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HIDING BEHIND THE CORPORATE VEIL: A GUIDE FOR NON-PROFIT CORPORATIONS WITH FOR-PROFIT SUBSIDIARIES

*Seong J. Kim**

I. INTRODUCTION

The non-profit industry holds a unique position in the economic and social functions of the United States. The countless varieties of non-profit organizations are often labeled as the “third,” “charitable,” “voluntary,” “philanthropic,” “civil society,” and “tax-exempt” sector of the economy and receive favorable treatment.¹ Currently, federal tax law exempts charities, often referred to as 501(c)(3) organizations, from paying federal income tax and allows them to receive tax deductible contributions.² Although there is a general assumption that non-profit organizations exercise a position that is independent from the government and private sectors, this assumption is misguided.³ On the contrary, numerous non-profits exercise close governance and financial relationships with both the government and private sectors.⁴ Often times non-profit organizations earn

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1. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 2 (3rd ed. 2006).

2. *Tax Treatment of Charities*, COUNCIL ON FOUNDATIONS, (Spring 2001), available at <http://www.cof.org/files/Documents/Legal/tax&charity.pdf>

3. FISHMAN & SCHWARZ, *supra* note 1.

4. *Id.*

a profit and do not exclusively rely on volunteers, public, or private support.⁵ In fact, many non-profits conduct their operations just like for-profit businesses, complete with large profits, handsome salaries, political lobbyists, and invest billions of dollars in stocks and bonds.⁶

As the financial side of the non-profit industry is measured, it has become increasingly clear that both the public and the government must carefully monitor their activities. Independent Sector, an organization created to conduct research and advocate on behalf of non-profits, estimated that as of the late 1990's there were approximately 1.6 million non-profit organizations in the United States.⁷ By the year 2000, charitable organizations, excluding churches, held an astounding \$2.07-trillion in assets and reported approximately \$939-billion in revenues.⁸ However, even with the economic significance of non-profit organizations, a unique feature of the sector is the relative freedom it enjoys.⁹ Within the boundaries of the law, individuals are generally able to create non-profit organizations to pursue any idea or program they desire.¹⁰ Unlike the government, non-profit organizations are not required to gain support from a large constituency.¹¹ Similarly, unlike the business sector, non-profit organizations do not have to pursue only those ideas that have the potential to become profitable.¹²

Because of the unique regulatory positions of non-profit organizations, favorable tax treatment, and potential to earn large profits, the non-profit sector is ripe for abuse. Private foundations for example have become "great warehouses of untaxed wealth" that provide these non-profit organizations with great economic power.¹³ Additionally, dozens of non-profit directors and executives are also officers of outside companies that engage in business activities with non-profit organizations.¹⁴ What compounds this problem and allows abuse is the fact that the Internal Revenue Service is so understaffed compared to the increasing number of exempt organizations, that it has become administratively impossible to audit all of them at the present rate.¹⁵

In this article I intend to address an emerging and complex problem

5. *Id.*

6. GILBERT M. GAUL & NEILL A. BOROWSKI, *FREE RIDE: THE TAX-EXEMPT ECONOMY* 4 (1993).

7. FISHMAN & SCHWARZ, *supra* note 1, at 17.

8. *Id.*

9. JOHN W. GARDNER, *The Independent Sector*, in *AMERICA'S VOLUNTARY SPIRIT* xiii (Brian O'Connell ed., 1983).

10. *Id.*

11. *Id.*

12. *Id.*

13. GAUL & BOROWSKI, *supra* note 6.

14. *Id.* at 5.

15. *Id.*

surrounding non-profit corporations. I will analyze whether or not a party should be able to pierce the corporate veil of a non-profit corporation for actions of their for-profit subsidiary. In examining the issue, I will look at the responsibilities and standards of both non-profit and for-profit corporations. I will then attempt to reconcile the two areas of law and argue that the equitable remedy of piercing the corporate veil should be available in the non-profit sector. I plan to show how this issue is complicated by the different underlying principles and premises surrounding the formation of non-profit organizations and for-profit corporations. Finally, I will propose a number of changes in the regulations to attach greater liability to officers of non-profit organizations, and to increase responsibility while reducing abuse.

II. BACKGROUND

In order to determine the scope of the legal rights and privileges of non-profit organizations and their officers, it is necessary to understand the underlying premises surrounding their creation. Without understanding the rationale behind granting favorable treatment to non-profit organizations, it becomes extremely difficult to decide whether those privileges should be revoked. Unfortunately, the reasons *why* non-profit organizations exist have been subject to a large amount of debate.

A common understanding surrounding the creation of non-profit organizations centers on history. It is argued that American philanthropy began with the Indians of the Bahama Islands who greeted Columbus on his first arrival into the New World.¹⁶ Accordingly, there are countless other stories of Indians offering practical assistance to white settlers as more colonists began arriving in America.¹⁷ This philanthropic movement in turn spurred efforts by white colonists to create communities better than the ones they had left in Europe.¹⁸ In his *Essays to Do Good*, Cotton Mather is credited with beginning the modern American philanthropic movement.¹⁹ It is argued that by urging men and women to engage in "a perpetual endeavor to do good in the world," Mather's had set the stage for the creation of non-profit organizations.

Others attribute the creation of non-profit organizations to more pragmatic reasons rather than just mere existence through history. Two contrary arguments that have been made involve the twin failures of the

16. ROBERT H. BREMNER, *AMERICAN PHILANTHROPY* 5 (2d ed. 1988).

17. *Id.*

18. *Id.* at 7.

19. *Id.* at 12.

market and the government.²⁰ The failure surrounding the market exists because it is driven by consumer demand.²¹ While the market is responsive to the goods and services that we consume *individually*, such as food and clothes, the market is generally irresponsive to things consumed *collectively*, such as safe neighborhoods and clean air.²² In order to account for this disparity, non-profits organizations act as non-market providers of collective goods and services.²³ Government failures on the other hand refer to the inherent restraints on the government's ability to provide support in the limitless interests of the public.²⁴ Like the market failures argument, non-profit organizations are said to exist in order to fill the gap in services that the government is not able to provide.²⁵

It is important to distinguish between the different explanations of why non-profit organizations exist in order to determine how much deference to provide them. The argument that non-profit organizations should be given deference to govern themselves holds less weight if the explanation and purpose for their existence is that they have always existed. However, if non-profit organizations were created to fill gaps in society resulting from market and government failures; it makes more sense to give them deference to allow them to keep providing such services. This issue is complicated by the fact that numerous other explanations exist for the creation non-profit organizations. Ideas that non-profit organizations exist to promote the values of pluralism or so democratic societies can "express solidarity through joint action" are a combination of historical and pragmatic arguments.²⁶ In these instances, it is foggy and unclear how much deference should be given to these non-profit organizations.

Aside from the different theories regarding why non-profit organizations exist and how they came to be, it is also essential to analyze the rationale behind granting them favorable legal treatment.

Almost all charities receive their favorable tax exempt status under §501(c)(3) of the Internal Revenue Code.²⁷ §501(c)(3) organizations include all those:

[O]perated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes. . . [provided

20. LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 13 (Lester Salamon ed., The Foundation Center 2d. 1999); FISHMAN & SCHWARZ, *supra* note 1, at 44.

21. *Id.* at 12.

22. *Id.*

23. *Id.*

24. *Id.* at 13.

25. *Id.*

26. FISHMAN & SCHWARZ, *supra* note 1, at 44.

27. *Id.* at 327.

that] no part of the net earnings of the organization inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carry on propaganda, or otherwise attempting, to influence legislation. . .and which does not participate in, or intervene in any political campaign on behalf of any candidate for public office.²⁸

Additional benefits include public recognition, eligibility for federal, state, and local grants, tax exempt contributions, free public service announcements, and cheaper mailing rates.²⁹ Some §501(c)(3) organizations may even benefit through exemptions under antitrust, securities, labor, bankruptcy, and other regulatory regimes.³⁰ However, there must be a reason for giving non-profit organizations all of these legal and tax exemptions. Furthermore, we must determine whether these non-profit organizations “deserve” this preferential treatment.

One of the most common and optimistic views in support of non-profit organizations focuses on the “public benefit” that they provide.³¹ Like the government failure and market failure theories, the public benefit analysts argue that non-profit organizations provide services that fall outside the scope of the government for one of two reasons.³² First, a private enterprise may be able to do a better specific job in a particular sector.³³ Second, the American policies of decentralization allow non-profit organizations to provide services that are inappropriate for the government.³⁴ Consequently, non-profit organizations are able to provide these public services without reference to politics or other undesirable influences.³⁵ From this viewpoint, it makes sense for the government to provide non-profit organizations more deference to conduct their activities as they see fit. Under this theory, non-profit organizations are essentially relieving the government from services they would otherwise have to provide.³⁶ Regardless of why the government cannot or does not provide these services, in this model, non-profit organizations are seen as separate from the government and private sectors. Assuming that these reasons for granting non-profit organizations favorable treatment are true, it would be counterintuitive to require them to abide by stricter government controls. This is because theorists in this model have pointed to the negative

28. 26 C.F.R. § 1.501(c)(3) (2008).

29. Tony Rhodin, *Benefits of Being a 501(c)(3) Nonprofit*, THE TONY RHODIN BLOG, Oct. 22, 2004, http://blog.pennlive.com/tonyrhodin/2007/10/benefits_of_being_a_501c3_nonp.html.

30. FISHMAN & SCHWARZ, *supra* note 1, at 327.

31. *Id.* at 328.

32. Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*.

33. *Id.* at 329.

34. *Id.*

35. FISHMAN & SCHWARZ, *supra* note 1, at 330.

36. *Id.* at 331.

consequence of those particular controls as the reasons that non-profit organizations exist separately from the government.

Although the public benefit theory is one of the most often cited rationales behind granting non-profit organizations favorable legal treatment, it is not the only possible explanation. Income measurement theorists take a less optimistic view of non-profit organizations and argue that we cannot view their favorable treatment as a purely natural occurrence.³⁷ Instead, income measurement theorists argue that non-profit organizations receive favorable tax treatment, simply because it would be contradictory and conceptually difficult to compute their "net income."³⁸ These difficulties include issues such as what to allow as a "business" deduction, what the appropriate tax rate should be, and a lack of reasonable certainty regarding who the ultimate beneficiaries will be.³⁹ Under the income measurement theory, it is questioned whether or not a non-profit organization should be considered to be merely a conduit through which funds move from a donor to the ultimate recipients.⁴⁰ If this explanation is accepted as true, it can be argued the non-profit organization's income should be imputed to the ultimate beneficiary.⁴¹ By doing so, the amount of donations could be taxed more accurately at the individual personal tax rates.⁴² However, the very nature of non-profit organizations makes the ultimate beneficiary unknown before disbursements.⁴³ It is this very contradiction that income measurement theorist attempt to avoid by exempting non-profit organizations from certain taxes.

Like the different theories regarding how non-profit organizations came to be, the different explanations for granting them favorable treatment provides guidance on how much deference to allow them. Under the public benefit theory, it would make sense to provide non-profit organizations with a greater degree of independence. This is because non-profit organizations are providing services not supplied through government and private entities. For one reason or another, government and private entities are not capable of fulfilling this gap. Consequently, under this rationale, non-profit organizations should be able to provide their services as they see fit.

Unfortunately, the public benefits theory may be overly optimistic concerning the purpose and motives of non-profit organizations. There have been countless concerns about whether or not non-profit organizations

37. *Id.*

38. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 *YALE L. J.* 299, 307 (1976).

39. *Id.* at 334-36.

40. *Id.* at 333.

41. *Id.* at 336.

42. *Id.*

43. *Id.*

actually provide as much public benefit as it was originally thought. For example, many critics argue that non-profit organizations fail to actually disperse a significant amount of their investment income.⁴⁴ In these instances, people have argued that the amount of tax and legal benefits provided to non-profit organizations should be limited to what they “actually do to improve the world.”⁴⁵ Additionally, these critics point out those non-profit organizations may actually provide more harm than good.⁴⁶ Because non-profit organizations are granted favorable tax exempt treatment, there is an erosion of the tax base that must be picked up by home owners and small businesses.⁴⁷ For example, in Baltimore Maryland, while one out of every five jobs is provided by the non-profit sector, the estimated price of that to local taxation is around \$70-million.⁴⁸ This sum is larger than the cities general funds deficit for the year.⁴⁹ In the city of Berkeley, California, the proportion of benefit to harm is even more staggering. The tax losses from non-profit organizations from Berkeley were two thirds as large as the taxes actually collected.⁵⁰

The problem with tax exemptions and favorable legal treatment for non-profit foundations are compounded by the services that they do not provide. Many non-profit organizations are using the favorable tax and legal treatment to provide services and goods that compete with existing for-profit businesses.⁵¹ Additionally, critics argue that we have lost sight of what are truly “public benefits.”⁵² This is compounded by the fact that it is difficult to evaluate the value of non-profit services and the reluctance of local governments to relate with these organizations.⁵³ Although it seems overly simplified, under the public benefits theory, in order for favorable tax and legal treatment to be justified, non-profit organizations must actually provide what they are thought to provide. For example, favorable tax exemptions could help leverage the cost of lost tax revenues through the social services provided by the non-profit organizations.⁵⁴ Unfortunately, because this is not often the case, we must carefully consider whether non-profit organizations should be provided favorable

44. Sean Stannard, *Mission Related Investing*, TACTICAL PHILANTHROPY: CHRONICLING THE SECOND GREAT WAVE OF PHILANTHROPY (2007), <http://tacticalphilanthropy.com/2007/05/mission-related-investing#comment-281>.

45. *Id.*

46. Susan Raymond, *The Tax Man Cometh- Should Non-profits Pay?*, ON PHILANTHROPY, July 25, 2004, <http://www.onphilanthropy.com/site/News2?id=6189&page=NewsArticle>.

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. Paul Atkinson, *Taking Advantage of the Non-profit Sector's Potential: Policy Priorities*, (Sept. 2006), available at http://gem.sciences-po.fr/content/publications/pdf/Atkinson_Taking_advantage0906.pdf.

treatment when the public good they provide is limited.

Similarly, the argument for greater deference makes less sense under an income measurement theory. First, it must be noted that the actual merit of the income measurement test has been questioned. For example, law and economics theorists claim that non-profit organizations can accurately be calculated, and they are exempt from taxes because they lack access to equity capital.⁵⁵ Second, if non-profit organizations receive favorable tax treatment simply because it would be difficult to compute the taxes, it seems that the favorable treatment should be less absolute.

Regardless of what the reasoning is behind the existence of non-profit organizations and the rationale behind granting them favorable legal treatment, these privileges should not be absolute. Far from the ideas of the public benefit theorists, abuse within non-profit organizations is rampant.⁵⁶ In fact, non-profit organizations are often created and operated for tax benefits and they may even go so far as engaging in fraud.⁵⁷ While is undeniable that non-profit organizations as a whole provide *some* public good, regulations must be tailored and adjusted to limit abuse. Although certain tax exemptions and favorable legal treatment can assist non-profit organizations conduct their operations, they must understand that these benefits are a privilege rather than a right. Instead of focusing on the charitable and voluntary nature of non-profit organizations and their officers, we should concentrate on the actions. Because of the large presence of non-profit organizations in our society and their potential for abuse, we should be willing to hold non-profits organizations and even their officers liable for their actions.

III. ANALYSIS

A. DO "VOLUNTEERS" HAVE ANY DUTIES?

A problematic concept in the regulation of non-profit organizations revolves around the common misunderstanding that directors and officers on non-profit boards are essentially "volunteers." As the baby boomer generation reaches retirement age, it has been noted that it will be increasingly important to attract *and* retain highly skilled workers in all sectors, but especially in the non-profit industry.⁵⁸ In fact, both Lynda

55. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 *Yale L. J.* 54, 72-75 (1981).

56. Albert B. Crenshaw, *Tax Abuse Rampant in Nonprofits, IRS Says*, WASHINGTON POST, at E01, (Apr. 5, 2005), available at <http://www.washingtonpost.com/wp-dyn/articles/A26388-2005Apr4.html>.

57. *Id.*

58. Ron Saunders, *Passion and Commitment Under Stress: Human Resource Issues in Canada's*

Ducharme, president of Ducharme Group Inc., an executive non-profit recruiting agency, and Karen Iddon, national director of human resources for the Canadian Red Cross Society, recognize that there is already significant competition to attract top talent in the sector.⁵⁹ While talented individuals *are* attracted to the flexibility, goals, and challenges available at non-profit organizations, a huge obstacle to overcome is that senior level executives in the non-profit sector can take a 50 percent pay cut and still be considered to be near the top of the non-profit salary range.⁶⁰ Additionally, directors and non-profit officers face virtually the same exposure to lawsuits as directors and officers of for profit corporations.⁶¹ Because the compensation for such non-profit positions is not proportional to the potential liability, this can only result in more ineffective directors.⁶²

Because there are few standards by which to measure the success of a non-profit organization, it is difficult to govern non-profit officers and directors.⁶³ Unlike a business corporation, there are no bottom line profit margins or returns on investment that must be met.⁶⁴ Although the results and effectiveness of non-profit organizations are intangible and difficult to quantify, officers and directors must act in the best interests of the organization and be cognizant of their duties.⁶⁵ Regardless of whether or not non-profit officers and directors are “volunteers,” their actions must conform to generally accepted codes of conduct.

In California, the corporate code requires that each corporation have a board of directors that conducts the activities and affairs of the corporation.⁶⁶ However, the California Legislature recognizes the importance of the services provided by directors and officers of non-profit corporations who work without compensation.⁶⁷ Because of the unavailability and high cost of appropriate liability insurance, California finds that public policy requires incentives and protection for these individuals to perform important functions at non-profit organizations.⁶⁸ Consequently, the corporate code generally disallows any cause of action

Non-profit Sector, available at <http://www.cprm.org/doc.cfm?doc=504&l=en>.

59. Louise Chatterton Luchuk, *Attracting Top Talent in the Non-profit Sector*, CHARITY VILLAGE NEWSWEEK, (Aug. 23, 2004), available at <http://www.charityvillage.com/cv/archive/acov/acov04/acov0426.html>.

60. *Id.*

61. See *Volunteers Insurance Service*, at <http://www.cimaworld.com/htdocs/d&o.cfm>.

62. Karen Leigh Chapman, *Statutory Responses to Boardroom Fears*, 1987 COLUM. BUS. L. REV. 749, 750 (1987).

63. See Thompson & Thompson, *The Key to Non-profit Governance, Part 2*, at <http://www.ttlaw.com/np-02a.htm>.

64. *Id.*

65. *Id.*

66. CAL. CORP. CODE § 5210 (West 2007)

67. CAL. CORP. CODE § 5047.5(a) (West 2008)

68. *Id.*

for monetary damages against any person serving without compensation as a director or officer of a non-profit corporation.⁶⁹ This generally applies to damages as a result of negligent acts or omissions, given the individual was working within the scope of their duties as a director or officer in their official capacities, in good faith, in a manner they believe to be in the best interests of the corporation, and in the exercise of their policy making judgment.⁷⁰ This immunity is *not* absolute however, and does not limit the liability of a director or officer for abuses of power that include self dealing, conflicts of interest, intentional, wanton, or reckless acts, gross negligence, actions based on fraud, oppression, or malice.⁷¹ Additionally, any duties and liabilities set forth in the “standards of conduct” portion of the California Corporations Code apply *without* regard to whether a director is compensated by the corporation.⁷²

The Revised Model Nonprofit Corporation Act expressly recommends that states adopt generally accepted standards of conduct for both non-profit directors and officers.⁷³ These recommendations are similar to the California law and include the duty of care, the duty of loyalty and the duty of obedience.⁷⁴ The California Corporations Code explains that this requires a director to perform their duties in good faith and in a manner that they believe to be in the best interest of the corporation.⁷⁵ Additionally, the duty of care requires a director to use the same care that an ordinarily prudent person in a like position would exercise in similar circumstances.⁷⁶ A director or officer can violate their duty of care by either failing to supervise the corporation or failing to make an informed decision.⁷⁷ In determining whether a director violated their duty of care, we must first ask whether they acted with sufficient care in reaching their decision.⁷⁸ Next, we must make a substantive assessment to see if the decision was so “rash as to warrant being set aside or imposing personal liability on the directors.”⁷⁹ In the non-profit context, a director may rely on the business judgment rule, also known as the best judgment rule.⁸⁰ This rule allows a director to avoid both judicial inquiry and liability if the action taken was an informed decision made without violating a conflict of interest.⁸¹

69. CAL. CORP. CODE § 5047.5(b).

70. *Id.*

71. CAL. CORP. CODE § 5047.5(c).

72. CAL. CORP. CODE § 5230 (West 2008).

73. *The Key to Non-profit Governance*, *supra* note 63.

74. *Id.*

75. CAL. CORP. CODE § 5231(a) (West 2008).

76. *Id.*

77. FISHMAN & SCHWARZ, *supra* note 1, at 151.

78. *Id.*

79. *Id.* at 152.

80. *Id.* at 168.

81. *Id.*

Next, directors and officers must respect their duty of loyalty. This duty requires directors to avoid using their position in the non-profit organization to unlawfully obtain a personal benefit or advantage, which might more properly belong to the non-profit organization.⁸² This is codified in a variety of sections of the California Corporate Code, including provisions that disallow self dealing transactions between the corporation and another party, where one or more of the directors have a material financial interest.⁸³ Essentially, the duty of loyalty requires directors to place the interests of the corporation ahead of their own personal gains.⁸⁴ In determining whether an officer or director should be held liable for violating their duty of loyalty, it is necessary to analyze whether the corporate procedural requirements for interested transactions were followed.⁸⁵ Additional factors that will be considered are the extent of disclosure, whether the decision was impartially made, and whether the interests of the director were disclosed to the relevant decision makers.⁸⁶

Finally, a director or officer must also fulfill their duty of obedience. The duty of obedience requires that directors and officers follow and carry out the mission of the organizations.⁸⁷ Unless allowed by the law, the *ultra vires* doctrine states that a director cannot deviate in “any substantial way” from the duty to fulfill the particular purposes of the organization.⁸⁸ Under the Model Nonprofit Corporate Act, a director may be exposed to liability if they enter into or complete an *ultra vires* transaction.⁸⁹ The duty of obedience is especially important in the non-profit sector, because unlike for-profit corporations, non-profit organizations are defined by their specific objectives.⁹⁰

B. THE CEMENT-LOCK MISTAKE

The problems involved regarding non-profit corporations and their for-profit subsidiaries are exemplified in *Cement-Lock v. Gas Technology Institute*.⁹¹ By using the facts of this case as a model, we will be able to better analyze the duties and liabilities of non-profit directors and officers.

82. *Id.* at 176.

83. CAL. CORP. CODE § 5233 (West 2008).

84. FISHMAN & SCHWARZ, *supra* note 1, at 176.

85. *Id.* at 179.

86. *Id.*

87. *Id.* at 219.

88. *Id.*

89. REV. MODEL NONPROFIT CORP. ACT § 3.04(c) (1987).

90. FISHMAN & SCHWARZ, *supra* note 1, at 220.

91. *Cement-Lock v. Gas Tech. Inst.*, No. 05 C 0018, 2007 WL 4246888, at *1 (N.D. Ill. November 30, 2007).

In this current case, a Federal District Court in Illinois has refused to dismiss a case involving a non-profit corporation's breach of fiduciary duty by their for-profit subsidiary.⁹² This case is centered on a number of fraud and racketeering claims arising from a failed effort to commercialize a technological process that converts waste into a beneficial cement additive.⁹³ The Institute for Gas Technology ("IGT") is a non-profit corporation that is involved in research in both natural gas and related projects.⁹⁴ Endesco Services, Inc. ("ESI") is a wholly owned subsidiary of IGT that has a stated mission to "design, construct, and operate a 100,000 ton cement manufacturing facility to process contaminated harbor sediment from the New York/New Jersey harbor area using the propriety Cement-Lock Technology of the Institute of Gas Technology."⁹⁵ ESI was a member of the Cement-Lock Group ("CLG"), which owned the intellectual property rights to that process.⁹⁶ Among other things, other members of CLG filed a derivative suit on behalf of CLG and argued that ESI has breached their fiduciary duty to CLG.⁹⁷ Because of this breach, CLG argues that they should be able to pierce the corporate veil to impose liability on IGT.⁹⁸

Since ESI is a wholly owned subsidiary of IGT, IGT would be bound by fiduciary duties to CLG *only* if it would be appropriate to pierce the corporate veil between ESI and IGT.⁹⁹ Under Illinois law, this can only happen when a two part test is satisfied.¹⁰⁰ First, "there must be such unity of interest and ownership that the separate personalities of the corporation and the individual or other corporation no longer exist."¹⁰¹ Second, "circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice."¹⁰²

In determining if there is a unity of interest and ownership, Illinois law focuses on four factors.¹⁰³ These include the failure to maintain adequate records or abide by corporate formalities, the mixing of funds and assets, undercapitalization, and one corporation treating the assets of

92. Don Kramer, *Court Refuses to Dismiss Effort to Pierce Corporate Veil*, NONPROFIT ISSUES, (Nov. 1-30, 2007), available at <http://www.nonprofitissues.com/public/features/lead/2007nov1-IS-4.html> (subscription required).

93. *Id.*

94. *Cement-Lock*, 2007 WL 4246888, at *4.

95. *Id.* at *6.

96. *Id.* at *3.

97. *Id.* at *28.

98. *Id.* at *44.

99. *Id.* at *40

100. *Id.*

101. *Id.* at *40-41.

102. *Id.* at *41.

103. *Id.*

another as if they were its own.¹⁰⁴

In *Cement-Lock*, the issues are complicated by the fact that there was evidence of unacceptable conduct on the part of IGT in their operation and control of ESI. The Illinois court recognized that “the mere fact that ESI is a subsidiary of IGT is not sufficient to meet the test for piercing.”¹⁰⁵ Additionally, a parent corporation is generally free from the liable acts of its subsidiaries.¹⁰⁶ However, in this case, there was no evidence that ESI ever held any board meetings whatsoever.¹⁰⁷ What was even more deplorable was that Borys, the person who signed CLG Unanimous Written Consents, did not even know whether they were signing on behalf of IGT or ESI.¹⁰⁸ Other factors that gave the appearance of mismanagement included the fact that ESI was thinly capitalized and there was an “utter lack of documentation” of *any* corporate formalities.¹⁰⁹ At this stage, this evidence suggests that the Plaintiffs will be able to show a unity of interest and ownership.¹¹⁰ Because a reasonable fact-finder could determine that ESI was intended to insulate IGT from fiduciary obligations to CLG, the jury is entitled to determine if ESI’s corporate veil should be pierced.¹¹¹

C. CAN AND SHOULD THE CORPORATE VEIL BE PIERCED IN *CEMENT-LOCK* SITUATIONS?

In determining if a non-profit corporation like IGT should be liable for actions of its for-profit subsidiaries, we must analyze a number of other issues. First, it is necessary to determine if an operation of a for-profit subsidiary by a non-profit corporation is permissible. Section 502 of the Internal Revenue Code generally states that an organization that is operated with a primary purpose of carrying on a trade or business for profit shall not enjoy tax exempt status merely because all of its profits are payable to one or more tax exempt organizations.¹¹² However, it is not unusual for a non-profit organization to have a subsidiary that is a for-profit corporation.¹¹³ Generally, there is no problem with this arrangement as long as the non-profit organization owns 100 percent of the subsidiary

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.* at *43.

108. *Id.*

109. *Id.* at *43-44.

110. *Id.*

111. *Id.* at *44-45.

112. 26 C.F.R. § 1.502 (2008).

113. Don Kramer, *Can a 501(c)(3)(c) Charity (a hospital) Have a For-Profit Subsidiary That is Taxed as a “C” Corporation?*, NONPROFIT ISSUES, at <http://www.nonprofitissues.com/public/features/point/257.html>.

stock.¹¹⁴ Although there are no bright line tests of to what extent a non-profit organization can carry on commercial activity without jeopardizing their tax exempt status, there are regulations that provide that the articles of incorporation of a non-profit may not expressly empower them to engage in more than an “insubstantial part” of unrelated activities that do not further their exempt purposes.¹¹⁵ For the sake of argument, let us assume that non-profit organizations in the *Cement-Lock* type situations are allowed to own their for-profit subsidiaries without losing their tax exempt status.

Next, we must analyze the remedy of piercing the corporate veil. A corporation generally exists as a separate entity, in a state that is independent of its owners.¹¹⁶ Generally, a corporation’s separate legal existence insulates its shareholders from liability.¹¹⁷ Through the legal fiction of a corporation, a shareholder can reduce the amount of liabilities to the amount of their investments, and not for the debts of the individual corporation.¹¹⁸ Piercing the corporate veil is the most radical form of shareholder liability.¹¹⁹ In causes of creditor protection, the court may set aside the entity status of the corporation and hold its shareholders directly liable for contract or tort obligations.¹²⁰ However, courts will only pierce the corporate veil in unusual circumstances, including the prevention of fraud, to promote equity, to prevent the violation of law, or to promote public policy.¹²¹ Because of the extreme nature of piercing the corporate veil, courts will generally only apply the doctrine in cases where corporate actors misuse the corporate form for their own personal gain, rather than the business of the corporation.¹²²

To determine whether the corporate veil should be pierced, courts have come up with a number of tests that primarily focuses on the relationship between the controlling persons of the corporation and the corporation itself. The first of these tests is the Alter Ego test. Under the Alter Ego test, the separate existence of a corporation will not be respected if a controlling person can exercise so much influence over the corporation that there is a unity of both ownership and interest.¹²³ Additionally, the Alter Ego test will allow the piercing of the corporate veil if adhering to the legal fiction of a separate entity would perpetuate a fraud or promote

114. *Id.*

115. 26 C.F.R. § 1.501(c)(3)-1(b)(1)(i) (2008).

116. Mathew D. Caudill, *Piercing the Corporate Veil of a New York Not-for-profit Corporation*, 8 FORDHAM J. CORP. & FIN. L. 449, 463 (2003).

117. *Id.*

118. *Id.*

119. WILLIAM ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 151 (2d ed. 2007).

120. *Id.*

121. Caudill, *supra* note 116, at 463.

122. *Id.*

123. *Id.* at 464.

injustice.¹²⁴ The rationale surrounding the Alter Ego test is: if a shareholder does not respect the boundaries of a corporation as a separate legal entity, neither will the laws.¹²⁵

The second test is the Instrumentality test. Under the Instrumentality test, the corporate veil will be pierced between a parent corporation and a subsidiary if there was complete dominion over a transaction to the extent that the subsidiary had no will or existence of its own.¹²⁶ Additionally, it must be shown that the defendant used such dominion to commit fraud or some wrong, and the dominion was the proximate cause of the loss or unjust injury.¹²⁷

The third test is the Equity test. Courts who are dissatisfied with both the Alter Ego and Instrumentality test have created their own equitable tests that focus on the particular factors of a case.¹²⁸ These factors include undercapitalization, failure to observe the formalities of corporate existence, nonpayment or overpayment of dividends, misuse of funds, and guarantees for corporate liability by the majority shareholders.¹²⁹

Finally, courts have also pierced the corporate veil in instances where the defendants have utilized the corporate form to violate laws, perpetuate fraud, or other public policies.¹³⁰

In analyzing whether we can pierce the veil of a non-profit corporation for the actions of a for profit subsidiary, we must determine whether the piercing doctrine is applicable to non-profit organizations. In *Macaluso v. Jenkins*, an Illinois appellate court held that a non-profit organization *could* have their corporate veil pierced as an equitable remedy.¹³¹ In *Macaluso*, the defendant used the non-profit corporation for his own personal gain and controlled its funds for his own personal use.¹³² The court held that the defendant *could* be held personally liable for the debts of the non-profit if it can be shown that she fraudulently made misrepresentations, misappropriated funds, or violated a fiduciary duty through gross negligence.¹³³

In the *Cement-Lock* scenario, it seems apparent that the corporate veil *can* and *should* be pierced. First, under the Instrumentality test, it is apparent that IGT exercised control over their for-profit subsidiary.

124. *Id.*

125. *Id.* at 465.

126. *Id.*

127. *Id.*

128. *Id.* at 466.

129. *Id.*

130. *Id.*

131. *Macaluso v. Jenkins*, 95 Ill. App. 3d 461, 469 (1981).

132. *Id.* at 463.

133. *Id.* at 469.

However, it is questionable whether IGT used their dominion over ESI to commit fraud or some wrong. Here, it is clear that exercising ownership over a subsidiary is not enough to justify piercing the corporate veil. Additionally, the fact that IGT handled and completed the financial documents of ESI is not in itself conclusive.

What we must rely on in order to pierce the corporate veil between IGT and ESI is the Equity test. It is apparent that the corporate formalities were almost completely disregarded by IGT. There was no evidence that there had ever been any board meetings, there was a lack of documentation, there was undercapitalization, and even officers of IGT were unclear about the relationship between ESI and CLG.

IV. CONCLUSION

Although the *Cement-Lock* scenario involves many different players and confusing transactions, it exemplifies that corporate formalities must be followed. Regardless of the fact that IGT is a non-profit corporation and ESI is supposed to be shielded from liability through incorporation, insulation from liabilities will not necessarily follow unless the separate legal status of subsidiaries are respected. Unless both parent and subsidiary companies have been following the rules all along, courts may be reluctant to respect the legal fiction behind treating corporations as a separate entity.

Generally, non-profit corporations must be careful to conduct the business of their for-profit subsidiaries in a manner that respects their independent status. Although non-profit organizations are generally given favorable legal treatment, this should not act as a shield against liability in all instances. When the favorable statuses of non-profit organizations have been misused to inure personal or inappropriate gains, those favorable laws should no longer insulate defendants from liability. The issue is complicated however, by the fact that non-profit directors and officers are often viewed as “volunteers.” Regardless of whether or not non-profit officers are volunteering their time to promote public good, they should not be granted a total shield from liabilities. Instead, the courts should look at the control that these individuals exercise over the organization. In instances where non-profit directors and officers are using the non-profit organization for their own personal gain, they have violated their duty of obedience and duty of loyalty. Additionally, the other board members who have been ignorant of the problem or have refused to resolve it are guilty of violating their duty of care.

Because the remedy of piercing the corporate veil of a non-profit corporation is extremely severe, it should only be used in the most egregious cases. It is undeniable that non-profit organizations provide

countless services for the public. Additionally, it has become increasingly difficult to attract and maintain qualified officers. By imposing severe punishment for non-profit directors and officers, the courts can essentially deter talented individuals from entering the non-profit sector. In analyzing the issue of whether or not to pierce the corporate veil of a non-profit organization, I would suggest the court look beyond the basic standards for piercing the veil of a typical corporation. The courts should also consider whether the non-profit organization itself should be held liable or whether it would be sufficient to punish the individuals who were committing the crimes.

Unfortunately, non-profit organizations are difficult to regulate. Because non-profit organizations do not have shareholders, there are only a limited number of people who ensure they fulfill their stated purposes. Although the Attorney General is responsible for enforcing non-profit activities, the utter lack of resources provides huge potential for misuse. While the media does provide a watchful eye, it is often difficult to uncover schemes where the non-profit status of an organization is being abused.

What I would suggest is a process of verification that holds directors and officers of non-profit organizations responsible for the transactions that occur under their control. By doing so, it ensures that officers and directors pay attention to the activities of the organization and fulfill their duty of obedience. Furthermore, to make sure this does not discourage individuals from entering the non-profit sector, I would suggest that there be a presumption against personal liability. However, this presumption *should* be able to be overcome if a director or officer fails to observe or regulate the activities of the non-profit in gross negligence. Through this process, non-profit directors and officers can enjoy a buffer zone of liability without jeopardizing the presence and status of non-profit organizations in our society.

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