

LEGAL UPDATE - NOVEMBER 2007
SHAREHOLDER LIABILITY FOR THE DEBTS OF THE CORPORATION

On October 15, 2007, the Pennsylvania Superior Court issued a comprehensive decision on whether a shareholder of a corporation can be held personally liable for the debts of the corporation. Generally, the phrase “piercing the corporate veil” is used to describe when a business owner is held personally liable for the debts of his or her corporation.

The Lower Court Decision

The case arose in Chester County, Pennsylvania, involving the liability of David G. Szymanski, personally, for the debts of Delmarva Concrete, Inc. Mr. Szymanski was the sole shareholder, director and officer of that corporation. The Court of Common Pleas for Chester County had ruled that Mr. Szymanski could not be held liable for the debts of his corporation under established case law in Pennsylvania. The Court of Common Pleas decided that because Mr. Szymanski did not commit fraud, fraudulent transfers, illegality, or injustice, he could not be held personally liable for the debts of the corporation.

The Upper Court Reversal

The Pennsylvania Superior Court reversed the decision of the Court of Common Pleas for Chester County and found in favor of the creditor and against the shareholder, personally.

The Facts of the Case

The facts in the case were extremely complex. Essentially, Mr. Szymanski’s corporation had won a contract for concrete work at an elementary school from the plaintiff, the general contractor for the elementary school. Problems arose, and the general contractor won an arbitration award by default against Mr. Szymanski’s corporation, the subcontractor on the job, for \$313,179.52 plus fees, which was ordered to be paid by the subcontractor to the general contractor. The subcontractor ceased doing business and filed for bankruptcy protection.

The Key to the Lower Court Decision

The lower court decision indicates that the owner of the bankrupt subcontractor corporation had not committed any fraud, fraudulent transfers, illegality, or injustice. The Court of Common Pleas for Chester County, in issuing its decision, noted that *“when a person enters into a contract with a corporation and that person does not seek a personal guarantee from someone with interests in the corporation, a court cannot rewrite the contract to shift liability away from the corporation and toward the interested individual.”*

Making Sense of the Upper Court Reversal

Why then, did the Pennsylvania Superior Court reverse the decision and find the owner of the bankrupt subcontractor fully liable for his bankrupt company’s debt of \$313,179.52 plus fees to the general contractor? Did the Pennsylvania Superior Court essentially rewrite the contract to, in effect, include a personal guarantee of the owner of the subcontractor? In a word, yes.

But why? The Pennsylvania Superior Court emphasized that this result is only applicable if and when a court “pierces the corporate veil.” It was because the upper court found that the Court of Common Pleas of Chester County should have “pierced the corporate veil” that the lower court’s decision was overturned. The Pennsylvania Superior Court analyzed four (4) key factors in determining whether to

“pierce the corporate veil” and then provided an overarching standard beyond the four (4) factors to analyze the issue as a whole.

The Four (4) Key “Technical” Factors

1. Undercapitalization

The first reason given by the Pennsylvania Superior Court in holding Mr. Szymanski personally responsible for the debts of the corporation is that the corporation was inadequately capitalized. The primary evidence as to undercapitalization was the threefold response of the corporation to the \$300,000+ claim of the general contractor, as follows:

- A. Failure to enter a defense against the claim;
- B. Ceasing all business in response to the claim; and
- C. Filing bankruptcy upon loss of the claim.

The Pennsylvania Superior Court looked to Black’s Law Dictionary for the definition of undercapitalization, which defines it as “the financial condition of a firm that does not have enough capital to carry on its business.” The Pennsylvania Superior Court held that the amount of capitalization was irrelevant, as these three key facts indicated that the capital was, by definition, inadequate.

Key Learning Point: A corporation which fails to defend itself against a legal claim, ceases doing business and files for bankruptcy may be deemed undercapitalized. However, there are other instances beyond this, obviously, in which a finding of undercapitalization could occur.

2. Failure to Adhere to Corporate Formalities

The second reason given by the Pennsylvania Superior Court in holding Mr. Szymanski personally responsible for the debts of the corporation is that he failed to adhere to corporate formalities. Corporate formalities include keeping minutes at least once each year for annual shareholder and director meetings, issuing stock certificates, and otherwise behaving as an organization is expected to behave under the applicable statutes. In this case, some corporate formalities were followed by Mr. Szymanski, but both courts noted that the corporation “*failed to adhere to corporate formalities with the rigor which would be desirable.*”

3. Substantial Intermingling of Corporate and Personal Affairs

The third factor in analyzing whether to hold Mr. Szymanski personally responsible for the debts of the corporation was whether he substantially intermingled corporate and personal affairs. Interestingly, the Pennsylvania Superior Court held that he had not done so. Although he on at least one occasion deposited corporate funds into his personal bank account, and stored his personal and corporate records together, such intermingling was not substantial. In other words, this factor was not used against Mr. Szymanski.

4. Use of the Corporate Form to Perpetuate a Fraud

The fourth factor in analyzing whether to hold Mr. Szymanski personally responsible for the debts of the corporation was whether he used the corporation to perpetuate a fraud. The Pennsylvania Superior Court agreed with the lower court that Mr. Szymanski had not done so. In fact, no occasions of perpetuating any fraud were noted, and this factor was not used against Mr. Szymanski.

Two out of Four and the Importance of the General Standard

As discussed above, Mr. Szymanski met two out of four tests, failing only the tests as to undercapitalization and adherence to corporate formalities. The Pennsylvania Superior Court went on to explain that the four “technical” factors were merely the starting point, and that what really matters is the “general standard” for determining whether to “pierce the corporate veil.”

What is the “General Standard”?

The “general standard” is as follows:

“The legal fiction that a corporation is a legal entity separate and distinct from its shareholders was designed to serve convenience and justice, . . . and will be disregarded whenever justice or public policy require and where rights of innocent parties are not prejudiced nor the theory of the corporate entity rendered useless We have said that whenever one in control of a corporation uses that control, or uses corporate assets, to further his or her own personal interests, the fiction of the separate corporate identity may properly be disregarded.”

What does that mean?

It means that the court will look at all the facts as a whole, and decide on a case-by-case basis, without being bound by the four (4) “technical” factors. The “general standard” is a “catch-all.” In this particular case, the “catch-all” caught Mr. Szymanski. Particular facts noted under the “general standard” were that Mr. Szymanski held out another corporation as being the same as the bankrupt corporation, that he used the same office address for all of his corporations, the same computer and employees, and that the lower court noted his credibility seemed questionable. In other words, the court will know a sham corporation when it sees one, regardless of any technical factors. The concept will be applied as justice, or equity, requires.

Does this mean the technical factors are irrelevant?

The technical factors are not rendered irrelevant by this case and should continue to be rigorously complied with by owners. It would have been harder (and the decision would be less credible) for the Pennsylvania Superior Court to invoke the “general standard” without reference to the technical factors. Each case is unique, and, to a certain extent common sense is needed, as well as experience, in determining what is and is not a “sham” corporation. The judgment of the court, however, will outweigh technical compliance.

Would this decision be applicable to Limited Liability Companies?

This decision is also applicable to limited liability companies, although the statutory requirements regarding formalities differ between corporations and limited liability companies. Generally, we believe it is easier to pierce the veil of a limited liability company than of a corporation, precisely because the lack of required formalities of limited liability companies essentially places the focus on the remaining factors, eliminating the chance for an “easy win” on the most mechanical factor. We note, however, that we are unaware of definitive case law on these points and understand that different people can take differing views on this issue.

Will the Pennsylvania Supreme Court overturn the Pennsylvania Superior Court?

We don’t know if the upper court’s decision will be overturned by the Pennsylvania Supreme Court if it is appealed. We would not be surprised if the Pennsylvania Supreme Court takes what could be termed an “intermediate” position half-way between the decision of the Court of Common Pleas for Chester County and the Pennsylvania Superior Court. We suspect that there should be some way of finding a safe harbor, such as a ruling if all of the technical tests are met, then there should not be liability under the “general standard.” However, time should tell.

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