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This paper discusses the issue of shareholder liability for corporate obligations in small business. Although the law allows individuals to incorporate their businesses to limit liabilities, the courts have in many cases pierced the corporate veil and held shareholders liable for obligations of the corporation. The doctrine of piercing the corporate veil rarely affects shareholders of publicly-traded firms. In most cases, this doctrine would only reach shareholders of small, closely held firms. While fraud or unjust intent provide reasons for the court to disregard corporate entity, oftentimes the honest but uninformed actions of shareholders are to blame. To maintain limited liability, shareholders of small businesses must act in accordance with the corporate form of ownership in representing the firm, managing the firm's assets, and financing the firm.

I. INTRODUCTION

Limited liability is often cited as an advantage of the corporate form of business organization. The law allows individuals to incorporate their businesses to shield them in such a way that their maximum loss is limited to their capital contribution to the corporation. To take advantage of this legal provision, proprietors often decide to incorporate their businesses. However, the courts have in many cases pierced the "corporate veil" and held shareholders liable for obligations of the corporation. Typically, these situations only happen to small, closely-held corporations. Conrad [1] conducted a corporate census of American firms and found that the majority of corporations are small, whether measured by assets, revenues, or number of shareholders. Conrad estimated that 90% of American corporations have fewer than ten shareholders, and that 99% of all corporations have fewer than 100 shareholders. These numbers suggest that the corporate finance literature should pay attention to the problems and important issues of small corporations. While fraud or unjust intent provide reasons for the court to disregard the corporate entity, oftentimes the honest but uninformed actions of shareholders are to blame. This paper will focus on the latter of these

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situations. To maintain limited liability, shareholders must act in accordance with the corporate form of ownership in representing the firm, managing the firm's assets, and financing the firm.

II. CORPORATE REPRESENTATION

In sole proprietorships the distinction between business and personal activities is often blurred. Because the proprietor is liable for the obligations of the business and income from operation is taxable to the individual at personal income tax rates, there is little motivation to distinguish between personal and business activities. When the proprietorship is incorporated, the natural tendency is to continue to operate the corporation as a personal business, intertwining personal dealings with those of the new corporation. Treating the corporation as a personal business constitutes a disregard for the corporate entity by the shareholder and is likely to result in the court's disregard for the corporate entity as well.

The courts have generally failed to protect shareholders from third-party claims when they chose to carry on their incorporated business as individuals or as partners. The shareholder may be found to be acting in his capacity as an individual proprietor or a member of a partnership rather than as an employee of the corporation if he does not represent himself to third parties as such. This applies to both oral and written communication. The shareholder who does not make clear to third parties that they are dealing with the corporation, rather than the shareholder individually may be endangering the corporate entity. Thus letterhead used in corporate communication should reflect the name of the corporation rather than the name of the shareholder or of the formerly unincorporated proprietorship. Separation of the individual from the corporation is also reflected in a distinct corporate address, telephone number, and checking account. Failure to maintain a separation between the personal business of the shareholder and the business of the corporation is likely to result in the court's disregard for the corporate entity.

The shareholder who exercises complete domination and control of the corporation is likely to be found conducting business as an individual rather than as a corporation. If the shareholder consistently makes business decisions and conducts financial transactions without consulting other directors or officers, the corporation may be found to be merely an instrument through which the shareholder conducts his personal business affairs. Under the instrumentality rule, the shareholder is not protected by the corporate form and is liable for corporate obligations.

Representing the business as a corporation also requires adhering to corporate formalities and recognizing corporate rules and duties as specified in the bylaws. Legal requirements of the state must be followed in the initial incorporation of the company including actually paying in the amount of paid-in capital specified in the Articles of Incorporation. Board meetings are to be held and attended and minutes from meetings kept on file. Corporate legal and accounting records are to be properly maintained and kept separate from those of any other business or individual.

While following corporate rules and formalities may in some ways restrict or lessen the autonomy of the shareholder/manager, it is nevertheless necessary if the corporate entity is to be preserved and the shareholder's personal liability limited. One such corporate requirement, which is sometimes overlooked or neglected, is the issuance of stock. The failure to issue stock is often a contributing factor in the decision to disregard the corporate entity. While usually insufficient in itself, when accompanied by a lack of paid-in-capital, inadequate capitalization, incomplete organization, or individual domination, the failure to issue stock may result in piercing the corporate veil. However, this is one area in which state laws differ and in some jurisdictions there is no requirement that stock be issued before beginning corporate operations.

The rights and privileges of corporate ownership may be jeopardized if the corporation is not represented and run distinctly from other affiliated incorporated or unincorporated businesses. The shareholder who has ties to multiple businesses will not be shielded from liability if each corporation does not have its unique business purpose and is not operated separately from the others. Thus, in Mull v. Colt Cp. (1962, DC NY) 31 FRD 154, stockholders were found to be doing business as individuals rather than as a corporation because incorporated businesses each owned two taxicabs, garaged them together, and were completely controlled by the parent corporation. This is an example of the court holding the shareholder liable for the obligations of a single business operation which is divided into multiple corporations solely for the purpose of shielding the shareholder or parts of the business from liability.

III. ASSET MANAGEMENT

Mismanagement of the firm's tangible and financial assets may provide grounds for the court's disregard of the corporate entity. The classic Jensen and Meckling [3] agency problem arises when the shareholder is also the manager of a partially debt-financed firm. Conflicts of interest exist between the shareholder/manager and the debtholders regarding investment, dividends and risk. Some of these conflicts may be more pronounced in the closely held corporation.

There is also the potential for underinvestment (See Myers, [4]). The shareholder/manager may reject a positive net present value if the resulting value of the firm would not be sufficient to cover the claims of the debtholders. Therefore, the project will be rejected even if it increases the value of the debt. The greater the debt outstanding, the greater is the potential for underinvestment.

The shareholder will also prefer greater dividends than the debtholders. In the closely held corporation, dividends are only one of the many forms that distributions to shareholders can take. As manager, the shareholder has the ability to transfer real or financial assets from the corporation to himself. Distributions from the corporation to the shareholder lessen the coverage of debt claims, thus the wealth of the shareholder increases at the expense of the debtholders.

One conflict which presents itself in publicly held corporations is less evident in the closely held firm. The shareholders in a publicly held firm prefer more risk than the debtholders because the shareholders have a claim which is like an option on the value of the firm. However, the shareholder/manager of the closely held corporation holds a poorly diversified portfolio and will, therefore, be more risk averse than the shareholder of a publicly held firm. He will, therefore, have incentive to purchase insurance, hedge, and undertake other risk reduction strategies which debtholders will find to be mutually beneficial. (See Nance, Smith, and Smithson, [5]).

Monitoring management may prevent or control wealth transfers. However, some of the traditional forms of monitoring are not available in the closely held corporation. For instance, the financial statements of the closely held firm do not have to be audited. The closely held corporation seldom uses bond financing, so bond rating agencies do not monitor the company. There is also less monitoring of the closely held firm because its stock is not publicly traded. The closely held firm is not required to make disclosures to the Securities and Exchange Commission.

Because controls or restrictions under which the shareholder/manager operates may be fewer in the closely held corporation, there are fewer impediments to transferring wealth from the debtholder to the shareholder. While the job of the manager of a publicly held company may be threatened due to unacceptable performance, the shareholder/manager of the closely held firms likely to have complete job security regardless of his actions. While bond covenants may restrict the actions of the manager of the publicly held firm, it is more likely that any restrictions on the manager of the closely held firm will take the form of loan agreements with banks. Such agreements provide a degree of protection for the bank but the firm's other creditors may still suffer a loss in the value of their claims due to actions taken by the shareholder/manager.

The courts have recognized the conflicts which exist between the shareholder/manager and the corporation's creditors and have in many cases disregarded the corporate entity due to transfers of wealth from debtholders to the shareholders resulting from the mishandling of corporate assets. The court has often cited either the stripping or the personal use of corporate assets by the shareholder as examples of improper treatment.

Stripping the corporation of assets is one shareholder activity which has been frequently noted by the courts in their decision to hold the shareholder liable for corporate obligations. For instance, the shareholder is stripping the corporation of assets and expropriating wealth from the debtholders if he borrows money in the corporate name and then proceeds to distribute excessive sums from the corporation to himself and/or family members. The courts have ruled that corporate profits are to be made available to meet obligations to the firm's debtholders *before* distributions are made to the shareholders. In cases where the shareholder is also a creditor, the value of the other creditors' claims would be reduced if the corporation repays loans to the shareholders before repaying loans to other debtholders.

Ceteris paribus, debtholders prefer lower dividends and shareholder salaries than do shareholders. While paying excessive dividends and salaries is one form of asset stripping, it is not the only form of asset stripping which the courts have recognized. The sale of corporate assets to the shareholder or another of his businesses at below market value prices could be construed as asset stripping. Paying personal obligations out of corporate bank acccounts or withdrawing sums in excess of the stated salary are examples of more blatant forms of asset stripping.

Asset stripping sometimes occurs when the firm is in financial distress or has a large claim against it pending and bankruptcy looms. The shareholder has in some cases transferred assets from the corporation to himself to protect the assets from the claims of third parties. The shareholder's wealth thereby increases at the expense of the debtholders. Prior cases have shown that the courts regard asset stripping as evidence of the shareholder's disregard for the corporate entity and will, therefore, hold the shareholder liable for the corporation's debts.

Instead of stripping assets **from** the corporation, the shareholder may try to avoid financial responsibility by transferring assets **to** the corporation. That is, the shareholder may transfer tangible or financial assets from his personal name into the name of the corporation to protect himself from the claims of a personal creditor from an ex-spouse in a divorce settlement. The corporation is not to be used as a shield to protect an individual from promises or agreements he has made with third parties, thus the shareholder will not avoid personal liability for his obligations by transferring personal assets to the corporation.

The use of corporate financial or tangible assets for personal purposes is the second activity associated with asset management which is often mentioned by the courts in their decision to disregard the corporate entity. Using corporate funds to discharge personal obligations or using corporate-owned real estate without paying rent are evidence that corporate assets are being used for personal purposes. The personal use of corporate assets may also take the form of the intermingling of personal and corporate funds or the intermingling of corporate funds with those of another business. The exclusive use and control of corporate assets by one individual may also provide reason for the court to rule that corporate assets are being used for personal purposes. Furthermore, it may appear that corporate assets are being put to personal use if they are registered in the name of the shareholder rather than the name of the corporation.

Evidence of asset stripping or the personal use of corporate assets does not have to be accompanied by fraudulent purpose or unjust intent as improper asset management has been sufficient in itself to result in the court's disregard of the corporate entity. Shareholders of previously unincorporated firms may be prone to take asset management lightly because there is less reason to distinguish and maintain a separateness between business and personal assets in the unincorporated firm. The shareholder of a small firm with one or a relatively few shareholders may be more prone to asset stripping or using corporate assets for personal purposes simply because there is likely to be little or no disagreement within the firm regarding the use and disposal of assets. However, the debtholders, employees, suppliers, and customers also have direct or indirect claims on the firm and may seek restitution from the court for damages or unfulfilled obligations of the firm resulting from improper asset management.

IV. FINANCING OF THE FIRM

To preserve the corporate entity, the firm must be sufficiently capitalized and corporate debt or obligations must be separate from those of the shareholder. Lenders, realizing the potential for asset stripping or the diversion of funds from the corporation to the shareholder, will often require that the shareholder co-sign for corporate loans. The courts have ruled that the shareholder who guarantees the debt of the corporation either verbally or in writing has given up the protection afforded by the corporate entity and will be held personally liable. Paying even a single installment of a corporate obligation with a personal check from the shareholder is an indication that the shareholder is assuming responsibility for the entire obligation.

In small firms a shareholder often provides infusions of capital to finance one or more of the corporation's projects. While it is acceptable for the shareholder to provide loans, gross undercapitalization of the firm and the resulting dependence on the stockholder to maintain continuing operations may signify that the corporation is the alter ego of the shareholder. Inadequate or undercapitalization of the corporation has been cited as a contributing factor in the court's decision to disregard the corporate entity.

Whether the firm is undercapitalized is a judgement call by the court. In the case of Wheeler vs. Superior Mortgage Co. (1961) 196 Cal App 2d 822, 17 Cal Rptr 291, the court remarked that "if the capital is illusory or trifling compared with the business to be done and the risk of loss, this is a ground for denying the separate entity privilege." In this particular case, the corporation was capitalized for only $30. Undercapitalization may even be considered fraudulent if it is persistent and endangers the claims of debtholders.

Loans between the shareholder and the corporation should be arms-length transactions. Loans without accompanying promissory notes or no-interest loans made to the corporation. The courts may construe this to mean that the corporation is the alter ego of the shareholder. To maintain the corporate identity, shareholder loans to the corporation must be properly recorded as such on the corporation's books, and a repayment schedule for principal and interest decided upon and followed.

The holders of bad debts of the closely held firms are often the parties who seek to pierce the corporate veil as a means of gaining access to the shareholder's personal assets. However, even the all-equity firm is not immune to attempts by outside parties to break the corporate shield and hold the shareholder personally liable. Employees, customers, and the estate of the shareholder are among the potential claimants. For instance, an employee may sue due to an on-the-job accident, or a customer may sue due to bodily injuries or property damage caused by the firm's product.

Therefore, even the firm with no outstanding debt has reason to take precautions to maintain the corporate identity through proper representation, asset management, and financing.

V. CONCLUSION

This paper discusses the issue of shareholder liability for corporate obligations in small business. Although the law allows individuals to incorporate their businesses to limit liabilities, the courts have in many cases pierced the corporate veil and held shareholders liable for obligations of the corporations. State laws and individual cases differ so it is impossible to compile a complete list of what actions should be taken (or not taken) in order to preserve the corporate benefit of limited personal liability. Court decisions are based on the facts and circumstances of each case. The actions noted above are not an all-inclusive "to do" list but are rather intended to serve as a guideline based upon the court's previous decisions to pierce the corporate veil. While any one of the actions discussed above may not constitute disregard of the corporate entity, any one or more may together be construed as such. A direct implication for a small business owner is to be aware of the doctrine of piercing the corporate veil and to determine if certain measures would be appropriate to preserve the corporate benefit of limited personal liability.

In practice, it is unlikely that shareholders of a publicly-traded firm would bear personal liability for corporate obligations. In most cases, the doctrine of piercing the corporate veil would only reach shareholders of small, closely-held firms. Piercing the corporate veil is a form of unlimited liability. The issue is to decide in which particular cases, and for how much, shareholders are held personally liable. This is an interesting area for future research in small business.

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