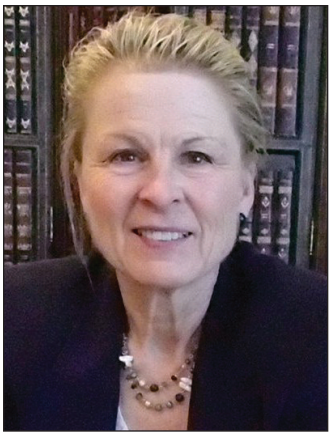
BusinessAdvisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON
VOLUME 38
NUMBER 1
SEPTEMBER
2021



Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 30 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

CORPORATIONS AND LLCS: When They Don't Protect Owners from Personal Liability

by Mary Hanson

Corporations and limited liability companies (LLCs) are utilized to provide business owners with protection or insulation from the liabilities arising from operation of businesses. However, the desired protection from personal liability may not be effective under a number of circumstances. The use of a business entity does not protect a business owner from all claims. The nature of the business and the nature of the claim being made determine how effective will be the protection provided by use of a corporation or an LLC.

The Protection Expected from Use of an Entity

The business liabilities that corporate shareholders and LLC members wish to avoid include:

product liability;

liability for failure to perform contractual obligations;

liability for faulty services that cause injury or damage;

liability for accidents caused by employees;

liability for employee actions that cause injury or loss to others;

liability for violations of employment law;

liability for injury to persons on the business premises;

penalties for noncompliance with laws and regulations; and

liability for taxes and penalties and interest for nonpayment of taxes.

The intended protection comes from using an entity to do business, employ employees, sell products, and perform contracts, rather than having the shareholders, members, or limited partners engage in business. The intended result is that claims against the business are not claims against the owners of the entity that operates the business.

However, there are many circumstances under which shareholders, LLC members, and owners of other business entities can be held personally liable for business liabilities. Under certain circumstances the entity owner may remain exposed to so many of the potential liabilities that incorporation (or the use of any other entity) does not offer much protection from personal liability.

Personal Claims

Where individual owners are personally active in the business, a customer, employee, or other party claiming harm caused by the business may ignore the entity and make a direct claim against an owner of the business. For example, an injured party may claim that the individual owner was negligent in providing the services offered by the business, driving a vehicle, supervising employees, hiring employees, or some other business action that resulted in harm or loss to the claimant.

If the business owner is the sole employee of a service business and provides all the services, the business owner will find it difficult to hide behind the corporate veil and avoid personal liability if claims are made against him or her for services provided.

"… there are many circumstances under which shareholders, LLC members, and owners of other business entities can be held personally liable."

If the services of the business are provided by employees, the owner's direct personal liability to customers and other parties is reduced, but not eliminated. If all employees are hired and supervised by the owner, there is potential personal liability for personally failing to adequately check employee backgrounds, train employees, or supervise employees, if a claim alleges such failures caused harm.

Personal Guaranties and Payroll Taxes

Even if a business owner is not exposed to business liabilities because of his or her business activities, he or she may incur personal liability based on personal contracts or based on state or federal law that imposes liability on individuals.

Contractual commitments made by a shareholder or LLC member in his or her own name are personal commitments that create personal liability. Even if the business will be performing the contract, personal liability rests with the party that entered the contract. Personal guaranties of business obligations are personal commitments that expose the guarantor to liabilities based on the obligations guaranteed under the contract. If the entity fails to perform, the other party to the contract may pursue the guarantor for performance of the contract.

Even without a contract or personal commitment, state and federal law can make an individual responsible for business liabilities. Corporate officers or other employees responsible for payment of taxes may be held liable for non-payment of taxes owed by the entity. It is not uncommon for state tax agencies or the IRS to hold individuals responsible for payment of unpaid payroll taxes based on laws that impose such liability on individuals with responsibility for deposit of payroll taxes.

Piercing the Corporate Veil

Even if a business owner is not so involved in every aspect of the business that he or she is exposed to the business liabilities, an individual or business with a claim against a business entity may attempt to "pierce the corporate veil" and hold the shareholders (or members of an LLC) liable based on state law that defines when shareholders (or owners of another type of entity) may be held responsible for business liabilities.

Under California law, shareholders of a corporation (and members of an LLC) can be held liable for harm caused by their corporation or LLC if there is a "unity of interest and ownership" between the individual owners and the entity such that there is no effective separation between them, and the court finds that there would be an "inequitable result" if the acts of the business were treated as those of the corporation alone. The bulk of the caselaw on piercing the corporate veil involves corporations, but the same law applies to LLCs and other entities. The fact situations found to support holding entity owners liable include:

- Failure to issue stock. The issuance of stock is a primary step in the formation of a corporation. Without the issuance of stock, share ownership is not established and no sale of stock has generated funds for the corporation.
- Failure to capitalize the corporation. Shareholders need to provide capital to establish the corporation as an entity financially separate from the shareholders.
- "Inadequate capitalization." The corporation must not only be funded,

CORPORATIONS AND LLCS: When They Don't Protect Owners from Personal Liability

but must be funded with an amount of money that is adequate to make the corporation financially viable.

- Failure to distinguish between corporate and personal assets or "commingling" of personal and corporate funds. A corporation's assets and activities should be distinct from those of its shareholders.
- The use of corporate assets as a shareholder's own. This use of the corporation as an "alter ego" is contrary to the separation between the owners and the entity that are necessary for shareholders to avoid personal liability. Under California law this would establish the a "unity of interest" between the corporation and the shareholder.
- Failure to maintain corporate records. California corporations are required to have an annual shareholders' meeting for the purpose of electing directors. A properly established and maintained corporation should have evidence of annual meetings and actions taken reflecting the structure of a corporation – with shareholders electing a Board of Directors, and the Board of Directors authorizing actions to be taken by the corporation.
- Failure to keep corporate financial records. The separate status of the corporation should be clear from the accounting records and financial statements.

In a lawsuit against a corporation or LLC owned by one shareholder or member, it is common that the claimant will add the shareholder or member to the lawsuit, claiming that state law on "piercing the corporate veil" or "alter ego" liability will allow the plaintiff to hold the individual owners liable as well as the entity.

This potential failure to provide protection from liability also applies to affiliated entities. If two or more entities are owned and operated by the same owner or group of owners and the entities are not maintained separately, affiliated entities uninvolved in a contract or accident that caused liability may be held liable for performance of contract obligations or payment for injury or harm caused by an affiliated entity.

The most common situation in which sister companies are held liable is one in which assets, facilities, and employees are shared between affiliated entities. A financially weaker sister company may rely on funds and facilities of affiliated entities, exposing the affiliated entities to liability for the acts or obligations of the weak sister company. The use of more than one entity may fail to provide protection if the entities are not adequately maintained as independent and separate.

Individual owners (shareholders or members) and affiliated companies are more likely to be pursued by customers, employees, vendors, or injured parties if there is inadequate insurance to cover claims. The prime target in litigation has become insurance.

Insurance

By covering the costs of defense and payment of claims, insurance protects the business entity, affiliated entities, and the entity owners, if the insurance provides the right type of coverage with limits adequate to cover the claims.

To make sure all potentially liable parties – business entities, affiliated entities, and shareholders or members – are protected by the insurance, each party that might be named in a lawsuit must be named as an "additional insured."

"Contractual commitments made by a shareholder or LLC member in his or her own name are personal commitments that create personal liability."

BusinessAdvisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON
21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

RETURN SERVICE REQUESTED

Publisher's Note

Business owners should regard the use of entities and insurance as a part of a larger business issue of "risk management." Risk management encompasses not only effective use of entities, but also smarter use of insurance policies and more careful negotiation of contracts to make sure risks are placed with other parties where appropriate.

The most basic step in risk management is reviewing internal operations of a business to find activities, facilities, methods, and policies that can be changed to eliminate or lower the risk of accidents, defects, and losses. A serious risk review of a business may find certain lines of business, particular products, problem sources, unreliable transportation methods, and other aspects of the business that could be changed to reduce risk and potential liability or loss.

The business of risk management has developed greatly in recent years and finding worthwhile assistance may be easier than in the past.

Mary Hanson
Attorney/Publisher

BusinessAdvisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON

Insurance does not do what incorporation or the use of other entities does. An insurance policy only covers the risks specifically identified in the policy as covered risks, excluding risks identified as "exclusions," up to the policy limits. Insurance coverage is established by the terms of the insurance policy and the protection provided should be understood as that of a contractual agreement. It does not provide the type of broad protection from personal liability that the use of an entity may provide.

Walking Away from an Entity

When a business entity incurs liability that is not covered by insurance, is above insurance coverage limits, or is below the insurance deductible, the business (and/or its owners) will typically use available funds or borrow additional funds to pay the liability. If the entity or its owners do not pay off the amounts owed, the ultimate protection from personal liability by use of an entity means abandoning the entity to bankruptcy or some other demise, hoping that creditors will not take action to hold related entities, shareholders, or members liable. Walking away from a bankrupt entity means losing the entire value of past investment in the entity as well as its prospects for the future.

Owners of businesses relying on LLCs and corporations for protection from liability need to understand that they will typically pay the business liabilities, effectively limiting the "protection from personal liability" to catastrophic events. BA