

News & Types: Corporate, Finance & Acquisitions Update

Business Update: Action to "Pierce Corporate Veil" Fails – Another Creditor Spurned

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Practices: Corporate, Finance & Acquisitions, Litigation

The 7th Circuit has again left a disappointed creditor with no recourse because of the creditor's failure to do basic investigation or take steps to protect itself. (On Command Video Corporation vs. Samuel J. Roti, Nos. 12-1351 and 12-1430, January 14, 2013). This case follows other cases in which the 7th Circuit has shown itself decidedly unfriendly to creditors who sought compensation through the courts in failed business ventures but could have, but failed, to prevent their unfortunate situation.

On Command Video (OCV) supplies in-room entertainment in hotels, motels and resorts. It is a large company, selling its video services to thousands of hotels, motels and resorts. One of its customers was a Holiday Inn near Chicago. The Holiday Inn was owned by Markwell Hillside which, in turn, was owned by Samuel Roti. OCV had supplied video services to the hotel's previous owner and continued to do so after Markwell Hillside's acquisition in 2002.

In 2004, OCV asked for a new contract because it was changing to a new system. What followed was a monumental misunderstanding. OCV was apparently unaware of the acquisition of the hotel by Markwell Hillside. So it performed a credit check on the former owner, which had been dissolved. Finding nothing, OCV contacted the hotel manager that there was a problem. The hotel manager understood that OCV did not want Markwell Hillside as the counterparty. So Markwell Properties, also owned by Mr. Roti, was substituted for Markwell Hillside. But Markwell Properties did not own the hotel and, in fact, had only leased some vans to the hotel. Mr. Roti used Markwell Properties to shield Markwell Hillside from liability in case the vans had an accident. Otherwise Markwell Properties had no assets.

Remarkably, OCV did not run a credit check on Markwell Properties or even ask Mr. Roti about Markwell Properties. OCV only confirmed that Markwell Properties was in good standing in the State of Illinois. OCV continued to send invoices to the hotel, rather than to Markwell Hillside or Markwell Properties. The checks were paid by Markwell Hillside which OCV apparently failed to notice was not the party to the contract.

Only a few days after Markwell Properties signed the contract with OCV, Markwell Hillside (the owner of the hotel) filed for bankruptcy. Nevertheless, Markwell Hillside continued payments to OCV with checks marked "D.I.P.", standing for debtor in possession. OCV did not notice this either. The trustee in Markwell Hillside's bankruptcy sold the hotel and the new owners continued paying OCV. But then a dispute between the new owners and OCV ensued so OCV ceased dealing with the new owners.

OCV then apparently noticed the discrepancy between the entity that had owned the hotel and had been paying its invoices and the entity that actually signed its contract. Both entities were insolvent. OCV sued Markwell Properties in Colorado and obtained a default judgment of \$641,959.54, including the contract amount of \$261,058.31 along with interest and attorneys' fees. OCV then brought claims against Mr. Roti for a) piercing the corporate veil, and b) fraud. The only claim on appeal was the claim for piercing the corporate veil. OCV failed on its claim of piercing the corporate veil, and based on the language in the opinion written by Judge Posner, it has little hope on its fraud claim.

The court first acknowledged that this veil piercing claim is governed by Illinois law, since the state of formation of the entity governs such claims. It also acknowledged that the standards for piercing the corporate veil of a limited liability company are the same or similar to those of a business corporation.

Illinois law requires two conditions to pierce the corporate veil: 1) the owner has failed to operate it as a corporation, neglecting such requisites of the corporate form as adequate capitalization, election of directors and officers, and separation of corporate from personal funds; and 2) refusing to pierce the veil would sanction a fraud or promote injustice.

The court noted the first condition was satisfied, as Markwell Properties was obviously undercapitalized to meet its obligations under the OCV contract. But was there fraud? Judge Posner did not think so.

Mr. Roti's personal assets were never the issue, rather it was the distinction between Markwell Properties and Markwell Hillside. OCV never expected that Mr. Roti's personal assets would be used to pay OCV. Said Judge Posner, "It was Markwell Hillside that OCV should have sued, seeking to pierce the veil between the two Markwell companies on the theory that they were really a single business enterprise whose assets were in one of the constituent companies and whose liabilities were in the other. That is a permissible form of piercing the veil (call it "sideways piercing" – piercing to reach a sister company rather than a parent or other owner)." If OCV had obtained the judgment earlier, before Markwell Hillside's bankruptcy trustee sold the hotel, OCV would have had a strong case for piercing the corporate veil between the two entities. But Judge Posner acknowledged that, even if successful, OCV would only have been an unsecured creditor in bankruptcy and may not have been able to recover much.

Then Judge Posner went back to the facts he had cited earlier. OCV failed to run a credit check on Markwell Properties. It failed to require a balance sheet or financial information. It failed to require a personal guarantee from Mr. Roti. It failed to take action even after it discovered (or should have discovered) that Markwell Hillside was in bankruptcy, through the "D.I.P." designation on Markwell Hillside's checks. "[A] person who signs a contract after months of negotiation is in a position to determine whether his counterparty is solvent, and if he makes no effort to do so, though not deflected from doing so by representation by the party he's negotiating with, he's on weak ground complaining if the other party turns out to be insolvent."

As noted, this case follows other cases in which the 7th Circuit has shown itself decidedly unfriendly to creditors who sought compensation through the courts in failed business ventures but could have, but failed, to prevent their unfortunate situation. (See, for example, our updates of July 2011 at http://www.masudafunai.com/Files/11407_Business_Update_July_2011.pdf and August 16, 2010 at

http://www.masudafunai.com/Files/10325_Business_Update%208_16_10.pdf.) So, for disappointed creditors, the 7th Circuit is not the place to be.