Foundation, were able to invest the assets of the Foundation at will, conceal all financial reporting information of the Foundation and effectively used threats and other tactics to silence any Foundation opposition. These factors would seem to demonstrate *de facto* control over the Foundation, and thus subject the Directors to the piercing remedy.

Scheuer must then demonstrate the first element of the *Morris* piercing test: complete domination. Scheuer must prove that the Directors “exercised complete domination of the [not-for-profit corporation] with respect to the attacked transaction.”<sup>256</sup> With regards to the investment decisions of the entity, the Directors effectively acted alone, concealing and threatening any attempted involvement from other persons in their decision-making. In so doing, the Directors effectuated investments to benefit themselves and affiliated entities rather than the Foundation. The Directors’ conduct is apparently demonstrative of complete control under *Morris*.

Next, Scheuer must also show that the Directors utilized that domination “to commit a fraud or wrong against the plaintiff which resulted in plaintiff’s injury.”<sup>257</sup> The Foundation purportedly lost over \$5 million in assets due to the investment decisions made by

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to allege very egregious activity on the part of the director.

256. *Morris*, 603 N.Y.S.2d at 810.

257. *Id.* at 810–11.

the Directors.<sup>258</sup> The conduct of the Directors, in seeking personal pecuniary benefits over the interests of the Foundation, proximately caused the loss to the Foundation. Therefore, Scheuer would likely be able to establish a successful piercing remedial claim. Whether the individual assets of the Directors should be reached to satisfy the judgment, or should Scheuer pierce again against affiliated entities, the Foundation benefits from the applicability of the remedy.

Officers and directors who choose to serve a not-for-profit corporation should do so responsibly. Tax exempt entities receiving tax deductible donations and performing charitable services should not be less regulated than for-profit entities that can, for the most part, patrol themselves due to the rights afforded to equity holders. The public benefits by having entities that actually fulfill the services professed in their formation documents. The occasional headline, scandal or indictment against persons who grossly profit at the expense of a not-for-profit corporation raises the question of how many of these organizations fall below the radar screen. The piercing equitable remedy follows common law and the current New York statutory construction, relieves the government of the burden of sole enforcement of not-for-profit corporate duties and empowers creditors, members, and honest officers and directors to recover funds for the entity, so that it may fulfill its true mission.

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258. *See* Amended Complaint.