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SMALL BUSINESS GROWTH STRATEGIES

Going on the defensive minimizes liability exposure

Expert Opinion

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The president and owner of a New Jersey construction company was personally sued in Maryland recently for amounts owed to an equipment rental company pursuant to rental agreements between the two companies. While this small business owner was ultimately found not to be personally liable for the debt, no doubt he fought a costly legal battle. The owner endured nearly four years of litigation, including a trial and two appeals, before succeeding. All of it could have been easily avoided.

A corporation is a legal fiction; it is a creation of the law and is regarded as a separate legal entity. One of the most important benefits of doing business as a corporation is that the corporation's officers, directors, members and stockholders are insulated from the debts of the corporation. For example, when a small business owner signs a contract for his company, it is a corporate act, not a personal act, and the owner is not personally liable for the debt — at least not usually.

PIERCING THE CORPORATE VEIL

Under certain circumstances, courts will allow a creditor to "pierce the corporate veil" of a company, holding its owner personally liable to the creditor. A court may disregard the existence of the corporate entity to prevent fraud or to enforce "a paramount equity." In the latter case, a creditor must show that an inequitable result, involving fundamental unfairness, will result from a failure to disregard the corporate form. It is the amorphous nature of the latter legal concept that results in much litigation for small business owners who may not adhere strictly to the formal requirements of corporations under the law.

When most of a company's stock is held by one or a few individuals and certain other factors exist, a court may choose to disregard the corporate shield and attach liability to the individual owners. This can happen if the company is grossly undercapitalized, the company's owners fail to observe corporate formalities, the company is insolvent at the time of the transaction with the creditor, the company is not registered with the state, the company's owners fail to keep corporate records, the owners commingle personal and corporate assets or siphon corporate funds, the corporation's other officers or directors are nonfunctioning, or the corporation's status is a façade for the owner's operations. Essentially, if the owners don't treat the company like a "real" corporation, neither will a court.

SMALL BUSINESS, BIG TARGET

Suits by creditors against small business owners and officers of small companies are more common than suits against officers and stockholders of larger companies, whose compliance with corporate rules and filing requirements are institutionalized. Small business owners are often sued individually for legal and strategic reasons. If a creditor suspects that the company will not be able to satisfy a judgment, the creditor may name the owners of the company as defendants hoping that they have somehow failed to do the things that protect themselves against this sort of legal action. Suing owners individually also creates leverage because it puts their personal assets at risk.

In the case involving the New Jersey business owner, the creditor alleged, and the trial court agreed, that he should be personally liable because he was directly involved in the transaction, his company was not registered to do business in Maryland and he did not disclose during the negotiations that his company was HCE in New Jersey, as opposed to another company named HCE that was registered in Maryland and in which the businessman had no interest.

The Court of Appeals of Maryland, the State's highest court, reversed the decision. It found no evidence of fraud by the owner or that the company was simply an "alter ego" for the owner's personal transactions. It also decided that doing business as an unregistered company in Maryland knowing that the company name is already registered by someone else in the state is not enough for the court to ignore the corporate form and hold an officer individually liable.

While the Court of Appeals ultimately saved the New Jersey business owner's personal assets from a judgment, it is extraordinarily important for small business owners to take the necessary, often ministerial, steps to protect themselves from a lawsuit in the first place. If the New Jersey business owner had simply registered his company to do business in Maryland, it is unlikely the case would have gotten as far as it did.

PREEMPTIVE STEPS

There are several simple yet critical steps small business owners should take to prevent a lawsuit being filed against them individually or to prevail if they are sued individually:

- Create and maintain a corporate charter, articles of organization, operating agreement and/or by-laws as is appropriate for the type of corporate entity. Also, register the corporation with the state in any place in which you conduct business. An attorney can assist you in creating and filing these documents and registering the company. Make sure to renew the registration periodically and file property tax returns.
- Conduct and keep minutes of annual meetings and regular stockholders' meetings, even if a spouse or other family members are the only employees or owners.
- Maintain corporate record books.
- Observe corporate formalities — do not treat the company like your personal checkbook or engage in personal transactions through it.
- Don't commingle your personal income and expenses with those from your business.
- Make sure the company is sufficiently funded to do business and do not engage in transactions when the company is knowingly insolvent.
- Don't use the company to engage in fraud or as a front, deceiving others who transact business with the company. The company's creditors should clearly understand with whom they are doing business.

While the courts ultimately hold the corporate form fairly sacred, small business owners can avoid costly, protracted litigation if they comply with these guidelines. It's prudent to protect yourself, particularly when the effort required is minimal.

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