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UNAFFILIATE THE AFFILIATED: LIABILITY CONSIDERATIONS FOR MULTI-ENTITY BUSINESSES

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Creating a robust business profile of multiple legal entities is a foundational strategy for asset protection and risk management within a larger affiliated business group.

This practice, often referred to as corporate structuring, works by establishing legal barriers (as separate legal entities) between various operational units, thereby isolating the liabilities and risks of one entity from the assets of another. By preventing cross-contamination of liability among entities, such as a lawsuit against a high-risk business practice, this technique operates to safeguard core assets in certain entities and ensure the financial stability of the entire organization. However, creating a separate legal entity alone will not provide adequate protection to prevent the potential imputation of liability from an affiliate.

This article will discuss the strategies to deploy to ensure that affiliated entities are sufficiently separate to ensure an effective corporate structure.

Structuring in General

A proper multi-entity structure can be achieved through creating, combining, or shifting multiple legal entities (such as corporations and LLCs) and operating those entities as separate and distinct. Effective structuring can operate to protect an organization's assets from exposure to the liabilities, lawsuits, and debts of related legal entities. This practice is also useful in establishing a clear framework for management, reporting structures, and proper corporate governance.

Creating a corporate structure with multiple legal entities is best suited for organizations with distinct and self-sufficient business units, divisions, and/or leadership. The practice can also be used in cases where there are certain business activities that are inherently riskier than the remainder of the business. These scenarios are ripe for a comprehensive corporate structure where certain activities can be ringfenced into a standalone entity. There are some potential downsides, such as the added cost and effort to maintain separate entities, but this is often outweighed by the added asset protection.

Creating an Effective Structure

In the U.S., whether you are a small business or multi-national corporation, operating through a legal entity creates a presumption of *limited liability* intended to shield owners and affiliates from liability stemming from activities within that entity. In order to achieve this limited liability with multiple legal entities, your organization must first create an effective legal entity structure, and then maintain that separate structure by following applicable legal principles.

Below are common structuring principles and best practices to prevent cross-contamination of liability, often referred to as horizontal liability, between affiliated entities.

Observe and comply with corporate formalities.

- File an organizational record (e.g., certificate of formation) with a state's Department of State to form the legal entity.
- Adopt governance documents, such as bylaws and operating agreements, issuing stock or membership certificates, and otherwise ensuring that each entity's equity rights are properly memorialized.
- Follow proper governance requirements under applicable law and the entity's formation documents, such as by holding annual board meetings and memorializing resolutions.

Ensure the legal entities operate separately in practice.

- Maintain an independent board of directors and officers.
- Maintain separate books and records, utilizing separate bank accounts, and filing separate tax returns.
- Adopting and enforcing separate internal policies.
- Maintaining separate offices, telephone numbers, and emails.
- Contracting with vendors/customers through separate agreements.
- Hold each entity out to the public as separate and distinct.

Maintain arms' length transactions between affiliated entities.

- Properly document all intercompany transfers of money and assets, including loans from one entity to another.
- Hire employees into the distinct entity that they will support, and compensating them through revenue generated by such entity.
- Adopt a document dissemination policy and communication strategy for the transfer of records and discussions among entities.

Because each state has specific rules defining these principles, you should consult your legal advisor to establish the required practices in your jurisdiction.

Piercing the Corporate Veil

If the above structuring principles are not followed by your multi-entity organization, the affiliated entities could be implicated in disputes and required to cover liabilities and debts of a related entity. This is often referred to as ***piercing the corporate veil***, whereby a court, under the ***enterprise liability doctrine*** or ***alter ego theory***, could find an entity liable for the actions and liabilities of a parent or affiliate.

In Pennsylvania, in an affiliated entity relationship, the corporate veil may be pierced if one entity is essentially making all decisions of the other entity. In other words, if a court deems one entity a "sham corporation," or a mere instrumentality of the other entity, the limited liability protections may be put aside. Following other jurisdictions, the Pennsylvania Supreme Court has recognized the enterprise liability doctrine, which expressly permits pursuing affiliated or "sister" entities for liability of a related entity if certain facts are present.

In making these determinations, courts will often analyze: (i) if common ownership and interest is present; (ii) whether one entity was grossly undercapitalized; (iii) if corporate formalities were not observed; (iv) whether the entities intermingled funds; (v) whether officers and directors of an entity were functioning in their applicable roles; (vi) whether individuals are holding themselves out as agents of multiple entities; and (vii) ultimately, whether a finding of fraud or fundamental unfairness is required.

The cardinal rule is to ensure that your organization is not only creating an effective structure, but also maintaining that structure through continued compliance with these practices.

Evaluation on a Spectrum

While adherence to all structuring principles may be essential to safeguard against veil-piercing claims, the failure to meet a single factor does not necessarily compromise the group's overall protection. Courts assess a non-exhaustive list of factors and evaluate the facts and circumstances of each case to determine whether an organization has maintained its entities as sufficiently separate and distinct. As such, compliance may be viewed on a spectrum, whereby forming a separate entity, in itself, is insufficient to establish a robust multi-entity structure; however, having more and more of the relevant factors will bolster a case against veil-piercing claims.

To mitigate potential claims, organizations should routinely review their practices against the structuring principles.

Summary

Overall, multi-entity structuring is a valuable tool to maximize liability protection, silo riskier business activities, and protect assets across an organizational structure.

Although the principles are widely regarded, the specific rules vary across state and international borders, and you should consult with your legal and tax advisors to properly structure and maintain these practices.

Chase Wright and the RCCB Team are here to help advise through these considerations.

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