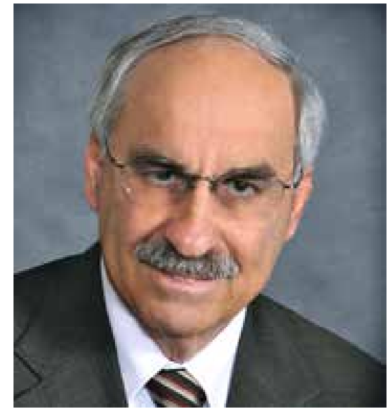
Avoiding the pitfalls of personal liability when making management decisions



by Gerald M. Newman
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Often in sales representative organizations, the sole or majority shareholder of the company or sole member of an LLC also wears the hat of president, CEO and all-around manager. These combined responsibilities require that the owner make many management decisions necessary to successfully run the organization.

While these decisions are presumptively made with the best interests of the organization in mind, certain decisions regarding personnel can often lead to litigation by an aggrieved employee. This is the nature of business and is often considered when management decisions are made. However, occasionally, aggrieved employees sue not only the rep organization, but also the individual decision maker who, of course, is the sole or majority shareholder, president, CEO and manager.

While most business owners think they are protected by the law of limited corporate liability or by the LLC, there are scenarios where the court will "pierce the corporate veil" and hold individual business owners liable for their management decisions. Although these scenarios are the exception and not the rule, **every business owner should be aware of the "line in the sand" when the law of limited corporate and LLC limited liability no longer applies.**

The significance of being individually named in a lawsuit can be great. If the individual is not immediately dismissed from the lawsuit, he or she may be subjected to the rules of discovery, which typically require the individual to answer questions regarding personal matters and to turn over personal information regarding the individual's finances. The scope of this discovery can be very broad, although your attorney will make every effort to limit it. The standard used by the court includes not only relevant evidence but also information that may lead to relevant evidence. Aggressive plaintiffs' attorneys may pursue the individual's personal information with a vengeance.

The prospect of having the individual's personal information disclosed is only part of the problem. If the employee's suit is successful against the individual company owner, the employee can pursue the individual's personal finances to recover on the resulting judgment. Also, there is the prospect of punitive damages if the court finds fraudulent or egregious activity.

In a recent case, Mr. Smith was the president, CEO and sole shareholder of a small sales representative company. As the president of the organization, Mr. Smith controlled all aspects of the business, including negotiating all contracts with principals and all of the employment agreements with its sales reps. After several years with the company, one of the sales rep employees started his own business and left the company. Mr. Smith paid the employee his commissions earned through the date of his resignation per their oral agreement. The rep disagreed with the amount of the commissions owed and sued the company and Mr. Smith (individually). In his lawsuit, the rep claimed that Mr. Smith should be held individually accountable because he made all of the organization's decisions regarding the commissions owed which, subsequently, resulted in Mr. Smith's personal financial gain. The employee also alleged that Mr. Smith had another organization operating out of the same offices and operated a satellite office out of his summer home in Florida.

The court dismissed Mr. Smith in his individual capacity — holding that the employee did not allege sufficient facts to pierce the corporate veil — but did so only after the court decided that Mr. Smith had run the organization in such a way as to avoid individual liability. This included adequate capitalization of the business, adhering to the corporate formalities and not commingling corporate funds with personal funds. A review of these factors may assist the small business owner to protect himself/herself from individual liability.

Adequate capitalization

More often than not, when the court decides to pierce the corporate veil, it is because the organization appears to be merely a facade by which the individual does business. This is typically established by showing that the organization does not maintain adequate capital to meet its responsibilities. Whether the capitalization of the organization is adequate depends on the nature of the business and the amount of potential corporate liability. Therefore, the amount of capitalization cannot be illusory compared with the type of business and the expected risk of loss. This will typically be determined based upon the equities of the situation. In other words, is the organization run with so few funds as to merely be a flimsy organization set up by the shareholder to avoid personal liability? If the organization is adequately capitalized in accordance with its business purpose, then it has begun a strong case against piercing the corporate veil and avoiding personal liability for the shareholder.

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LEGALLY SPEAKING

ASSOCIATION ROUND TABLE: House accounts

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where they are a target for going to the house. *See previous comments regarding the negotiable nature of commission rates and direct force compensation schemes.*

In the end, the job is to grow, likely by meeting and exceeding the customer's needs, and almost certainly one contributor to a growing account is that someone on the field sales team has done a good job. Why change horses? I've personally had a number of experiences whereby a good professional salesperson initiated the conversation around compensation rates in conjunction with a dramatic revenue boost at a customer, and that almost always yielded a continuance of the sales coverage and continued growth to the satisfaction of all parties.

Key questions for manufacturers

Finally, the deployment of house accounts fits in with many other factors in your marketplace and its impacts on your sales team. Do house accounts dominate the revenue in the territory, or are there lots of opportunities to be pursued? What is the design cycle for your products — weeks, years? That matters. What is the life cycle of the product — months, years? That matters too. For your reps, what is the "run-out" of compensation if a change is made, i.e., whether the sales firm will be retained for other than the house account or if a full parting of the ways is happening? These and other factors should all be considered in the practice of adding or discontinuing a house account for your sales force.

We at ERA would be happy to help interested parties, be they manufacturer or representative firm, with this evolving matter of house accounts and, as we hope you see here, bringing a thoughtful and fair approach for all. ■

LEGALLY SPEAKING: Avoiding pitfalls of liability

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Adhere to the corporate structure

The court will also look to see if the formalities of an organization are being followed. This includes regular corporate meetings with minutes, issuing stock, payment of dividends, filing all necessary annual reports and paying any franchise taxes, and keeping accurate corporate records. The incorporating attorney will be able to advise the organization on these requirements and the applicable laws in the state of incorporation.

Do not commingle corporate funds with personal funds

A very important way to protect an owner from individual liability is to completely separate corporate finances from personal finances. This may seem like a simple principle, but individual business owners often overlook routine transactions that may appear (or later be twisted by ambitious attorneys) to be commingling of funds. The simplest measure is to be certain that the organization has, in its own name, all of its own banking accounts necessary to run the business and does not pay for personal expenses from corporate accounts. This is the first place a suspecting plaintiff's attorney will look to see if you have commingled funds.

Be sure that all utility bills are in the name of the organization. This includes cell phones, although the occasional personal call on a company cell phone should not result in piercing the corporate veil. Also, be sure that all corporate vehicles and related insurance are in the name of the organization and that all premises used by the organization are either owned or leased by the organization and not by the individual shareholder. Also, if the organization has satellite offices, be sure that those leases are in the name of the organization and not the individual shareholder. Lastly, be sure that all loans or capital contributions to the organization are fully documented.

Final thoughts

The factors discussed above are not reviewed individually, but instead cumulatively, when the court decides to pierce the corporate veil. Moreover, the court reviews these factors only to decide the central question of whether the existence of the corporate identity perpetuates a fraud on creditors or would otherwise work a gross injustice to the law of limited corporate liability.

With these factors in mind, sole or multiple shareholders can control and dominate their organizations without the fear of individual liability. While no measure of protection can prevent owners of rep organizations from being named individually in the occasional lawsuit, these suggestions should assist your attorney in a swift and relatively painless dismissal. ■

Editor's Note: This article was published some years ago by ERA and has been updated by the co-authors to ensure its accuracy and relevancy today.

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