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### Real Estate Law, Bankruptcy Law Foreclosure & Debtor/Creditor

## When Limited Liability is **Not so 'Limited'**

It used to be that corporations and LLCs protected business people from personal liability. Not so fast! As a general rule, business owners and operators running their enterprises in a corporate or LLC form are not personally responsible for the debts and liabilities of their entities. There are, however, certain important exceptions to this

general rule. This article provides an overview these exceptions by describing those situations where a business owner or operator may have personal liability exposure.

The concept of "limited liability," whereby a business owner or operator's personal liability is limited to the value of his equity investment in his company, is a hallmark of

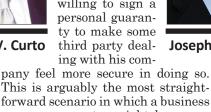
corporate law. Both statutory and case law, and the courts, recognize that this well-established principle serves an important public policy by encouraging business development, which in turn creates jobs and fosters economic growth. If the entity is sued, the liability exposure is typically limited to the entity itself and does not extend to its owners or operators. Such limited liability protection therefore encourages individual business owners and operators to pursue new ventures in corporate or LLC form,

without having to worry that their personal assets will be at risk.

#### **Personal Guaranty**

If a business owner or operator personally guarantees his company's debts or obligations, he is then personally liable for their non-payment. This occurs most commonly at the entity's start-up phase, as

> lenders. landlords and vendors will often require a personal guaranty before dealing with a newly formed company. An owner operator may be willing to sign a personal guaran-



This is arguably the most straightforward scenario in which a business owner or operator might bear personal responsibility for his company's debts and obligations.

#### 'Piercing the Corporate Veil'

Although doing business as a corporation or LLC typically protects individual owners from personal liability, in rare cases, courts will allow a litigant to "pierce the corporate veil" and will hold the owners personally responsible for the company's actions. A court may grant this extreme remedy in situations where a business owner misuses or abuses the corporate or LLC form, or attempts to use it as a shield to protect his own culpable conduct. Piercing usually occurs only in the closely held company context. The test for piercing has been stated in many ways, but the general concept

is that the litigant wishing to pierce must show: first, that the defendant owner dominated and controlled the entity, so that the entity had no will of its own; second, that the owner used this control to commit fraud or some other wrongdoing; and third, these wrongful actions were the cause of the litigant's loss or injury. The owner must have par-

ticipated in the actual wrongdoing in order to be personally liable - a court can "pierce," therefore, for one owner, without piercing for all of them.

Beyond the three-step inquiry stated above, courts will consider other factors. One is whether or not the company has observed corporate formalities, such as holding meetings, having shareholder or member votes, and keeping a minute book. If the company does not do these things, a court may be more apt to believe that the entity is simply a front for the business



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owner's individual actions. A court will also look to see whether there has been a commingling of individual and company funds and assets, another indicator that the owner is using his corporation or LLC for his own personal purposes. Finally, if a company uses deceptive business practices to give the appearance of stability and solvency, thereby luring potential investors and creditors to part with their money under false pretenses, a court is more likely to pierce the corporate veil and hold the culpable individual owner responsible.

#### Payment of Sales Tax

New York Tax Law § 1133 imposes personal liability for unpaid sales and use taxes upon "persons required to collect tax." With respect to companies, this can include shareholders, members, directors, managers, officers and employees who are under a duty to act for the entity and collect taxes. The inquiry is whether the business owner or operator is a "responsible person" who had adequate control and authority over the entity's tax collection function – an owner or operator is not automatically liable simply by virtue of being an owner or operator. If such individual does not exercise sufficient control over the collection of taxes, he is not a responsible person for purposes of the law. The Tax Commission considers various factors when making its determination, including the individual's status as an owner and the percentage of equity owned. Possible evidence that an owner or operator is a "responsible person" may be found if he is also the Chief Financial Officer or Treasurer, if he signs corporate tax returns, or if he has full access to the entity's books and accounts. The "responsible person" determination is made on a case-by-case basis.

#### Wages

New York's Business Corporation Law ("BCL") § 630 addresses the potential personal liability of corporate shareholders for wages owed to corporate employees. The aim of this statute is to safeguard corporate employees from corporate insolvency. Under BCL § 630, the ten (10) largest shareholders of a

New York corporation are jointly and severally liable for wages or salaries due to any of the corporation's employees for services performed for the corporation. The ten (10) largest shareholders are determined by the fair value of their interest at the beginning of the period during which the unpaid services were performed. Notably. since the ten (10) shareholders are jointly and severally liable, an employee may choose to go after the one wealthiest shareholder, increasing the chances for greater personal exposure for this shareholder. In this event, the targeted shareholder may seek contribution from the other "Top 10" shareholders, pro rata.

Before a corporate employee can pursue the corporation's shareholders for unpaid wages personally, he must attempt to collect directly from the corporation. It follows that the corporation must fail to satisfy his demand. If the employee decides to then pursue the corporation's shareholders, he must notify them, in writing, that he intends to hold them personally liable.

"Wages" include all compensation and benefits the corporation owes the employee for his services to the corporation. Under the statute's broad definition, wages can include: salary, overtime, vacation, holiday, and severance pay; employer contributions to insurance or welfare benefits; employer contributions to pensions or annuities; and any other money due for services rendered by the employee.

#### **Environmental Regulations**

Another notable instance in which business owners or operators may be personally responsible for a company's obligations relates to environmental regulatory law. In 1980. Congress enacted Comprehensive Environmental Response. Compensation, Liability Act ("CERCLA"). CERCLA addresses the release or threatened release of hazardous materials into the environment. Parties responsible for the release of such substances are liable for the costs associated with the cleanup. The "owner or operator" of a facility that stores or uses hazardous waste is strictly

liable for these costs.

New York has a similar statute, commonly known as the "Oil Spill Act," which relates to the discharge of petroleum, specifically. Under New York's law, a business owner or operator must be directly, actively, and knowingly in-volved in the action or inaction which led to the spill of petroleum. Therefore, some direct culpable individual conduct is required before the owner or operator will be held personally responsible.

#### **Personal Conduct**

Although a relatively self-evident exception, it is worth mentioning that neither corporate nor LLC form will protect individual business owners and operators from their own wrongful or fraudulent conduct. Individuals who engage in such conduct in their business practices face exposure both criminally and civilly on a personal level. Further, doing business in an entity form does not insulate individuals from personal tort liability, *e.g.*, negligent operation of an automobile.

Business owners and operators, for the most part, should be confident that they will not be held personally responsible for their company's debts or obligations. This fundamental principle of corporate law is well entrenched in New York. There are, however, several important exceptions to this general principle, which this article has briefly laid out. In these few limited instances, individuals owning and operating businesses should be aware of their potential personal exposure and plan and govern their conduct accordingly. Is it important to note, however, that even the best planning cannot always limit the exposure such individuals may face to getting sued.

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