FRAUDULENT CONVEYANCES AND PIERCING THE CORPORATE VEIL IN ILLINOIS

2013

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I. Introduction[1]

Fraudulent conveyance and piercing the corporate veil causes of action, if employed wisely, can enhance the likelihood of successfully collecting a claim against individuals and entities who are not primarily or directly liable for plaintiff's claims. Call these individuals and entities, "Second Tier Defendants," since the defendants directly liable for claims in litigation are in concept the "Primary Defendants."

Thus, for example, if plaintiff, ABC Company, had a breach of contract claim against defendant, XYZ Company, then defendant XYZ Company would be the Primary Defendant, and its shareholder, Bob Smith, could be a Second Tier Defendant for a cause of action for fraudulent conveyance or piercing the corporate veil, if the facts, and critically, the economics, merit pursuit of these causes of action against Bob Smith.

With this line-up in mind, the central questions for a plaintiff to ask are: (a) does the plaintiff have the facts to support the causes of action for either a fraudulent conveyance or piercing the veil; (b) what are the costs of pursuing either of these causes of action against Second Tier Defendants; and (c) what is the likelihood of success in pursuing either of these causes of action?

While a thoughtful attorney must due diligently answer these questions, the <u>good and thoughtful</u> attorney knows that these questions are sometimes more theoretical than practical. Certainly, no pursuit of meritless claims is being advocated; but when a plaintiff is faced with questionable transfers of assets and corporations that are operated as "mere facades" of their shareholders--aggressive litigation against Second Tier Defendants to enhance the plaintiff's ability to obtain a <u>collectible</u> judgment is the primary consideration. Central to the litigator's inquiry is collectability because achieving an uncollectible judgment is a failure: symbolic

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[1]The authors would like to thank Keshia Carswell, J.D. for her excellent contributions to the article.

victories in litigation, rarely are acceptable in the real world where the small business model dictates.

Today, litigators have numerous sources of information in the public domain through the internet, as well as traditional means to evaluate potential fraudulent conveyance and piercing the corporate veil causes of action against Second Tier Defendants. "Timing is everything" in litigation, and the plaintiff must use all of the tools at his/her disposal to evaluate the timing for asserting these claims against Second Tier Defendants, especially in light of time-sensitive statutes of limitation (discussed *infra*). A more conservative approach to due diligence on these claims is through traditional discovery, including the designation of Second Tier Defendants as Respondents in Discovery (see 735 ILCS 5/2-402). But, if time is of the essence, or if the naming of Second Tier Defendants in the original Complaint is key to "sending a clear message," necessary to gain immediate ascendancy in litigation, the litigator is tasked with the urgent need to correctly evaluate the strategy and tactics in pursuing the Second Tier Defendants. Clearly, the thoughtful litigator will aggressively pursue Second Tier Defendants if it is cost-efficient and the claims have merit, principally to enhance the possibility of successful collection of a claim.

The "starting points" for the plaintiff's analysis is, of course, the law pertaining to fraudulent conveyances and piercing the corporate veil. This article will discuss the law in Illinois, but due to a limitation of space this article will not discuss the actual pursuit of these claims in bankruptcy--although that is an important discussion, indeed. Thus, Section 548 of the Bankruptcy Code will not be specifically discussed, but the claims available in bankruptcy under the Uniform Fraudulent Transfer Act (UFTA) will be discussed. Also, to assist the practioner, in addition to the discussion of the law, the authors have included an appendix of important cases on these causes of action decided in the Seventh Judicial Circuit, the United States District Court for the Northern District of Illinois ("Northern District of Illinois"), the Illinois Supreme Court, and the First, Second and Third Illinois Appellate Court Districts.

The next point of inquiry for the pursuit of a fraudulent conveyance claim is to determine whether a "transfer" of any assets of the Primary Defendant occurred that can be avoided as a fraudulent conveyance. If so, the UFTA provides for a remedy of avoiding the transfer, itself (i.e., reversing the transfer), or obtaining a judgment against the transferee-defendant (i.e., the Second Tier Defendant). Practioners should avoid the mistake of avoiding the transfer as the sole remedy at all costs. It is imperative that both remedies should be property pleaded, but certainly, if given a choice, a plaintiff should plead the remedy under the UFTA for damages in an amount to be determined by the court, but in the minimum, equal to the value of the asset transferred.

The definition of "transfer" in the UFTA is very broad, and includes the traditional concept of the Primary Defendant transferring title in an asset(s) to a Second Tier Defendant; but also, this definition includes pledges of collateral belonging to the Primary Defendant and other direct and indirect acts in diminution of the creditor's rights. While there is no case law on point, an interesting discussion is whether a dilution of a Primary Defendant's equity securities in a business organization (stock or membership interests in a corporation or limited liability company, respectively) is a "transfer" under the UFTA.

Cost-efficiency is a critical factor in the pursuit of all litigation. This factor is especially important when considering the pursuit of piercing the corporate veil litigation against a Second Tier Defendant. As the discussion in this article will show, the pursuit of this cause of action is typically fact-intensive (the same is usually true for fraudulent conveyance litigation), and fact-intensive litigation is expensive, especially if the proof requires a review of the Primary Defendant corporation's financial and business affairs and practices. Unfortunately, this particular, fact-intensive analysis is the central focus of achieving a judgment against Second Tier Defendant shareholders, and it adds substantial costs to litigation. As such, plaintiff's commitment to a "piercing" cause of action requires an up-front commitment of time and resources to complete the initial analysis of the claim, let alone success on the merits. In addition, the pursuit of a "piercing" claim will often add substantial time to achieving a final judgment in litigation since the fact-intensity favors the defendant on a Motion for Summary Judgment. Thus, this is often "long haul" litigation with resolution only through settlement or trial—both only achieved after substantial resources are expended.

This article is meant to assist the practioner in the achieving success in evaluating and litigating the causes of action against Second Tier Defendants in fraudulent conveyance and piercing the corporate veil litigation. The best approach to litigating these causes of action, besides an aggressive, yet thoughtful attitude, is to analyze and evaluate the case as a dynamic, where change and the possibility for change is a constant. Remember, "what you don't know" is what will bring harm to the case, and surprises in this type of litigation must be avoided at all costs if success is to be achieved.

II. The Law of Fraudulent Conveyances in Illinois

A. Generally

Each state has its own fraudulent conveyance laws, but based on either of two uniform laws: (a) the Uniform Fraudulent Transfer Act; or (b) the Uniform Fraudulent Conveyance Act. These state laws are applicable both within and outside of bankruptcy cases. The Bankruptcy Code contains its own fraudulent conveyance provision, namely section 548, that is applicable only within the realm of bankruptcy; however, the state fraudulent conveyance statutes are applicable in bankruptcy pursuant to §544 of the Bankruptcy Code. [2] In Illinois, fraudulent

[2] 11 U.S.C. §101, *et seq*.

conveyances are governed by the Uniform Fraudulent Transfer Act ("UFTA").[3] Illinois adopted the UFTA effective as of January 1, 1990.[4] Prior to the adoption of the UFTA, the Illinois fraudulent conveyance statute followed the common law, which derived from the English Statute of Elizabeth.[5] At common law, a fraudulent conveyance was characterized as a transfer by the debtor of property made while the debtor was insolvent (or that caused the debtor to become insolvent) made with the intent to hinder, delay, or defraud creditors for inadequate consideration or to a transferee with bad faith.[6] The statute in Illinois that preceded the UFTA provided:

> Every gift, grant, conveyance, assignment or transfer of, or charge upon any estate, real or personal, or right or thing in action, or any rent or profit thereof, made with the intent to disturb, delay, hinder or defraud creditors or other persons, and every bond or other evidence of debt given, suit commenced, or judgment entered, with like intent, shall be void as against such creditors, purchasers and other persons.[7]

The UFTA was designed to harmonize various state laws with the Bankruptcy Code, and thus, the UFTA parallels §548 of the Bankruptcy Code in many respects.[8] In Illinois, fraudulent conveyance cases are categorized as either "fraud in fact" commonly known as actual fraud, or "fraud in law," commonly known as constructive fraud.[9] Generally speaking, actual fraud requires the actual intent to defraud creditors; whereas constructive fraud does not require intent and arises in situations where an insolvency exists before or after the subject transfer and there was inadequate or no consideration for the transfer (i.e., "no reasonably equivalent exchange").[10] If a transfer of property is proven fraudulent under either method, it is avoidable and can be set aside by the Courts and a judgment in the amount of the value of the asset transferred as of the date of the transfer can be entered against the transferee-defendant, plus punitive damages.[11]

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[3] 740 ILCS 160.
[4] JOSEPH P. KINCAID ET AL., Illinois Institute for Continuing Legal Education: Creditors' Rights in Illinois, Equitable Remedies 4s-8 (Robert G. Markoff 2009).
[5] *Id.*; 13 Eliz., Ch. 5 (1570).
[6] JOSEPH P. KINCAID ET AL., *supra* note 3.
[7] Ill.Rev.Stat. 1991, ch. 59, par. 110(a).
[8] PETER A. ALCES, The Law of Fraudulent Transactions 5-22 (West 2002).
[9] JOSEPH P. KINCAID ET AL., *supra* note 3.
[10] *Id.*
[11] PETER SPERO, Fraudulent Transfers: Applications and Implications 2-2 (West 2005).

B. The Uniform Fraudulent Transfer Act

i. UFTA Claims

To prevail on a fraudulent conveyance action under the UFTA, there must be a fraudulent transfer.[12] The UFTA defines a fraudulent transfer as one that is made (or an obligation incurred) by a debtor (1) with actual intent to hinder, delay, or defraud any of his or her creditors, or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, *and* the debtor either (a) engaged or was about to engage in a transaction or business with unreasonably small assets related to the transaction or business, or (b) intended to incur, believed, or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as the debts became due; or (c) the transferor was insolvent at the time of the transfer or became insolvent as a result of the transfer.[13] Shortly after the UFTA was adopted, the Appellate Court of Illinois, Second District held that the only property a debtor can transfer for fraudulent transfer purposes is property in which he or she has an interest.[14] Notably, the term "transfer" has been construed broadly by the Courts to include all methods of disposing or parting with property,[15] and may be in the form of a gift, lease, sale, pledge, release of guaranty, or a cancellation of an obligation.[16] Moreover, a creditor's claim may arise before or after such a transfer is made.[17]

It is important to note that the UFTA assumed the Bankruptcy Code's extremely broad definition of the term "claim."[18] Accordingly, a creditor's claim is a right to payment, "whether or not it is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured,

[12] 740 ILCS 160/5.
[13] 740 ILCS 160/5.
[14] *Regan v. Ivanelli*, 246 Ill.App.3d 798, 617 N.E.2d 808 (2nd Dist. 1993).
[15] *Jones v. Atchison*, 101 B.R. 556 (S.D.Ill. 1989) (holding that the debtor's pre-petition disclaimer of inheritance that resulted in devised property passing to the debtor's children was not considered a transfer).
[16] JOSEPH P. KINCAID ET AL., *supra* note 3, at 4S-9.
[17] 740 ILCS 160/5.
[18] 740 ILCS 160/2.

disputed, undisputed, legal, equitable, secured, or unsecured."[19] Thus, for purposes of a fraudulent conveyance action, a creditor has a UFTA cause of action once its claim arises even if the claim is contingent, and regardless of whether the claim has matured or been reduced to judgment after it was conveyed.[20]

ii. Insolvency

Insolvency is a critical element in fraudulent conveyance actions. The UFTA's definition of insolvency parallels the Bankruptcy Code's definition.[21] Pursuant to the UFTA, one definition of insolvency is when the sum of a debtor's debts is greater than all of his or her assets at a fair valuation.[22] This is the "balance sheet" test of insolvency. Further, a partnership is insolvent if "the sum of the partnership's debts is greater than the aggregate, at a fair valuation, of all of the partnership's assets and the sum of the excess value of each general partner's non-partnership assets over the non-partnership's debts."[23] Moreover, the test for insolvency is measured at the time of the transfer,[24] and a determination of solvency under the UFTA must be based on whether a debtor was actually insolvent and not the debtor's own beliefs as to his or her solvency or liabilities.[25]

The UFTA also sets forth an alternative test for determining insolvency.[26] Specifically, the statute provides that a debtor is presumed insolvent if it is unable to pay its debts as they generally become due or in the ordinary course of business.[27] This is the "equity test" of insolvency. In *Tower Investors*, the Appellate Court of Illinois, First District held that the entity

[19] 740 ILCS 160/2.
[20] *United States v. Brown*, 820 F.Supp. 374 (N.D.Ill. 1993).
[21] PETER A. ALCES, The Law of Fraudulent Transactions 5-93 (West 2002).
[22] 740 ILCS 160/3(a).
[23] 740 ILCS 160/3(c).
[24] PETER A. ALCES, The Law of Fraudulent Transactions 5-94 (West 2002); Dunham v. Kisak, 192 F.3d 1104 (7th Cir. 1999) (Affirming the Southern District of Illinois Court's finding of fact that the debtor was not insolvent at the time of the alleged fraudulent transfer is sufficient to support a finding of no fraudulent transfer).
[25] JOSEPH P. KINCAID ET AL., *supra* note 3, at 4S-9.
[26] 740 ILCS 160/3(b).
[27] 740 ILCS 160/3.

was not insolvent because at the time the forbearance agreement was created, the entity was still operating, generating revenue, paying bills, and holding assets; and continued to do so through the time of trial. Conversely, in *Matter of Vitreous Steel Products*, the court held that the debtor-corporation was insolvent despite paying all new bills on a cash basis as they came due when the corporation did not pay anything on past debts which had came due and was in default to the bank and other creditors resulting in an involuntary Chapter 7 proceeding.[28]

To aid in solvency determinations, the UFTA provides guidance on what cannot be considered assets and/or debts in the computaion of insolvency.[29] The statute provides that in computing insolvency, assets do not include property that has been "transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable" under the UFTA.[30] Furthermore, in computing insolvency, debts do not include any obligations that have been secured by a valid lien on the debtor's property that is not included as an asset.[31] In *Gregg v. SR Investors*, the Northern District of Illinois held that a personal guaranty is not the debtor's asset, but an asset of the bank to whom the guaranty was made.[32] Additionally, the Seventh Circuit, citing the Northern District of Illinois, held that in a determination of solvency, creditors must include an estimation of the debtor's contingent liabilities, which should account for the probability that a contingency will occur.[33]

iii. Cause of Action: Actual Fraud

A cause of action for fraudulent conveyance as "actual fraud" requires a showing of intent,[34] and is defined as a transfer of property made with the intent to disturb, delay, hinder, or

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[28] *Matter of Vitreous Steel Products Co.*, 911 F.2d 1223 (7th Cir. 1990) (affirming the Northern District of Indiana).
[29] 740 ILCS 160/3.
[30] 740 ILCS 160/3(d).
[31] 740 ILCS 160/3(e).
[32] *Gregg v. SR Investors*, 966 F.Supp. 746 (N.D.Ill. 1997).
[33] *Covey v. Commercial National Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992).
[34] 740 ILCS 160/5.

defraud creditors. Such a transfer is void against those creditors and may be set aside.[35] Intent will be found when the circumstances indicate that the debtor's purpose in making the transfer was to prevent a lawful creditor from collecting a debt.[36] If the plaintiff proves fraudulent intent, the burden shifts to the defendant-debtor to show that the fraud was harmless because the debtor's assets were not depleted.[37]

A debtor's intent to hinder, delay, or defraud is generally inferred from the circumstances surrounding the transaction in the absence of direct evidence.[38] The UFTA provides a set of factors, commonly known as the "badges of fraud," to be considered by the Courts in a determination of fraudulent intent.[39] Pursuant to the statute, a Court should consider the following 11 "badges of fraud" to determine actual fraud under the UFTA:

(1) the transfer or obligation was to an insider;
(2) the debtor retained possession or control of the property transferred after the transfer;
(3) the transfer or obligation was disclosed or concealed;
(4) before the transfer was made or the obligation was incurred, the debtor had been sued or threaten with a suit;
(5) the transfer was substantially all of the debtor's assets;
(6) the debtor absconded;
(7) the debtor removed or concealed assets;
(8) the value of consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
(10) the transfer occurred shortly before or after a substantial debt was incurred; and
(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

If, at the Court's discretion, sufficient badges of fraud are established, a rebuttable presumption arises in favor of the creditor.[40] It is not necessary for creditors to establish all, or

[35] 740 ILCS 160/5; *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).
[36] *King v. Ionization Intern, Inc.*, 825 F.2d 1180 (7th Cir. 1987).
[37] *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).
[38] *King v. Ionization Intern, Inc.*, 825 F.2d 1180 (7th Cir. 1987).
[39] 740 ILCS 160/5(b).
[40] PETER SPERO, *supra* note 9, at 2-9.

even a majority, of the badges of fraud to prove fraudulent intent.[41] As explained in the cases below, Courts have varied on which, and how many, badges are sufficient to give rise to the presumption. However, once the presumption arises, the burden then shifts to the debtor to show some legitimate, supervening purpose for the transfer at issue.[42]

In 2005, the Seventh Circuit explained that in a case where a debtor 1) absconded, or 2) transferred essential assets to a secured creditor, who then transferred the assets to an insider of the debtor, either one would be sufficient to entitle the plaintiff to relief as "actual fraud."[43] The Courts have not precisely defined "essential assets" in the context of the badges of fraud; however, it is generally understood to refer to those assets essential to the operation of the debtor's business. In 2012, the Seventh Circuit upheld a District Court's finding against a corporation where five of eleven badges of fraud were satisfied, noting that the badges of fraud are not additive.[44] The Court explained that to treat the badges of fraud as additive would be the equivalent of saying that a patient, who has only five of eleven symptoms of a serious disease, is not seriously ill.[45]

The Internal Revenue Service ("IRS") supports the Seventh Circuit's approach as well. In a 2011 Action on Decision Report, the IRS objected to the Tax Court's decision in *Norris*, in which the Tax Court held that husband and wife taxpayers were not liable for fraud penalties on their unreported income. The IRS believed that the Tax Court erred when, in evaluating evidence of fraud, it weighed each of the eleven badges of fraud equally, tallied the number "for," "against," or "neutral," and concluded that fraud was not established because only four badges were proven. The IRS explained that the Tax Court improperly used a "rigid" eleven-factor test

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[41] *See*, *Brandon v. Anesthesia & Pain Management, Ltd.*, 419 F.3d 594 (7th Cir. 2005).
[42] *Id*.
[43] *Brandon v. Anesthesia & Pain Management, Ltd.*, 419 F.3d 594 (7th Cir. 2005).
[44] *Wachovia Securities v. Banco Panamericano*, 674 F.3d 743 (7th Cir. 2012).
[45] *Brandon v. Anesthesia & Pain Management, Ltd.*, 419 F.3d 594 (7th Cir. 2005).

to determine the existence of fraud instead of making the determination by considering the taxpayer's entire course of conduct.[46]

It follows that a showing of intent without "numerosity" is quite attainable: meaning, the plaintiff need not rely on the number of badges of fraud proven to prove "actual fraud." This is especially the case because some badges are weighed more heavily than others.[47] For example, insolvency is the most important factor in determining whether a transaction can be set aside for actual fraud.[48] As explained *supra*, generally, insolvency turns on whether an entity's liabilities exceed its assets,[49] and under the UFTA, an entity is insolvent if the sum of its debts is more than the fair valuation of all of its assets.[50] Although insolvency is the most important factor in determining actual, fraudulent intent, it is merely one of the several badges of fraud, and intent can be established even if a debtor is solvent.[51] The badges of fraud have strength in numbers, but must be considered along with other attendant circumstances in either proving or disproving intent.[52]

iv. Constructive Fraud

Contrary to a claim under the UFTA for actual fraud, intent is not required to establish constructive fraud under the UFTA.[53] In fact, since actual intent is rarely proven, creditors often establish fraudulent conveyance claims by proving constructive fraud.[54] Constructive fraud has three elements, and tends to turn on the issues of insolvency and consideration, or whether there was "a reasonably equivalent exchange from the transferee to the transferor."[55] The UFTA

[46] *Norris v. Commissioner*, T.C. Memo, 2011-161 (Dec. 2011), *available at* http://www.irs.gov/pub/irs-aod/aod201105.pdf.
[47] *Brandon v. Anesthesia & Pain Management, Ltd.*, 419 F.3d 594 (7th Cir. 2005); PETER SPERO, *supra* note 9, at 2-15.
[48] PETER SPERO, *supra* note 9, at 2-15.
[49] 740 ILCS 160/3; PETER SPERO, *supra* note 9, at 2-16.
[50] 740 ILCS 160/3.
[51] PETER SPERO, *supra* note 9, at 2-16.
[52] *Alan Drey Co. V. Generation, Inc.*, 22 Ill.App.3d 611, 317 N.E.2d 673 (1st Dist. 1974).
[53] 740 ILCS 160/5.
[54] PETER SPERO, *supra* note 9, at 2-11.
[55] JOSEPH P. KINCAID ET AL., *supra* note 3.

provides that a transfer by a debtor can be fraudulent if the debtor made the transfer without receiving a reasonably equivalent value in exchange for the transfer, and the debtor intended to incur, or believed, or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as they came due.[56] Thus, to be found liable for constructive fraud (1) a transfer must have been made for inadequate or no consideration, (2) there must be an existing, contemplated debt against the transferor, and (3) the transferor was insolvent at the time of the transfer or became insolvent at the time of the transfer.[57]

Practically speaking, elements that support actual fraud are also elements of constructive fraud, and Courts will look to the "totality of the circumstances" in making a determination.[58] In fact, the "totality of the circumstances" is the mainstay of courts in Illinois in considering "constructive fraud" under the UFTA, especially the Seventh Circuit where it has ascended as the test for constructive fraud. Accordingly, there is some interplay between constructive and actual fraud, and the use of the badges of fraud, particularly insolvency as it pertains to adequate consideration and a debtor's ability to pay debts as they come due. This is because insolvency is determinative of whether a debtor has unreasonably small assets or whether the debtor will be able to pay his or her debts as they come due.[59] In 2009, the Seventh Circuit held that if the burden of debt created by a transaction was so heavy that the corporation had no reasonable chance of surviving, the buyer's payment to shareholders is a fraudulent conveyance because consideration was inadequate and there was no reasonably equivalent exchange. The Court explained that in exchange for the money the shareholder's received from the corporation's buyer, they provided no value to the corporation and instead increased its debt thereby "pushing it over the brink."[60]

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[56] 740 ILCS 160/5.
[57] *See*, 740 ILCS 160; *People ex rel Hartigan v. Anderson*, 232 Ill.App.3d 273, 597 N.E.2d 826 (3rd Dist. 1992).
[58] PETER SPERO, *supra* note 9, at 2-11.
[59] PETER SPERO, *supra* note 9, at 2-33.
[60] *Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787 (7th Cir. 2009).

Since the UFTA was adopted in 1990, Illinois courts have consistently held that a transfer will be deemed fraudulent if the insolvent debtor made the transfer without receiving a reasonably equivalent value in exchange.[61] In fact, in *Scholes*, the Seventh Circuit, citing the Northern District of Illinois, held that a transfer made for fair consideration cannot constitute a fraudulent transfer.[62] In *Barber v. Golden Seed Co.*, the Seventh Circuit, applying Illinois law and citing the District Court for the Central District of Illinois, held that the test used to determine reasonably equivalent value under the UFTA requires the Court to determine the value of what was transferred and compare it to the value of what was received.[63] While the exact definition of value will vary depending on the nature of the transaction, the United States Supreme Court held that the term "reasonably equivalent value" typically means fair market value.[64] Accordingly, Illinois Courts will look to fair market value, noting in *Barber v. Golden Seed Co.* however, that fair market value is one of several factors considered, including whether the transfer was an arms' length transaction and the good faith of the transferee.[65]

In addition to the transfer having been made for inadequate or no consideration, the debtor must have insufficient assets to pay its indebtedness: in short, insolvency.[66] This is true whether the creditor argues that the debtor engaged or was about to engage in a transaction with unreasonably small assets related to the transaction or business, or that the debtor intended to incur, believed, or reasonably should have believed that he or she would incur debts beyond his or her ability to pay as the debts became due. This suggests that the UFTA applies to transfers that result from either business or personal transactions.[67]

v. UFTA Limitations Period

[61] See, *Barber v. Golden Seed Co., Inc.*, 129 F.3d 382 (7th Cir. 1997).
[62] *Scholes v. Lehmann*, 56 F.3d 196 (7th Cir. 1995).
[63] *Barber v. Golden Seed Co., Inc.*, 129 F.3d 382 (7th Cir. 1997).
[64] *BFP v. The Resolution Trust Corp.*, 511 U.S. 531 (1994).
[65] *Barber v. Golden Seed Co., Inc.*, at 387.
[66] *Stoller v. Exchange National Bank*, 199 Ill.App.3d 674, 557 N.E.2d 438 (1st Dist. 1990).
[67] PETER SPERO, *supra* note 9, at 2-59.

The limitations period depends on the cause of action brought under the UFTA. The limitations period for "constructive fraud" under the UFTA is four years from the date of the transfer. Remarkably, the limitations period for "actual fraud" under the UFTA, that is, a transfer made with the actual intent to hinder, delay or defraud--is within one year from the date the transfer was or could have been reasonably discovered by the creditor (i.e., the "discovery rule" applies). Thus, a party may bring a fraudulent conveyance action alleging actual fraud within four years after the *transfer was made*, or one year from the date the fraud *was or could have been reasonably discovered*.[68] There is no Discover Rule for constructive fraud cases: A cause of action for constructive fraud must be brought within four years from the date of the *transfer or obligation*, or the claim will be extinguished.[69] Under the UFTA, the claim itself is extinguished after the limitations period has run – therefore, a cause of action pleaded under the UFTA should actually include allegations that show that the limitations period has not yet run. Specifically, if a party is relying upon the one year Discovery Rule, the complaint should contain specific allegations setting forth the requisite intent and the actual date the fraud was discovered. This is crucial to understand, because this time period will elapse as to any creditor, regardless of pending litigation or whether a creditor's claim has been reduced to a judgment.

(1) Limitations: Actual Fraud

In *Workforce Solutions v. Urban Services* in 2012, the Appellate Court of Illinois, First District explained that two clauses in the UFTA govern the limitations period.[70] The first bars a fraudulent transfer action brought more than four years after the transfer at issue was made. The second bars claims, after the four years has run, filed more than one year after the claimant discovered, or could have reasonably discovered the transfer.[71] The Court explained that the

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[68] 740 ILCS 160/10(a).
[69] 740 ILCS 160/10(b).
[70] *Workforce Solutions v. Urban Services*, 2012 IL App (1st) 111410, 977 N.E.2d 267 (1st Dist. 2012).
[71] *Id*.

second clause of section 10(a) of the UFTA reiterates the Discovery Rule, which "postpone[s] the commencement of the relevant statute of limitations until the injured plaintiff knows or reasonably should have known that he has been injured and that his injury was wrongfully caused."[72] However, the one year "extension" included within § 10(a) of the UFTA begins on the date the fraud was or could have been discovered, and provides a one year extension from that date. In *Fidelity National Title Insurance Co. of New York v. Howard Savings Bank*, the Seventh Circuit, citing the Northern District of Illinois, held that the action accrues when the plaintiff discovered or should have discovered "not that money has been transferred illegally but that it has been transferred to someone who is a fraudulent transferee."[73]

(2) Limitations: Constructive Fraud

This limitation period is designed to operate as a statute of repose.[74] The drafters of the UFTA commented that "Its purpose is to make clear that lapse of statutory periods prescribed by the section bars the right and not merely the remedy."[75] In contrast with the limitation period acting as a statute of limitations, equitable tolling is not applicable to toll the limitations period for constructive fraud under the UFTA.[76] Accordingly, it is imperative to determine precisely when the transfer was made, or the obligation incurred.

vi. Rights to Fraudulently Conveyed Property

(1) Transferee's Rights and Defenses

An order setting aside the conveyance is for the creditor's benefit and makes the property available to satisfy its claims. Thus, generally a court's finding that a fraudulent transfer took place will not render the transferee personally liable, unless he or she sold or converted the

[72] *Id*.
[73] *Fidelity National Title Insurance Co. of New York v. Howard Savings Bank*, 436 F.3d 836 (7th Cir. 2006).
[74] PETER SPERO, *supra* note 9, at 4-28.
[75] UFTA § 9, Comment (1).
[76] *See*, *Levy v. Markal Sales Corp.*, 311 Ill.App.3d 552, 724 N.E.2d 1008 (1st Dist. 2000); PETER SPERO, *supra* note 9, at 4-28.

property. However, a creditor may elect to recover the property or its cash value to satisfy the debt. Notably, in a recent decision, *Dexia Credit Local v. Rogan*, the Seventh Circuit held that a creditor could raise a fraudulent conveyance issue in a supplementary proceeding to prove that certain transferees held the assets of the debtor, and the Court ordered that the assets be turned over to satisfy the creditors' claim.[77]

Generally, if the Court finds that a conveyance was fraudulent and sets it aside, under the UFTA, the transferee's rights to the property depend on whether the fraud was actual or constructive, whether the transferee was a *bona fide* purchaser, and whether the transferee has unclean hands. Regarding actual fraud, if the transferee intended to defraud, the property must be returned for the benefit of the creditors and the transferee is entitled to an unsecured claim against the transferor-debtor, but only to the extent of consideration paid.[78] In this context, a judgment can be entered against a transferee for the value of the asset transferred at the time of the transfer, plus punitive damages.

Furthermore, any transfer of property made with the actual intent to defraud, while void against creditors, is binding on the parties to the transfer, as well as those in privity with them, and cannot be set aside by the participating grantor. Accordingly, a debtor cannot set aside his or her own conveyance.[79]

With respect to constructive fraud, if the transferee is a *bona fide* purchaser, he or she is protected under the UFTA and keeps the property.[80] To attain *bona fide* purchaser status, the transferee must show he or she purchased the property for value without notice of the fraud.[81]

The concept of the initial transferee is important in the aforementioned analysis. An individual's status as an initial or subsequent transferee makes a difference for purposes of

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[77] *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).
[78] JOSEPH P. KINCAID ET AL., *supra* note 3, at 4S-13.
[79] *Id*.
[80] 740 ILCS 160/9(d).
[81] *Alan Drey Co. V. Generation, Inc.*, 22 Ill.App.3d 611, 317 N.E.2d 673 (1st Dist. 1974).

establishing liability. The party who directly receives the property from the debtor is generally considered to be the initial transferee. This person must exercise dominion and control over the property to be a transferee. Thus, another party exercising dominion and control over the property may be the initial transferee as a matter of law. For example, however, this does not apply to a party that is a "mere conduit, intermediary, or agent." A "mere conduit must have acted in good faith for this protection to apply.[82] In I*n re Butler*, a Bankruptcy Court in the Northern District of Illinois held that a party who receives a transfer directly from the debtor is not the initial transferee unless that party has actual dominion and control over the property as a result of the transfer.[83] The Court explained that the initial transferee, for fraudulent transfer purposes, was the tax foreclosure sale purchaser himself, not the state whose tax lien had been foreclosed. The Court reasoned that the state acted as mere conduit in the foreclosure sale, and never gained actual dominion and control over the property.

The UFTA provides that a) a transfer is not voidable as actual fraud if the transferee took the property in good faith for value; b) the protection afforded to other transferees resulting from a constructively fraudulent transfer requires that the property was received in good faith (for example, a lien to the extent of value given); and c) recovery of property from a voidable fraudulent transfer from a subsequent transferee is barred if the subsequent transferee had good faith. Thus, under the UFTA, an initial transferee who engaged in the transaction in good faith and for value has a defense to avoiding actual fraud, but not constructive fraud. However, a subsequent transferee who took in good faith and for value has a complete defense. This is

[82] *See generally,* PETER SPERO, *supra* note 9, § 4; *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890 (7th Cir. 1989) (Affirming the Northern District of Illinois and holding that a bank, which received check from debtor payable to bank's order, with instructions to deposit check in depositor's account, was neither initial transferee of check nor entity for whose benefit transfer was made, so as to enable bankruptcy trustee to recover amount of check from bank as fraudulent conveyance; bank received no benefit from initial transfer, but rather, acted as financial intermediary which held check only for purpose of fulfilling an instruction to make funds available to someone else.)
[83] *In re Butler*, 171 B.R. 321 (N.D.Ill. 1994).

designed to prevent a transferee from gaining a defense by passing transactions through innocent third parties.[84]

Good faith is measured objectively. Thus, a Court will not find good faith if the transferee knew or should have known of the debtor's fraudulent purpose. Accordingly, good faith generally requires an absence of actual or constructive notice of either the debtor's fraudulent purpose or insolvency. Good faith will also be lacking where a transferee has sufficient knowledge that would put him or her on inquiry notice of the debtor's possible insolvency or fraudulent purpose. The good faith requirement is to be read in accordance with the purpose of the UFTA, and thus is generally not affected by the transferee's knowledge of the source of the funds.[85]

(2) Creditor's Rights

A creditor's claim may arise before or after a fraudulent transfer is made. A creditor has a UFTA cause of action once its claim arises even if the claim is contingent and regardless of whether the claim has matured or has been reduced to judgment.[86] Accordingly, it is imperative for creditors to protect their rights pre- and post-judgment. Such an action may be pursued in an original lawsuit against transferees or in supplementary proceedings. It is now well-settled that causes of action under the UFTA can be brought against non-judgment debtor transferees in post-judgment remedies (i.e., supplementary proceedings) under 735 ILCS 5/2-1402 and Illinois Supreme Court Rule 277.

In 2010, the Seventh Circuit issued a significant opinion that opened the door widely for creditors to pursue equitable claims against a debtor, and non-debtor third parties to whom the debtor may have transferred assets on a very broad basis in supplementary proceedings. In *Dexia Credit Local v. Rogan* (Dexia II), the creditor obtained a $124 million judgment against the

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[84] *See generally,* PETER SPERO, *supra* note 9, § 4.
[85] PETER SPERO, *supra* note 9, at 4-16, 17.
[86] *United States v. Brown*, 820 F.Supp. 374 (N.D.Ill. 1993).

debtor in the Northern District of Illinois. Pursuant to Federal Rule of Civil Procedure 69(a), the creditor initiated supplementary proceedings, during which the creditor discovered that the debtor formed six trusts in the names of his adult children. The creditor subsequently served citations to discover assets on each trust, and ultimately filed a motion for turnover for assets in the trusts. The creditor argued that the property held in the trusts was actually under the control of, and belonged to, the debtor.[87]

The children intervened in the proceedings and argued that the trial court did not have the authority to turn over the trust property, as it was not permitted to adjudicate "the substantive property rights of third parties under equitable theories," such as alter ego, without a separate claim. During the trial, the evidence showed that that when the debtor's business was purchased, the trusts received the proceeds of the transaction, the corpus of the trust was comprised of entities through which the debtor previously operated his business, and that the debtor's attorney was named trustee of half of the trusts while a company owned by the debtor's attorney was trustee of the other trusts. The trial court found that the assets in the trusts actually belonged to the debtor, ordered the trust property to be turned over, and imposed a constructive trust on the assets.[88]

The Seventh Circuit affirmed the trial court's ruling and rejected the children's argument stating:

> "Dexia has already prevailed on its claims against Peter Rogan [the debtor]. Dexia now seeks to satisfy its judgment against Rogan by collecting assets in the possession of the Rogan domestic trusts that Dexia contends are actually Peter Rogan's assets based on the equitable theories listed above. Dexia does not need to assert a new claim to engage in such proceedings to enforce its judgment against Peter Rogan. Though the situation might be different were Dexia seeking to hold the Rogan domestic trusts directly liable to Dexia (in other words, irrespective of whether the trusts' assets are actually Peter Rogan's), Dexia is not now attempting to do so.[89]

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87 *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).
88 *Dexia Credit Local v. Rogan*, 624 F.Supp.2d 970 (N.D.Ill. 2009).
89 *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).

The Court explained that the children placed undue emphasis on the labels that the creditor used to describe its equitable theories.[90] In its discussion, the Court cited *Kennedy v. Four Boys Labor Service*, which held that supplementary proceedings "may only be initiated after a judgment has been entered and are designed to assist a judgment creditor in order to satisfy that judgment."[91] The Court in *Four Boys* explained that after a creditor discovers the debtor's assets in the hands of a third party, the Court may order the third party to turn over those assets in order to satisfy the judgment.[92]

In *Dexia*, the Seventh Circuit stated that in supplementary proceedings, "Dexia can utilize a fraudulent conveyance theory to prove that others hold the assets of Peter Rogan," citing *Four Boys*.[93] The Court explained that Dexia was not attempting to hold the trusts directly liable; but instead, asserted that the trusts actually held the debtor's assets. The Court further explained that the creditor was permitted to use equitable theories, such as alter ego to prove up that assertion. Ultimately, the Court concluded that Illinois Supreme Court Rule 277 permits actions in supplementary proceedings against a judgment debtor as well as any third party whom the creditor believes has the property of or is indebted to the judgment debtor.[94]

Accordingly, *Dexia* has set a precedent that Illinois Courts will allow the use of equitable remedies, and particularly, the pursuit of alter-ego, "pierce" litigation and fraudulent conveyances in supplementary proceedings, as long as the relief sought is for the recovery of the debtor's assets, which are in the possession of a third party.[95] However, creditors must be cautious with respect to the language of their pleadings. The *Four Boys* Court also held that an action brought under the Business Corporation Act is an attempt to impose personal liability on a

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[90] *Id.*
[91] *Kennedy v. Four Boys Labor Service, Inc.*, 279 Ill.App.3d 361, 664 N.E.2d 1088 (2nd Dist. 1996).
[92] Id. at 1093.
[93] *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).
[94] IL R S.Ct. Rule 277; *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).
[95] *Dexia Credit Local v. Rogan*, 629 F.3d 612 (7th Cir. 2010).

corporate director for damages sustained by the creditor, and is not concerned with the debtor's actual assets.[96] The Court explained that:

> Such an action does not require allegations that assets of the judgment debtor are in the hands of a third party or that the third party is indebted to the judgment debtor. Thus, because such an action imposes personal liability independent of the debtor's assets, such an action constitutes a separate action not properly brought in a supplementary proceeding.[97]

vii. Additional Considerations

Fraudulent conveyance actions often arise in the context of the marital relationship. Asset transfers between spouses can easily give rise to either actual or constructive fraud actions. Accordingly, it is noteworthy that certain aspects of the property or relationship can affect the outcome of a fraudulent conveyance claims involving spouses. It is particularly important for practitioners to be aware of the implications of property that is held in tenancy by the entirety, and the effects of a dissolved marriage.

(1) Tenancy by the Entirety

Tenancy by the entirety is an estate recognized in Illinois by the Joint Tenancy Act.[98] It is an estate in real property that may only be held by spouses and is limited to homestead property.[99] Tenancy by the entirety has several advantages including survivorship and the inability of creditors to force the non-consensual transfer of any interest in the property.[100] Holding property in tenancy by the entirety protects spouses as the real property cannot be foreclosed by a judgment creditor to satisfy the debt for which only one spouse holds its liability.[101] As long as the judgment debtor-spouse is on the title of the protected property, the judgment-creditor of only one of the spouses cannot foreclose on the property.[102] That judgment

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[96] *Kennedy v. Four Boys Labor Service, Inc.*, 279 Ill.App.3d 361, 664 N.E.2d 1088 (2nd Dist. 1996).
[97] *Id.* at 1093.
[98] 765 ILCS 1005.
[99] *Id.*
[100] 735 ILCS 5/12-112.
[101] ROBERT J. DUFFIN, Illinois Institute for Continuing Legal Education: The Role of an Attorney in a Real Estate Transaction: Is an Attorney Really Necessary? § 7.5 (2011).
[102] *Id.*

will continue to remain an inchoate lien on the property during that time.[103] However, upon the death of the non-debtor spouse, a dissolution of the marital relationship, or if the property ceases to be the principal residence of the couple, that inchoate lien will develop into an immediately enforceable judgment lien.[104]

Importantly, if a debt is against both spouses, it may be attached to homestead property held in tenancy by the entirety, and the surviving spouse may be held liable.[105] However, if there is a debt for which only one spouse holds liability, upon the death of the debtor-spouse, the debt cannot be assessed against the property of the surviving non-debtor spouse (this is true for joint tenancy, too). Note that while liability does not pass to the non-debtor spouse on property held in tenancy by the entirety, a debt that is not dischargeable by death may nonetheless be assessed against the decedent's estate because the debtor-spouse is still personally liable depending on the terms of the creditor's agreement.

With respect to fraudulent conveyances and property held in tenancy by the entirety, the UFTA does not apply. A debtor who transfers property with the actual intent to defraud is generally governed under the UFTA. However, the tenancy by the entirety provision of the Code of Civil Procedure establishes its own standard for fraudulent conveyances. Specifically, the rule provides that a fraudulent conveyance of tenancy by the entireties property exists only if the property was transferred with the sole intent to avoid the payment of debt which existed at the time of the transfer, and it is beyond the debtor's ability to pay those debts as they become due.[106]

In *Premiere Property Management*, a creditor sought to have a judgment-debtor's conveyance of his personal residence to himself and his wife as tenants by the entirety set aside and sold to satisfy the judgment. The creditor brought the action under the UFTA and the Illinois

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[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Premier Property Management, Inc. v. Chavez*, 191 Ill. 2d 101, 728 N.E.2d 476 (2000)

Supreme Court held that the Code of Civil Procedure's tenancy by the entirety provision applied, not the UFTA. Accordingly, actual intent to defraud was not the standard. The Court explained that the only way the creditor could "break through" the protection afforded to the property as a tenancy by the entirety was to show that that property was transferred into the tenancy by the entirety with the "sole intent to avoid payment of debts existing at the time of the transfer beyond the transferor's ability to pay those debts as they became due." The Court explained that the sole intent standard provides greater protection to a spousal debtor from his or her creditors. Under the sole intent standard "if property is transferred to tenancy by the entirety to place it beyond the reach of creditors of one spouse *and* to accomplish some other legitimate purpose, the transfer is not avoidable." The Court noted that such a transfer would have been voidable under the UFTA's actual intent standard, if it indeed applied, but since it did not, the transfer could not be avoided.[107]

(2) Apportionment of Assets

A court order providing for the division of assets will not protect a transferee from a claim under the UFTA. Thus, if a divorce decree has been entered and another court renders a judgment, the divorce decree will not preclude a fraudulent transfer action. In *In re Schaudt,*[108] the United States prevailed on its fraudulent transfer claim against a debtor who received a house pursuant to the terms of an uncontested marital dissolution judgment. The house was previously held in a trust established by the debtor's husband, who owed over half a million dollars to the Internal Revenue Service ("IRS"). The Court found that the transfer of the home was motivated by the couple's shared fraudulent intent to remove the home from the IRS' reach. In this case, the Court found that the debtor knew of her husband's tax debt and the couple began communicating with tax counsel, who inquired with the IRS about title and ownership of the

[107] *Premier Property Management, Inc. v. Chavez*, 191 Ill. 2d 101, 728 N.E.2d 476 (2000)
[108] *In re Schuadt*, WL 909299 (N.D.Ill. 2012).

home, and upon receipt of the title report, filed for divorce eight days later. Furthermore, the couple quickly came to "lopsided" terms in the Divorce Decree that favored the debtor.

The Court explained that the transfer was made in furtherance of the marital settlement agreement, which was incorporated into the divorce decree. The Court noted that the divorce was not entered into for legitimate personal reasons, but to "lend an air of legitimacy to the transfer of the house out of the reach of the United States." The Court further explained that the badges of fraud are especially relevant in the context of a sham divorce, and that:

> They include a number of facts: the quickly agreed upon split of property, the completion of the divorce proceeding on a "fast-track," the fact that one of the spouses was not represented by counsel in the divorce proceeding, the existence of a short interval between the entry of the divorce decree and the bankruptcy filing, the fact that spouses continue to live together after the divorce in the very house that was transferred to one of the spouses, the fact that the transferor spouse continues to pay the mortgage, taxes, and other costs on the transferred house, the inequitable distribution of debts and assets in the divorce, and the fact that the couple holds themselves out in the public as still being married.[109]

The Court also noted that the dynamic between the spouses, while not dispositive, is also relevant.[110] Ultimately, the Court concluded that the debt was obtained by actual fraud and imputed the shared fraud to the debtor, who became liable to the United States separate from the tax debt owed to the IRS.[111]

III. Piercing the Corporate Veil in Illinois

A. Introduction

Illinois Courts have recognized veil piercing since the 1800's. Traditionally, veil piercing has been applied as an equitable remedy to impose personal liability upon a corporation's shareholders. Illinois courts have also reverse-pierced corporate entities to hold a corporation

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[109] *In re Schuadt*, WL 909299 (N.D.Ill. 2012).
[110] *In re Schuadt*, citing *In re Hill* 342 B.R. 183 (N.D.Ill. 2008) (explaining "there are situations in which a bona fide divorce exists, but the transferor nonetheless favors transferring assets to the ex-spouse rather than seeing them go to a creditor body.")
[111] *In re Schuadt*, WL 909299 (N.D.Ill. 2012).

liable for the obligations of its shareholders. While veil piercing is rooted in Illinois law and has been consistently applied to shareholders and corporations, the rise and popularity of Limited Liability Companies ("LLC") in Illinois leaves questions as to the applicability of veil piercing to other corporate forms. Piercing the LLC veil is a relatively new issue in Illinois and the case law is contradictory. As a result, two approaches have emerged regarding the applicability of veil piercing to LLCs and it remains to be seen which approach Illinois Courts will embrace.[112]

B. Piercing the Corporate Veil

Veil piercing issues arise when a party seeks to have a corporate entity disregarded and impose personal liability on the corporation's shareholders.[113] Generally, a corporation and its shareholders are regarded as separate legal entities and accordingly, shareholders are not liable for the corporation's obligations.[114] However, in some situations, a Court will use its equitable powers to pierce the corporate veil and impose personal liability on shareholders.[115] Illinois courts have long held that the corporate entity will not be regarded when doing to would result in fraud or injustice.[116] In *Van Dorn v. Future Chem. & Oil Corp*., the Seventh Circuit, citing the Northern District of Illinois, explained that a corporation's veil of limited liability will be pierced only when (1) "there is such unity of interest and ownership that the separate personalities of the corporation and the individual or other corporation no longer exist," and (2) "when adherence to the fiction of separate corporate existence would sanction a fraud or injustice."[117]

In *Main Bank of Chicago v. Baker*, the Illinois Supreme Court rephrased the first prong such that the corporation must be "so controlled and its affairs so conducted that it is a mere

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[112] Seventh Circuit cases discussed in this article apply Illinois law, unless otherwise indicated.
[113] *Van Dorn v. Future Chem. & Oil Corp*., 753 F.2d 565 (7th Cir. 1985); *See,* JOSEPH P. KINCAID ET AL., Illinois Institute for Continuing Legal Education: Creditors' Rights in Illinois, Equitable Remedies 6-19 (Robert G. Markoff 2009).
[114] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).
[115] JOSEPH P. KINCAID ET AL., Illinois Institute for Continuing Legal Education: Creditors' Rights in Illinois, Equitable Remedies 6-19 (Robert G. Markoff 2009).
[116] *Id*.
[117] *Van Dorn v. Future Chem. & Oil Corp*., 753 F.2d 565 (7th Cir. 1985).

instrumentality of another."[118] A corporation is a mere instrumentality when it is merely the alter ego or business conduit of another person or entity.[119] Thus, an entity or individual who uses a corporation as a method of conducting his or her business may be liable for using the corporation as his or her alter ego.[120] In *People v. Pintozzi*, the Court explained that an individual is an alter ego of a corporation where "there is such unity of interest and ownership that the separateness of the individual and the corporation has ceased to exist."[121] Moreover, the existence of an alter ego relationship is a question of fact dependent on the circumstances of each case.[122] In *Ampex Corp. v. Office Electronics, Inc.*, the Court found that two corporations were mere instrumentalities of one another when the "affairs of the two corporations were so managed and controlled by the same interlocking officers, directors, and single stockholder, as to constitute one corporate entity in its dealings with creditors."[123]

i. Case Discussion: *Fontana* and *Wachovia*

(1) The Fontana Rule

In 2005, in *Fontana v. TLD Builders*, the Appellate Court of Illinois for the Second District delineated eleven factors, generally known as the badges of fraud, to be considered in establishing the "mere instrumentality" or "unity of interest" prong.[124] However, practically speaking, courts look to the badges of fraud to determine whether the second prong has been

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[118] *Main Bank of Chicago v. Baker*, 86 Ill. 2d 188, 427 N.E.2d 94 (1981).
(holding that the use of common officers and directors does not, alone, render one corporation liable for obligations of another.).
[119] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).
[120] *Id*.
[121] *People ex rel. Willian J. Scott v. Pintozzi et al.*, 50 Ill.2d 115, 277 N.E.2d 844 (1971) (holding "evidence sustained trial court's findings that corporations which had operated retail liquor establishments and failed to pay retailers' occupation tax were alter egos of individuals and that such individuals were liable for tax.").
[122] *Koch Refining v. Farmers Union Cent. Exchange, Inc.*, 831 F.2d 1339 (7th Cir. 1991).
[123] *Ampex Corp. v. Office Electronics, Inc.*, 24 Ill.App.3d 21, 320 N.E.2d 486 (1st Dist. 1974) (holding "Evidence, in action on account to recover value of magnetic tapes sold to two corporations, one of which was a new corporation formed by the other as its marketing arm, was sufficient to justify application of doctrine of piercing corporate veil against the parent corporation several of whose officers served as directors and officers of the marketing corporation.").
[124] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).

established as well.[125] Accordingly, these factors tend to serve a dual purpose in the veil piercing two-step analysis.[126] The badges of fraud are as follows:

(1) Inadequate capitalization;
(2) Failure to issue stock;
(3) Failure to observe corporate formalities;
(4) Nonpayment of dividends;
(5) Insolvency of the debtor corporation;
(6) Nonfunctioning of officers or directors;
(7) Absence of corporate records;
(8) Commingling of funds;
(9) Diversion of assets from the corporation by or to a stockholder, or other person or entity to the detriment of creditors;
(10) Failure to maintain arms' length relationships among related entities; and
(11) Whether the corporation was merely a façade for the operation of the dominant stockholders.[127]

In *Fontana*, the Court explained that to disregard the entity and pierce the corporate veil, the two-pronged test mentioned *supra* must be satisfied. In making that determination, the Court will look to the badges of fraud. The Court further noted that it will not base its decision on a single factor, but examine several factors and the totality of the circumstances.[128] In this case, home purchasers brought an action against TLD Builders, a construction company, and the company's president for breach of contract. The home purchasers sought to pierce the corporate veil and hold the president personally liable. Ultimately, the Court found that veil piercing was warranted for several reasons. TLD Builders' actions implicated numerous badges of fraud including undercapitalization, commingling of funds, failure to follow corporate formalities,

[125] 7 Ill. Prac., Business Organizations § 8:9 (2d ed.)
[126] *Id*.
[127] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).
[128] *Id.*

absence of corporate records, and the nonfunctioning of officers and directors. The Court's findings as to each factor are discussed in turn within the relevant sections of this article.

(2) Wachovia Securities, LLC v. Banco Panamerico

In *Wachovia*, a brokerage firm obtained a multimillion dollar judgment against a corporation for failing to pay margin debt. The firm sued to collect the judgment and sought to hold the corporation's insiders personally liable for the judgment. The Northern District of Illinois pierced the corporate veil finding that the corporation was inadequately capitalized, diverted assets to insiders and related entities, failed to observe corporate formalities, officers were nonfunctioning, failed to maintain arms' length relationships among related entities, and that adherence to the separate identities of the corporation and its insiders would sanction fraud or injustice. The Seventh circuit affirmed these findings and imposed personal liability on the corporation's insiders.[129]

Just as in *Van Dorn*, the Court in *Wachovia*, explained that veil will be pierced only when (1) there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) circumstances are such that adherence to the fiction of separate corporate existence would sanction a fraud or injustice.[130] In making this determination, the Court relied upon the badges of fraud. The Court reasoned that, in support of the unity or interest prong, the corporation diverted assets to business insiders and related entities after incurring the margin debt to the brokerage firm. The corporation paid almost $1.2 million to its insiders and related entities after the stock purchased on margin collapsed, and it also paid suspect, "off-the-books" compensation to officers. The corporation also failed to observe corporate formalities by failing to conform to its bylaws or keep corporate records. These failures enabled the insiders to dominate the corporation's decision-making and its failure to

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[129] *Wachovia Securities, LLC v. Banco Panamerico, Inc. et al.*, 674 F.3d 743 (7th Cir. 2012).
[130] *Wachovia Securities,* 674 F.3d 743*; Van Dorn v. Future Chem. & Oil Corp*., 753 F.2d 565 (7th Cir. 1985).

maintain arms' length transactions with related entities. Moreover, the corporation's lack of corporate records related to the entity's capitalization allowed insiders to control loans from the corporation and transfers to related entities. The Court continued that the entity's officers were nonfunctioning as they had a 50% stake in the corporation, but the corporate secretary, who owned the remaining 50%, was the entity's dominant shareholder and controlled the entity that financed the corporation's operations. The secretary refused to allow the corporation to pay the brokerage firm with loans from an entity that he controlled, and at the secretary's discretion, the corporation's accountant falsely held himself out to be the corporation's vice president. Furthermore, with respect to capitalization, which is discussed in more detail in the following section, the entity's assets were encumbered by a loan from the shareholder-controlled entity. Ultimately, the Court found that these facts supported the District Court's ruling to pierce the corporate veil.[131]

ii. **Undercapitalization**

As mentioned *supra*, Courts look to several factors to determine whether the two-prong test has been satisfied.[132] One highly litigated factor is whether the corporation had inadequate capitalization to conduct its affairs. In *Fontana*, the Court explained that to determine whether a corporation is inadequately capitalized for purposes of piercing the corporate veil, the court must compare the amount of capital to the amount of business to be conducted and the obligations to be fulfilled. The Court found that a corporation was undercapitalized when the president and a shareholder made loans to the corporation, and where there were no corporate resolutions authorizing repayment notes to be made from the corporation to the president and shareholder. The Court stated that the shareholder loans and line of credit issued by a bank did "not demonstrate adequate capitalization but, rather, show[ed] the inadequacy of TLD's capitalization

[131] *Wachovia Securities, LLC v. Banco Panamerico, Inc. et al.*, 674 F.3d 743 (7th Cir. 2012).
[132] *Van Dorn v. Future Chem. & Oil Corp.*, 753 F.2d 565 (7th Cir. 1985).

and indicate[d] that the initial capitalization, if any, was insufficient to conduct TLD's business of building homes." The Court reasoned that it is "inequitable to allow shareholders to set up a flimsy organization just to escape personal liability," and whether a corporation is adequately capitalized "is based on the policy that shareholders in good faith put at the risk of the business unencumbered capital reasonably adequate for the corporation's prospective liabilities."[133]

Similarly, in *Wachovia Securities, LLC v. Banco Panamerico*, the court explained that the undercapitalization factor compares the amount of capital to the amount of obligations to be fulfilled. The Court further explained that without adequate capitalization, a corporation is merely a liability shield instead of an independent entity capable of conducting its own business. The Court went on to say explained that adequate capitalization exists when a corporation has sufficient equity without considering loaned funds or encumbered assets. In this case, the Court held that, in Illinois, a secured insider loan is not wrongful per se; however, the corporation failed to pay its margin debt and received a loan from an insider-controlled entity. The insider structured the loan to avoid the entity's creditors by ensuring that its assets were encumbered by a blanket lien, which favored the insider. Thus, although the corporation had assets in addition to its initial $1,000 paid-in-capital, those assets were encumbered by a line of credit, and the corporation held itself out to others as "thinly capitalized," supporting a fining of undercapitalization.

Likewise, in *Laborers' Pension Fund v. Lay-Com, Inc*., the Seventh Circuit held that adequate capitalization exists when a corporation has sufficient equity without taking loaned funds or encumbered assets into account.[134] In *Gallagher v. Recono Builders, Inc.*, the Appellate Court of Illinois for the First District found that a corporation was undercapitalized when the

[133] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).

[134] *Laborers' Pension Fund v. Lay-Com, Inc.*, 580 F.3d 602 (7th Cir. 2009) (explaining "Under Illinois law, assessing whether a corporation is adequately capitalized is delicate business in the veil piercing analysis, and the legal test as to whether the corporation has so little money that it cannot operate its business 'on its own,' very generally, means that the corporation has adequate equity usually in addition to debt, though how much equity depends on the facts of the case.).

amount paid into the corporation at its formation was merely the former statutory minimum of $1,000,[135] and there were no other assets such as equipment, real estate or other resources to rely upon in the event something went wrong considering the "nature and magnitude of the corporate undertaking."[136] The Court found that the statutory minimum was not maintained for creditors and explained that no reduction of stated capital or paid-in-surplus can be made, even if the purpose is to pay creditors, if the withdrawal or reduction will reduce the stated capital (or paid-in-surplus) to an amount below the $1,000 statutory minimum.[137] In another case, the Appellate Court for the First District found that a corporation was "grossly undercapitalized" because its tax returns showed consistent negative retained earnings and virtually no cash on hand.[138]

With respect to shareholder loans, the Illinois Supreme Court has held that as long as a corporation remains solvent, directors can, with the shareholders' knowledge, "deal with the corporation, loan it money, take security or buy property of it, the same as a stranger."[139] The Court noted the instant the corporation becomes insolvent, the relationship between the entity and its directors and shareholders is materially changed.[140] In the event of insolvency the corporation's assets then become a trust fund to repay its creditors and directors cannot deal with the entity in a manner that would afford him or her priority over the corporation's creditors.[141] In *Plumbers' Pension Fund v. A-Best*, the Court held that regardless of whether the shareholders intended to "siphon money" from the corporation to place themselves in a better position than

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[135] Ill. Rev. Stat. 1971, ch.32, par. 157.50.
[136] *Gallagher v. Recono Builders, Inc.*, 91 Ill.App. 999, 415 N.E.2d 560 (1st Dist. 1980) (holding that "a Court's decision to disregard a corporation's limited liability is not based on one factor, but only after consideration of several factors. One of which, a corporation's capitalization, is a major consideration. Undercapitalization coupled with an element of injustice, fraud, or unfairness has been uniformly regarded as constituting a basis for individual liability.").
[137] *Id*.
[138] *McCracken v. Olsen Companies, Inc. et al.*, 149 Ill.App.3d 104, 500 N.E.2d 487 (1st Dist. 1986).
[139] *Roseboom v. Warner*, 132 Ill. 81, 23 N.E. 339 (1890).
[140] *Id*.
[141] *Id*.

the company's creditors, that is precisely what repayment of the loan accomplished and accordingly, constituted sufficient injustice to pierce the corporate veil.[142]

However, note that undercapitalization cannot be the sole factor and is insufficient on its own to render a corporation pierceable.[143] There must also be some element of unfairness, or something akin to fraud or deception to provide a basis for piercing the corporate veil.[144] For example, in *CM Corp. V. Oberer Development Co.*, the Court declined to pierce the corporate veil merely because the entity was insolvent at the time the suit was filed.[145] The Court explained that the claim must be supported with some evidence showing why the corporation was rendered insolvent; for example, some fraud perpetrated to make the corporation insolvent.[146] The Court held that without such evidence, an action to pierce the corporate veil cannot be justified.[147]

iii. **Failure to Observe Corporate Formalities**

An entity's failure to observe corporate formalities is often determinative in veil piercing cases. Pursuant to the Limited Liability Company Act, in Illinois, a failure to observe corporate formalities is not a ground for imposing personal liability on a member or manager of an LLC.[148] However, a failure to observe corporate formalities remains a factor for consideration in corporate piercing cases.[149] In an analysis of a corporation's failure to follow corporate formalities, several of the badges of fraud become intertwined. Courts often consider

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[142] *Plumbers' Pension Fund v. A-BestPlumbing & Sewer, Inc.*, 891 F.2d 1297 (N.D.Ill. 1992)
[143] *Browning-Ferris Industries of Illinois v. Ter Maat*, 195 F.3d 953 (7th Cir. 1999) (holding that "the fact that its motivation in operating with little capital was to reduce taxes does not argue for piercing the corporate veil, since taking advantage of lawful opportunities for avoiding taxes is not wrongful activity.").
[144] *Id*.
[145] *CM Corp. V. Oberer Development Co.*, 631 F.2d 536 (7th Cir. 1980) (holding "Parent corporation could not be held liable for debts of its subsidiary and subsidiary's predecessors, where there was no evidence that subsidiary or its predecessors were shells or sham corporations during period when plaintiffs and their assignors were dealing with them nor was there any evidence of wrong suffered by plaintiffs.").
[146] *CM Corp. V. Oberer Development Co.*, 631 F.2d 536 (7th Cir. 1980) (holding "Parent corporation could not be held liable for debts of its subsidiary and subsidiary's predecessors, where there was no evidence that subsidiary or its predecessors were shells or sham corporations during period when plaintiffs and their assignors were dealing with them nor was there any evidence of wrong suffered by plaintiffs.").
[147] *Id*.
[148] 805 ILCS 180/10 (as amended).
[149] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).

commingling of funds, the absence of corporate records, nonfunctioning of officers or directors, failure to pay dividends, and failure to issue stock evidence of a failure to follow corporate formalities.

(1) Commingling of Funds

Commingling of assets and funds tends to be a heavily weighed factor in a Court's veil piercing analysis,[150] and is generally viewed in the context of a failure to follow corporate formalities.[151] In *Sea-Land Services, Inc. v, Pepper Source*, the Seventh Circuit held that funds were commingled when a shareholder and owner of several corporations borrowed substantial amounts of money from those corporations, interest free, and where the corporations borrowed money from each other.[152] In this case, the shareholder also used the bank accounts of all of these corporations to pay personal expenses, including alimony, child support, educational expenses for his children, automobile maintenance, and healthcare for his pet.[153] In *Wikelund Wholesale Company Inc. v. Tile World Factory*, the Appellate Court for the First District upheld the trial court's finding that funds were commingled when a shareholder used the accounts of various corporations in which he had an interest to pay the debts of any one corporation, and where money received by one corporation might "come to rest" in the accounts of his other corporations.[154] Additionally, in a Second District case, the Court held that money paid into an officer's account that was not a salary, wage, dividend, or distribution demonstrated commingling between the officer and the corporation. [155]

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[150] 7 Ill. Prac., Business Organizations § 8:9 (2d ed.)
[151] *See*, *Sea-Land Services, Inc. v, Pepper Source*, 941 F.2d 519 (7th Cir. 1991) (holding "For purposes of determining whether corporation's veil could be pierced by creditor and money owed recovered from corporation's owner and other corporations he owned, there was such a unity of interest and ownership that separate personalities of debtor corporation no longer existed.").
[152] *Id.*
[153] *Id.*
[154] *Wikelund Wholesale Company Inc. v. Tile World Factory*, 57 Ill.App.3d 269, 372 N.E.2d 1022 (1st Dist. 1978).
[155] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).

On the contrary, in *Jay Steinberg v. Helen Buczynski*, the Seventh Circuit citing the Northern District of Illinois held that funds were not commingled where shareholders paid some of their personal expenses with checks issued by the corporation.[156] The Court explained that the shareholders "took no more than what would have been a reasonable amount in salary, merely omitting the formality of having salary checks issued to them and paying the personal expenses in question by personal check."[157] In this case, the entity was a Subchapter S corporation and the shareholders properly reported the payments of their personal expenses as personal income.[158] In *National Soffitt & Escutheons v. Superior System*s, another Seventh Circuit case, the Court declined to pierce the veil holding that assets were not commingled between related corporations when one entity purchased asset of the other at fair market value.[159]

(2) Absence of Corporate Records

The absence of corporate records is also viewed as evidence of a failure to observe corporate formalities. This is particularly so in "one-man" corporations where one person is the sole shareholder, director, and manager.[160] In *Jay Steinberg v. Helen Buczynski*, mentioned *supra*, the Seventh Circuit held that there was not a failure to follow corporate formalities despite the fact that the entity never held formal shareholder meetings or kept corporate minutes, and paid some of their personal expenses with checks issued by the corporation.[161] As mentioned above, the shareholders "took no more than what would have been a reasonable amount in salary, merely omitting the formality of having salary checks issued to them and paying the personal expenses in question by personal check."[162] Additionally, Illinois courts have

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[156] *Jay Steinberg v. Helen Buczynski*, 40 F.3d 890 (7th Cir. 1994).
[157] *Id*.
[158] *Id*.
[159] *National Soffitt & Escutheons v. Superior System*s, 98 F.3d 262 (7th Cir. 1996) (applying Indiana law, "directors and shareholders of second corporation had not been involved in wrongdoing leading to judgment in question, and second corporation's purchase of $700 of first corporation's tools at fair market value did not constitute sufficient commingling of assets.").
[160] 7 Ill. Prac., Business Organizations § 8:9 (2d ed.).
[161] *Jay Steinberg v. Helen Buczynski*, 40 F.3d 890 (7th Cir. 1994).
[162] *Id*.

consistently held that merely missing one annual meeting is not a sufficient showing of failure to observe corporate formalities.[163]

On the other hand, the Seventh Circuit did find a failure to observe corporate formalities between two related corporations where: one corporation used the other's stationery, where one corporation used a bank wire transfer account to assist in the exercise of options by the other's customers, and where both corporations conducted business from the same suite of offices.[164] These corporations also made undocumented asset transfers to one another and failed to notify creditors of the transfers.[165] In *Gallagher v. Recono Builders*, the Appellate Court for the First District held that a corporate defendant failed to follow corporate formalities because there were no corporate resolutions, meetings were undocumented, and the defendant failed to produce any corporate books.[166] The Court concluded that, in the absence of any evidence to support the corporation's claims that it maintained these records, no meetings occurred and no corporate books existed, or alternatively that corporate books contained information adverse to the corporation's claim.[167]

(3) Corporate Formalities and Other Badges of Fraud

Other badges of fraud that go towards proving or disproving a failure to observe corporate formalities, include nonfunctioning of officers or directors, failure to issue stock, and nonpayment of dividends. These issues are litigated significantly less than commingling and absence of corporate records. Illinois case law offers limited discussion for some of these factors

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[163] *Judson Atkinson Candies v. Latini-Hohberger*, 529 F.3d 371 (7th Cir. 2008); *Jacobson v. Buffalo Rock Shooters Supply*, 664 N.E.2d 328 (3rd Dist. 1996).
[164] *Matter of Palmer Trading, Inc.*, 695 F.2d 1012 (7th Cir. 1982) (holding that "attempts at accounting segregation were overshadowed by widespread intermingling of corporate affairs and other unorthodox and careless business practices," and affirmed Bankruptcy Court's conclusion that continued maintenance of *some* of the normal corporate formalities illustrated "wrongful deceit.").
[165] *Id*.
[166] *Gallagher v. Recono Builders*, 91 Ill.App.3d 999, 415 N.E.2d 560 (1st Dist. 1980)
[167] *Id*.

and courts have been vague in precisely defining their terms and the behaviors or limitations that trigger these badges of fraud.

With respect to a failure to issue stock, the Court in *People v. V & M Indus., Inc.* found a failure to follow corporate formalities where the evidence established that the corporation failed to issue stock. In this case, the defendant testified that he originally owned 99% of the stock and that his relatives owned the remaining 1%. However, no stock certificates were on file for those shareholders, the defendant admitted that "certificates of ownership may not have been [issued]," and one of two shareholders who purchased the relatives' stock testified that he was never issued a stock certificate.[168] In *Wachovia Securities v. Banco Panamericano*, the Seventh Circuit upheld the Northern District of Illinois' finding that the veil should be pierced noting only that the corporation's failure to issue stock weighed against it as a badge of fraud.

Regarding nonpayment of dividends, in *Jacobson v. Buffalo Rock Shooters Supply*, the Court noted only that Corporation's failure to pay dividends "was not a failure to observe corporate formalities, as would support piercing corporate veil, where corporation had only been in existence slightly more than one year."[169] In 1993, the Fourth District Appellate Court held that the facts supported a finding of failure to follow corporate formalities and nonpayment of dividends where no dividends were paid from 1972 when the stock was purchased through 1983 when the corporation was sold.[170] The Court rejected the shareholder-owner's argument that the business was never "strong enough" to pay dividends when the business made other suspicious cash payments to owners, and because owners received other monetary benefits from the corporation.[171]

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[168] *People v. V & M Indus., Inc.*, 298 Ill.App.3d 733, 700 N.E.2d 746 (5th Dist. 1998).
[169] *Jacobson v. Buffalo Rock Shooters Supply Inc.*, 278 Ill.App.3d 1084, 664 N.E.2d 328 (3rd Dist. 1996).
[170] *Ted Harrison Oil Co., Inc. v. Dokka*, 247 Ill.App.3d 791, 617 N.E.2d 898 (4th Dist. 1993).

[171] *Id*.

Illinois courts have been relatively broad in defining what constitutes nonfunctioning of officers and directors. In *Fontana*, the Court held that a shareholder was nonfunctioning since she was not an active director of officer of the corporation.[172] The Court explained that she had no real decision-making role, performed *de minimus* tasks, and did not know she was the sole shareholder and director of the corporation.[173] In different circumstances, the Seventh Circuit, citing the Northern District of Illinois, held that a defendant-shareholder's control over other officers, employees, and operations rendered them nonfunctioning where the defendant-shareholder held 50% of the corporation's shares, and was 100% owner of the corporation's lender and its sole source of financing.[174]

iv. **Reverse Pierce**

The concept of reverse veil piercing is a variation of the traditional veil piercing remedy. A reverse pierce subjects the corporation to liability for the acts of its shareholders.[175] Generally, reverse pierce issues arise when a shareholder's creditors try to reach the assets of the corporation.[176] In *Scholes v. Lehmann*, the Court explained that reverse piercing is ordinarily possible only in one-man corporations, since if there is more than one shareholder, seizing the corporation's assets to pay a shareholder's debts would be a wrong to the other shareholders."[177] In *Boatmen's Nat'l Bank of St. Louis v. Smith*, the Northern District of Illinois, the Court granted a judgment creditor's request to reverse pierce the veil of a corporation whose sole shareholder, director, and president was liable for the judgment.[178]

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[172] *Fontana v. TLD Builders*, 362 Ill.App.3d 491, 840 N.E.2d 767 (2nd Dist. 2005).
[173] *Id*.
[174] *Wachovia Securities, LLC v. Banco Panamerico, Inc. et al.*, 674 F.3d 743 (7th Cir. 2012).
[175] TIMOTHY S. FARBER, ILLINOIS INSTITUTE FOR CONTINUING LEGAL EDUCATION: ILLINOIS LIMITED LIABILITY COMPANY OPERATING AND MAINTENANCE ISSUES 3-28 (WILLIAM A. PRICE 2013).
[176] *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995).
[177] *Id*.
[178] *Boatmen's Nat'l Bank of St. Louis v. Smith*, 706 F.Supp. 30 (N.D.Ill. 1989) (holding "Under Illinois law, judgment against debtor, who was sole shareholder, director, president and treasurer of corporation, could be satisfied out of funds of corporation; corporation was alter ego of debtor since assets of debtor and corporation were commingled, debtor did not keep bank account in his own name, and debtor's wife paid household expenses by

In 2007, the First District Appellate Court in *Trossman v. Philipsborn* outlined a test for reverse piercing.[179] The Court explained that reverse piercing of the corporate veil is appropriate when (1) an insider owns all, or substantially all, of the stock, (2) the insider treats the property as his or her own, and (3) no shareholder or creditor would be adversely affected.[180]

In *Trossman*, a corporation was the general partner in a limited partnership.[181] The partnership was engaged in real estate development, and the corporation and plaintiff guaranteed a loan to the limited partnership.[182] The parties agreed that if either guarantor made a payment over their pro rata obligation, each could recover the excess payment from the other guarantor.[183] When the loan was in default, the corporation made payments, which the shareholders claimed should credited to them under the reverse pierce doctrine.[184] The Court suggested that while each element for reverse piercing appeared to be satisfied, it is bound by the Illinois Supreme Court's holding's in *Centaur* that a corporation may not assert an alter ego action against its own shareholders,[185] as well as the affirmation of *Centaur* in *Forsythe* where the Court refused to allow a corporation to pierce its own veil noting "direct participant liability does not rest on piercing the corporate veil such that the liability of the subsidiary is the liability of the parent. On the contrary, "this form of liability is asserted, as its name suggests, for a parent's direct participation, superseding the discretion and interest of the subsidiary, and creating conditions

borrowing money from corporation and other companies controlled by debtor.").

[179] *Trossman v. Philipsborn*, 373 Ill.App.3d 1020, 869 N.E.2d 1147 (1st Dist. 2007).

[180] *Id*.

[181] *Id*.

[182] *Id*.

[183] *Id*.

[184] *Id*.

[185] *In re Rehabilitation of Centaur Ins. Co.*, 158 Ill.2d 166, 632 N.E.2d 1015 (1994) (holding "Reinsurer could not bring alter ego action against its parent corporation, piercing its own corporate veil in the process, and, thus, reinsurer's rehabilitator could not seek to pierce corporate veil and lacked standing to pursue alter ego claim of reinsurer's policyholder against parent corporation.").

leading to the activity complained of."[186] Accordingly, the Court held that the shareholders did not have the right to contribution from the payments advanced by the corporation.[187]

In *Crum v. Krol*, the First District held that "the same equitable considerations of preventing injustice should apply when it is a third party, rather than a shareholder or officer, who attempts to use the corporate entity as a shield."[188] However, as the Illinois Supreme Court explained in *Centaur*, a subsidiary corporation cannot bring an action against its parent corporation seeking to reverse pierce, thereby piercing its own veil in the process.[189] The Illinois Supreme Court, citing the Northern District of Illinois in *In re Dakota Drilling, Inc.*, explained that "[T]he general law mandates that the piercing of a corporate veil must never be made for the benefit of the corporation or its shareholders. It is troublesome, in this court's view, to allow a corporation, through its trustee, to pierce its own veil since it would have the effect of denying the corporation of its own corporate existence."[190]

In *Main Bank of Chicago v. Baker*, the Illinois Supreme Court did not reverse-pierce the corporate veil at the request of the defendant-shareholder. Main Bank was a subsidiary of Main Corporation. Another corporation was created, for which Main Bank held 80% of the stock and the defendants owned the remaining 20%. The defendants leased services to the corporation and when the corporation defaulted on its lease payments, the defendants could no longer make payments on their note to Main Bank. Main Bank sued on the note and the defendant-shareholders sought to hold Main Bank liable via reverse pierce. The defendants requested that the court disregard the corporation in addition to disregarding Main Bank's corporate existence to hold Main Bank liable on the note, which would cover the defendant's liability. The Court

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[186] *Forsythe v. Clark USA, Inc.*, 224 Ill.2d 274, 864 N.E.2d 227 (2007).
(holding "The key elements to the application of direct participant liability are a parent corporation's specific direction or authorization of the manner in which an activity is undertaken and foreseeability; if a parent corporation specifically directs an activity, where injury is foreseeable, that parent could be held liable.").
[187] *Trossman v. Philipsborn*, 373 Ill.App.3d 1020, 869 N.E.2d 1147 (1st Dist. 2007).
[188] *Crum v. Krol*, 99 Ill.App.3d 651, 425 N.E.2d 1081 (1st Dist. 1981).
[189] *See, In re Rehabilitation of Centaur Ins. Co.*, 158 Ill. 2d 166, 632 N.E.2d 1015 (1994).
[190] *Id*.

declined to reverse pierce holding that a party "cannot assert the equitable doctrine of piercing the corporate veil to disregard the separate corporate existence of a corporation he himself created to gain an advantage which would be lost under his present contention."[191]

In an unusual situation, a corporation's director sought to reverse pierce to bring a claim against the corporation's primary shareholder. The plaintiff obtained a judgment against Heartland Pottery Company. The Defendant, Estes was a shareholder and provided the financing, while the Plaintiff was the other shareholder, president, and director. The plaintiff obtained a judgment against Heartland and filed a citation to discover assets. When no assets were discovered, the plaintiff sought to reverse pierce the corporate veil. The Court explained that while there is no Illinois authority expressly prohibiting directors from piercing the corporate veil for their benefit, to do so would "improperly allow them to hide behind the corporate veil when it benefits them and then discard it when it is no longer useful." The Court explained that the plaintiff "had an obligation to obtain information about the company that he served."[192]

While reverse piercing has not been litigated heavily in Illinois, based on the foregoing, it appears difficult to reverse pierce in a context other than the "one-man" corporation discussed *supra*.

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[191] *Main Bank of Chicago v. Baker*, 86 Ill. 2d 188, 427 N.E.2d 94 (1981).
[192] *Semande v. Estes*, 374 Ill.App.3d 468, 871 N.E.2d 268 (3rd Dist. 2007) (holding "Director of corporation, as judgment creditor of corporation, was not entitled to invoke the equitable doctrine of piercing the corporate veil, to collect the judgment from majority shareholder; director had an obligation to obtain information about the corporation that he served, and he therefore did not stand in position of innocent third-party creditor.").

C. Veil Piercing and LLC's

The Limited Liability Company Act ("LLCA") governs Limited Liability Companies ("LLC") in Illinois.[193] The statute originally provided that a member of an LLC would not be liable for any act, debt, obligation, or liability of the LLC to the extent that a shareholder of an Illinois corporation would be liable under analogous circumstances.[194] Thus, a member of an LLC could be held personally liable to the same extent that a shareholder of a corporation could be held liable using the veil piercing doctrine. [195] However, the Act was amended in 1998 to remove the language that provided personal liability for members or managers.[196] The LLCA now provides:

> The debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of a company solely by reason of being or acting as a member or manager.

Illinois case law on the matter is sparse and the amendment raises questions as to the legislature's true intent in amending the language. The concept of piercing the corporate veil has been applied by the Illinois judiciary dating back to 1910 and is strongly rooted in Illinois as an equitable remedy.[197] Pursuant to the United States Supreme Court decision in *Midatlantic National Bank v. New Jersey EPA*, the general rule of statutory construction is that if the legislature intends for legislation to change a judicially created concept, it must make that intent specific.[198] As a result, two approaches have emerged regarding the application of veil piercing in the LLC context.

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193 805 ILCS 180/10 (as amended).
194 805 ILCS 180/10-10 (1994).
195 *See*, *Id*.
196 *See*, 805 ILCS 180/10 (as amended).
197 MARK A. CARTER ET AL., Illinois Institute for Continuing Legal Education: Limited Liability Companies and S Corporations, Insolvency Implications for the Limited Liability Company and its Members 13-17 (William A. Price 2013).
198 *Midatlantic National Bank v. New Jersey EPA*, 474 U.S. 494 (1986).

Recently, in *Puleo v. Topel*, the Appellate Court for the First District of Illinois considered piercing the veil of an LLC that was administratively dissolved for failing to report.[199] The Court held that an individual member or manager of an LLC was not personally liable for obligations incurred by the entity after it was dissolved by the Secretary of State.[200] The Court relied on the amended LLCA § 10-10(a), and also on § 10-10(d), which provides that an LLC may assign personal liability to its members by including a provision to that effect in its articles of organization, or if a member consents to the imposition of such liability in writing.[201] It has been argued that this protection goes beyond the protections enjoyed by shareholders of a corporation.[202]

Moreover, the LLCA provides that an LLC's failure to observe corporate formalities is not a ground for imposing personal liability on its members or managers.[203] Specifically, the statute states that "the failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company."[204] Thus, there is a strong argument that unless the LLC has provided for personal liability in its articles of organization, its members are not subject to personal liability under the veil piercing doctrine.

The second approach is that veil piercing is applicable to LLCs just as it is to corporations. After analyzing § 10-10, a Bankruptcy Court in the Northern District of Illinois noted that while members and managers cannot be held liable for merely failing to observe

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[199] *Puleo v. Topel*, 368 Ill.App.3d 63, 856 N.E.2d 1152 (1st Dist. 2006).
[200] *Id*.
[201] 805 ILCS 180/10; *Puleo v. Topel*, 368 Ill.App.3d 63, 856 N.E.2d 1152 (1st Dist. 2006).
[202] MARK A. CARTER ET AL., *supra* note 86; *See, Carollo v. Irwin*, 2011 Ill.App. (1st) 102765, 959 N.E.2d 77 (1st Dist. 2006) (holding that a "Member of unformed limited liability company (LLC) could not be individually liable for signing the property sales contract on behalf of the unformed LLC due to insulation from liability under the Limited Liability Company Act.").
[203] 805 ILCS 180/10-10(c).
[204] 805 ILCS 180/10-10 (as amended).

corporate formalities, nothing in the statute bars piercing the LLC veil on other grounds.[205] In fact, a majority of federal courts for the Northern District of Illinois have held that traditional bases for veil piercing, such as undercapitalization, alter ego, and fraud, apply in the context of an LLC.[206] In *Westmeyer v. Flynn*, the Court declined to follow the First District's reasoning in *Puleo* and noted that § 10-10 of the LLCA "does not bar the other bases for corporate veil piercing, including alter ego, fraud and undercapitalization."[207]

In *Polo Builders Inc. v. Real Estate Resource Management*, a Bankruptcy Court in the Northern District of Illinois recognized the doctrine of piercing the LLC veil. The Court analyzed the "unity of interest" prong extensively, but declined to pierce the LLC veil because the "fraud or injustice" prong was not met.[208]

Further, it has been argued that the Court, in *Puleo*, did not appreciate that fact that, historically, limited liability provisions such as LLCA § 10-10 existed for tax benefit purposes. These provisions enabled LLC's to reap the benefits of being taxed as a partnership prior to the adoption of IRS "check-the-box" regulations. Accordingly, the legislature's intent in amending the statute was not to protect LLC members from personal liability, but to provide LLCs with the flexibility to override statutory default rules via articles of organization.[209]

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[205] 274 B.R.768 (N.D.Ill. 2002).
[206] MARK A. CARTER ET AL., *supra* note 86.
[207] MARK A. CARTER ET AL., *supra* note 86, at 13-17; *See also*, *Westmeyer v. Flynn,* 382 Ill.App.3d 952, 321 Ill.Dec. 406 (2008) (citing section 10–10(d) of the Limited Liability Company Act (805 ILCS 180/10–10(d) (West 2008)).
[208] *Polo Builders Inc. v. Real Estate Resource Management*, 388 B.R. 338 (N.D.Ill. 2008) (explaining "While failure on part of members of limited liability company (LLC) to observe 'corporate' formalities or to maintain books and records for LLC, along with fact that the LLC had no assets at time it entered into contract to purchase real property for more than $16 million, was sufficient to satisfy first requirement for piercing of veil under Illinois law, i.e., a unity of interest and ownership between LLC and its members, lack of evidence of any fraudulent intent on part of members of LLC in entering into purchase agreement, which they hoped to close with funds supplied by third party to whom they intended to 'flip' property, together with evidence that any harm suffered by seller, the trustee of Chapter 7 estate, was result not of misstatements made by members of LLC but of trustee's failure to engage in any due diligence regarding finances of LLC in order to obtain quick sale and to prevent mortgagee from foreclosing, prevented piercing of LLC's veil in order to hold its members personally liable for judgment entered in favor of trustee on his breach of contract claim.").
[209] CHARLES W. MURDOCK., Illinois Institute for Continuing Legal Education: Limited Liability Companies and S Corporations, Liability of Members and Managers in Limited Liability Companies, Including Breach of Fiduciary Duties 6-25 (William A. Price 2013).

Several states have recognized the doctrine of piercing the LLC veil, including Delaware and New York.[210] However, in Illinois, case law on the matter is sparse, somewhat contradictory, and largely undeveloped in light of the recent statutory amendment to LLCA § 10-10. Accordingly, it is yet to be seen which approach will prevail in the application of corporate veil piercing to Illinois limited liability companies.

CONCLUSION

In conclusion, great care must be given when a litigant is considering the pursuit of causes of action for fraudulent conveyances and piercing the corporate veil. Hopefully, the discussion of the law in Illinois in this article will assist the practioner in evaluating and pursuing these claims in a time- and cost-efficient manner with great success.

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[210] *See generally*, *Id*.