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# REPORT BY THE CORPORATION LAW COMMITTEE

## REPORT IN SUPPORT OF PROPOSAL BY THE JOINT LEGISLATIVE COMMITTEE OF THE BUSINESS LAW SECTION AND THE INTERNATIONAL LAW SECTION OF THE NEW YORK STATE BAR ASSOCIATION TO REPEAL VEIL PIERCING LEGISLATION

The Corporation Law Committee of the New York City Bar Association (the "Committee") supports the efforts of the Joint Legislative Committee of the Business Law Section and the International Law Section of the New York State Bar Association ("NYSBA") to repeal Section 630 of the New York Business Corporation Law ("BCL") and to repeal subdivisions (c) and (d) of Section 609 of the New York Limited Liability Company Law (the "LLCL") (collectively, the "Veil Piercing Legislation"). The Committee believes that the Veil Piercing Legislation, including recent expansions of BCL 630 to apply to foreign corporations (the "Expansion"),[1] is inadvisable for a variety of policy reasons and likely conflicts with the United States Constitution. The Committee believes that the policy rationales in favor of the Veil Piercing Legislation do not justify the reputational harm to New York as a place for doing business nor the risk of unconstitutionality. Accordingly, we urge the repeal of the Veil Piercing Legislation for many of the reasons articulated by the NYSBA Joint Legislative Committee and for the reasons set out below.

## INTRODUCTION

Under Section 630 of the BCL, the ten largest shareholders of a closely held New York corporation are jointly and severally personally liable for employee wages and, pursuant to the Expansion, shareholders of closely held corporations formed in other states and qualified to do business in New York State are personally liable for unpaid services performed in New York State. Similarly, under Section 609 of the LLCL, the ten members of a limited liability company in New York State with the largest percentage ownership interest of that company are personally liable for wages and salaries of employees. These provisions, which eviscerate traditional and widely expected notions of limited liability for equity investors, are widely divergent from investment practices throughout the rest of the United States, and make New York a particularly unattractive jurisdiction in which to incorporate or retain employees.

## POLICY CONCERNS

For decades, legal scholars and practitioners have pointed to BCL 630 as a primary reason that New York has failed to keep up with Delaware and other states in the competitive

[1] A.B. A737, 2015-2016 Leg., Reg. Session (N.Y. 2015); S.B. 4476, 2015-2016 Leg., Reg. Session (N.Y. 2015).

market for business incorporations.[2] Corporate and limited liability company investors demand and expect that the only money at risk in an investment is the money that is actually invested. Indeed, limited liability for shareholders is *the* hallmark feature of the corporate business organization.[3] The Committee believes that the Veil Piercing Legislation has done a disservice to the development of a corporate law regime that would attract investment, business and employment to New York.

The Committee believes that the Veil Piercing Legislation is an anachronism and extremely uncommon in American corporation law, and does not square with New York corporate law principles. Corporate piercing is not taken lightly in New York, and generally requires a showing of (1) domination by the shareholder in respect of a problematic action and (2) some fraud or wrong against a plaintiff.[4] The Veil Piercing Legislation holds shareholders liable for unpaid wages without regard to whether that shareholder exerted even a modicum of control over the business that led to that outcome. This is completely at odds with well-settled principles of New York corporation law.

At a time where New York State is heavily promoting incentives encouraging companies to move businesses into the State, expanding rather than eliminating the Achilles heel of its business corporation law moved New York farther from achieving its goal. The Committee believes that despite attractive tax breaks and cash incentives offered to New York incorporated and located businesses, companies will avoid New York to protect their investors from a legal regime of unlimited liability. An unknown amount of unlimited liability is simply a non-starter for sophisticated business investors. In turn, the Veil Piercing Legislation means real dollars lost to New York, in the form of lost corporate filing fees, taxes, unclaimed property, professional service fees and other losses to New York coffers from corporations that have incorporated elsewhere to avoid the Veil Piercing Legislation.

The Committee's membership includes lawyers that are actively involved in advising new and established businesses, including in matters concerning where a business should be

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[2] *See* Dominic Bencivenga, *At Long Last, a Bill*, N.Y. L.J., July 31, 1997, at 5 ("As long as 630 is in there, it serves as a sign that New York corporate law is still a step behind."); Renee L. Crean, *Has New York Effectively Challenged Delaware's Market Dominance With Recent Amendments to the New York Business Corporation Law?*, 72 ST. JOHN'S L. REV. 695, 718 (2012) (describing BCL 630 as the "most troublesome provision of the BCL, the epitome of New York's legislative failings"); *id.* at 719 ("Irrespective of the advancements made by the recent amendments to the BCL, this partial eradication of limited liability will dissuade private corporations from choosing New York as their domicile.").

[3] Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1039 (1991) ("A fundamental principle of corporate law is that shareholders in a corporation are not liable for the obligations of the enterprise beyond the capital that they contribute in exchange for their shares. . . . Without limited liability, the risk each investor would face in investing in an enterprise would turn in part on the wealth of other investors. Such a system would have search costs and other costs which would likely lead investors to make a few larger investments where risk-assessment information was accessible, and perhaps entail a reduced level of economic activity across the entire economy.").

[4] *Morris* v. *New York State Department of Taxation & Finance*, 623 N.E.2d 1157, 1161 (N.Y. 1993) ("The party seeking to pierce the corporate veil must establish that the owners, through their domination, abused the privilege of doing business in the corporate form to perpetrate a wrong or injustice against the party such that a court in equity will intervene.").

organized or domiciled. In light of the Veil Piercing Legislation, we have found that New York legal practitioners often cannot justify advising a client that it is in its best interest to form a New York business entity. The legal community is adversely affected by this reality, often having to keep up with corporation law developments in other states, rather than facilitating and promoting developments in New York corporation law. Additionally, the Internet has made it easier for companies to be formed without the aid of a lawyer; one publicly available book mentions as a consideration on where to incorporate to "what extent … incorporators enjoy limited liability," and cites New York's BCL 630 as an example of a statute that diminishes this benefit.[5] Risk-averse companies and investors can be expected to heed this formal and informal advice.

The sponsor statement for the recent Expansion of BCL 630 indicated the following expected fiscal implications: "There will be no costs to the State. Instead, it is expected that the bill will encourage more corporations to be formed in New York rather than in foreign jurisdictions by eliminating a disincentive to be incorporated in New York." Thus the legislature is clearly aware that this particular feature of New York business corporation law has been disincentivizing companies from incorporating in New York. Confusingly, rather than eliminating this disincentive, the legislature chose to broaden the reach of the disincentive not only to corporations that are incorporated in New York, but to foreign corporations that do business in New York. The Committee does not believe that treating foreign and New York corporations in an equally unusual manner will promote incorporation or business in New York. To the contrary, the Committee believes this expansion to the already rare approach to limited liability will further reduce investors' and entrepreneurs' willingness to have ties to New York.

Nor does the Expansion help in its purported efforts to protect New York employees. The sponsor statement mentions the "anomaly in which the wages of two employees working side by side are treated differently with respect to their remedies for unpaid wages depending on which corporation employs them and whether the corporation is foreign or domestic." By purporting to fix this "anomaly," and subject investors in foreign corporations to the veil-piercing wage laws, the Expansion has created a strong incentive for a corporation to reduce, if not eliminate, the number of people employed in New York. The Committee believes that the legislature should reconsider the balance of interests concerning the Veil Piercing Legislation and conclude that eliminating such legislation will better serve New York constituents as a whole.

## CONSTITUTIONAL CONCERNS

More than making for poor policy, the constitutionality of the recent Expansion is uncertain. The Committee believes that the Expansion is problematic under the "dormant Commerce Clause" doctrine, which invalidates state laws that place impermissible burdens on interstate commerce.[6] The Supreme Court has long recognized that "only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, *and shareholders* – because

[5] DAVID MINARS, CORPORATIONS STEP-BY-STEP 18 (2003).

[6] *Dep't of Revenue of Ky.* v. *Davis*, 553 U.S. 328, 338-39 (2008).

otherwise a corporation could be faced with conflicting demands."[7] Application of the law of the state of incorporation alone to a corporation's internal affairs achieves "the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation."[8] Little, if anything, is as fundamental to the internal affairs of a corporation as the liability relationship between the shareholders and the corporate entity. Subjecting foreign corporations to New York's veil-piercing regime, when such regime directly conflicts with the internal affairs of the corporation as established by the corporation's state of incorporation, contravenes these well-settled principles of constitutional law.[9] So too may conditioning the right to "do business" in New York on consent to unlimited liability pose an unconstitutional undue burden on interstate commerce.

Further, the Committee is troubled that the Veil Piercing Legislation may infringe on due process rights of shareholders. The Fourteenth Amendment's Due Process Clause protects the right of every person to "fair notice" of both "the conduct that will subject [them] to punishment" and "also of the severity of the penalty."[10] No less than others, a corporation's shareholders are entitled to fair notice of what law will govern their relationships and of the liabilities and the penalties that will attach to a violation. An investor investing in a foreign corporation will expect that certain corporate formalities will be honored in accordance with the law of the state of incorporation. Such investor may have no control, and often has no knowledge, of whether such corporation does business in New York. Nor does an investor typically have clear visibility into whether or not it is a top-ten shareholder in a corporation or one of ten largest members in a limited liability company. Investments in companies are fluid to meet the changing needs of a business; thus even the smallest investment in a company may hit the top-ten mark. Accordingly, the Veil Piercing Legislation, as applied to foreign corporations, may not offer fair notice to investing shareholders that more than their invested capital may be at risk.

**CONCLUSION**

The Committee believes that the adverse policy consequences and shaky constitutional footing of the Veil Piercing Legislation favor its repeal. The Committee joins the NYSBA Joint Legislative Committee in opposing the extension of personal liability for wages under BCL 630 to foreign corporations qualified in New York and supporting the repeal of the Veil Piercing Legislation in its entirety.

Corporation Law Committee
David M. Silk, Chair

January 2016

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[7] *Edgar* v. *MITE Corp.*, 457 U.S. 624, 645 (1982) (emphasis added).

[8] *First Nat'l City Bank* v. *Banco Para el Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983).

[9] *CTS Corp.* v. *Dynamics Corp. of Am.*, 481 U.S. 69, 90 (1987) (expressing that our free market system "depends at its core upon the fact that a corporation – except in the rarest situations – is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation").

[10] *BMW of N. Am., Inc.* v. *Gore*, 517 U.S. 559, 574 (1996).