

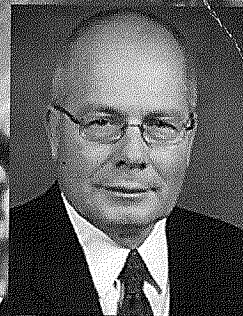
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# D • C • B • A BRIEF

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# The Limits of Limited Liability for Corporate Officers, Directors, and Shareholders: Eleven Things You Need To Know

By David M. Madden

**E**very lawyer knows that, absent fraud, corporate officers, directors, and shareholders are immune from corporate liability, right? Wrong.

As a general rule, it is true that

**“The information in this article is important to litigators who need to understand all of their offensive and defensive options, as well as to corporate counsel, who must know how to steer clients clear of possible minefields.”**

these persons are not liable for debts of the corporation.<sup>1</sup> This protection is often referred to as the “corporate veil.” As attorneys know, however, there are almost always exceptions to general rules. This article outlines some of the exceptions.

The information in this article is important to litigators who need to understand all of their offensive and defensive options, as well as to corporate counsel, who must know how to steer clients clear of possible minefields.

Before we get into the exceptions, we will address one question that might be on your mind: “What about the Business Judgment Rule?”

## The “Business Judgment Rule”

You may ask, “Doesn’t the

Business Judgment Rule protect officers and directors with respect to decisions they make on behalf of the corporation?” Sort of. The Business Judgment Rule “is a presumption that officers and directors of a corporation make decisions on an informed basis, in good faith, and with the best interests of the corporation at heart.”<sup>2</sup> The rule primarily applies where “mismanagement is the gravamen of the cause of action.”<sup>3</sup> The business judgment rule acts to shield directors who have been diligent and careful in performing their duties from liability for honest errors or mistakes of judgment.<sup>4</sup> As with all rebuttable presumptions, the rule arises as a matter of law.<sup>5</sup> It can be overcome with evidence that the officer or director “acted fraudulently, illegally, or without becoming sufficiently informed to make an independent business decision.”<sup>6</sup>

In other words, the Business Judgment Rule is not an absolute bar against liability of officers and directors; rather, it is a presumption which affects the burden of proof required to establish actionable mismanagement by an officer or director.

## The List

There are many exceptions to the general rule that officers, directors and shareholders are not liable for the corporation’s debts.



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This article outlines eleven of those exceptions, although there are many more. Some of these exceptions might surprise you. Most of the exceptions are interpreted through extensive bodies of case law, and this article does not attempt to convey the intricacies of each theory. In no particular order, here they are:

**1. Alter Ego Theory.** This was probably the first theory that came to mind when you read the title of this article. Under this equitable theory, a plaintiff may “pierce the corporate veil” and recover a corporate debt directly from a person who treats the corporation as his “alter ego.”<sup>7</sup> To pierce the corporate veil, a plaintiff must prove that: (1) there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) the circumstances are such that an



adherence to the fiction of a separate corporate existence would promote injustice or inequitable consequences.<sup>8</sup>

Courts examine a number of factors to determine whether a corporation is merely an alter ego of one of its principals. Those factors include inadequate capitalization, failure to observe corporate formalities, and several others.<sup>9</sup>

Alter ego theory is not a separate cause of action; rather, it is "a means of imposing liability in an underlying cause of action, such as a tort or breach of contract."<sup>10</sup>

**2. Breach of Fiduciary Duty.** Individuals who control a corporation have fiduciary duties to the corporation and its shareholders.<sup>11</sup> The fiduciary duties can apply to officers and directors, as well as majority or even minority shareholders in certain circumstances.<sup>12</sup> The fiduciary duty of loyalty prohibits individuals who control the corporation from (1) actively exploiting their positions within the corporation for their own personal benefit, or (2) hindering the ability of a corporation to continue the business for which it was developed.<sup>13</sup> Officers, directors and controlling shareholders may be held personally liable if they breach their fiduciary duties to the corporation or the shareholders.<sup>14</sup>

**3. Torts.** A corporate officer is not liable for the corporation's torts simply by virtue of his office. Believe it or not, however, an officer may be individually liable for torts of the corporation in which the officer actively participates.<sup>15</sup> Some corporate torts for which officers may be personally liable include negligence, fraud, trespass to realty, willfully inducing breach of contract, and conversion.<sup>16</sup>

**4. Crimes.** An officer, director, or shareholder can be held personally accountable for conduct which is an element of a criminal offense and which, in the name or in behalf of a corporation, she performs or causes to be performed, to the same extent as if the conduct were

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performed in her own name or behalf.<sup>17</sup>

**5. Actions After Dissolution.** Even after dissolution, corporations continue to exist for the purpose of winding up and liquidating their business and affairs.<sup>18</sup> They are prohibited, however, from carrying on any business that is not for the purpose of winding-up and liquidating.<sup>19</sup> Officers can be held personally liable for entering into contracts on behalf of the corporation after dissolution, and for debts incurred by the corporation during a period of dissolution.<sup>20</sup>

**6. Director Liability.** The Business Corporation Act of 1983 holds directors personally liable under certain specific circumstances, such as (a) assenting to a distribution that causes the corporation to become insolvent;<sup>21</sup> (b) failing to notify all creditors of the corporation's dissolution;<sup>22</sup> and (c) carrying-on the corporation's business after dissolution, other than as necessary for winding-up the corporation.<sup>23</sup>

**7. Kickbacks and Bribes.** Officers or directors who engage in commercial bribery or receive a

commercial bribe may be personally liable to the corporation for treble damages and attorneys' fees.<sup>24</sup> A person commits commercial bribery when "he confers, or offers or agrees to confer, any benefit upon any employee, agent or fiduciary without the consent of the latter's employer or principal, with intent to influence his conduct in relation to his employer's or principal's affairs."<sup>25</sup>

**8. Failure to Pay Wages.** Corporate officers who knowingly permit the corporation to violate the Illinois Wage Payment and Collection Act<sup>26</sup> may be deemed to be the employer of the employees of the corporation.<sup>27</sup> The effect of this provision is to make an officer personally liable to the same extent as the corporation for failure to pay employee wages, among other things.<sup>28</sup>

**9. Failure to Pay Taxes.** Corporate officers may be held personally liable for non-payment of corporate taxes. For example, personal liability for a retail corporation's unpaid retailers' occupation taxes may be imposed upon corporate officers or employees who are responsible for the filing of retailers' occupation tax returns and payment of taxes due, and who have "willfully" failed to file such returns or remit such taxes.<sup>29</sup> Persons who are required to collect, truthfully account for, and pay over any tax are referred to as "responsible persons."<sup>30</sup>

**10. Refusal to Allow Shareholder to Examine Corporate Records.** An officer of a corporation who refuses to allow a shareholder to examine the corporation's books and records for any proper purpose may be liable to the shareholder for an amount of up to ten percent of the value of

the shares owned by the shareholder, plus other damages.<sup>31</sup>

**11. Other Statutory Liability.** A number of other statutes have provisions imposing personal liability upon corporate officers and directors. For example, a person who controls a corporation may be personally liable under the Franchise Disclosure Act of 1987,<sup>32</sup> or for failure to procure workers' compensation insurance.<sup>33</sup>

The lesson to be learned here is that, while incorporation provides some valuable liability protections to officers, directors and shareholders, those protections are not absolute. It is important that you and your clients be aware of the potential traps, and do your best to avoid them.■

<sup>1</sup> See 805 ILCS 5/6.40 (regarding limitation of shareholder liability); *Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 500, 840 N.E.2d 767, 776 (2d Dist. 2005) ("A corporation is a legal entity that exists separately and distinctly from its shareholders, officers,

and directors, who generally are not liable for the corporation's debts.").

<sup>2</sup> *Willmschen v. Trinity Lakes Improvement Ass'n*, 362 Ill.App.3d 546, 550, 840 N.E.2d 1275, 1279 (2d Dist. 2005).

<sup>3</sup> *Id.*

<sup>4</sup> *Stamp v. Touche Ross & Co.*, 263 Ill.App.3d 1010, 1015, 636 N.E.2d 616, 621 (1st Dist. 1993).

<sup>5</sup> *Ferris Elevator Co. v. Neffco, Inc.*, 285 Ill.App.3d 350, 354, 674 N.E.2d 449, 452 (3d Dist. 1996).

<sup>6</sup> *Id.*

<sup>7</sup> *Semande v. Estes*, 374 Ill.App.3d 468, 471, 871 N.E.2d 268, 271 (3d Dist. 2007) (piercing remedy available against shareholders, officers, and directors); *Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 501, 840 N.E.2d 767, 776-77 (2d Dist. 2005) (piercing remedy may even be available against a nonshareholder).

<sup>8</sup> *Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 500, 840 N.E.2d 767, 776 (2d Dist. 2005); *Fiumetto v. Garrett Enterprises, Inc.*, 321 Ill.App.3d 946, 958, 749 N.E.2d 992, 1005 (2d Dist. 2001).

<sup>9</sup> *Fiumetto v. Garrett Enterprises, Inc.*, 321 Ill.App.3d 946, 958, 749 N.E.2d 992, 1005 (2d Dist. 2001).

<sup>10</sup> *Fontana v. TLD Builders, Inc.*, 362 Ill.App.3d 491, 500, 840 N.E.2d 767, 776 (2d Dist. 2005).

<sup>11</sup> *Anest v. Audino*, 332 Ill.App.3d 468, 476, 773 N.E.2d 202, 209 (2d Dist. 2002).

<sup>12</sup> *Id.*, 332 Ill.App.3d at 476, 773 N.E.2d at 209-210.

<sup>13</sup> *Cooper Linse Hallman Capital Management Inc.*, 368 Ill.App.3d 353, 357, 856 N.E.2d 585, 589 (1st Dist. 2006).

<sup>14</sup> *Id.*

<sup>15</sup> *People ex rel. Madigan v. Tang*, 346 Ill.App.3d 277, 284, 805 N.E.2d 243, 250 (1st Dist. 2004).

<sup>16</sup> *Id.*

<sup>17</sup> 720 ILCS 5/5-5.

<sup>18</sup> 805 ILCS 5/12.30.

<sup>19</sup> *Id.*

<sup>20</sup> *Forsythe-Fournier v. Isaacson*, 368 Ill.App.3d 674, 676-677, 857 N.E.2d 826 (1st Dist. 2006).

<sup>21</sup> 805 ILCS 5/8.65(a)(1).

<sup>22</sup> 805 ILCS 5/8.65(a)(2).

<sup>23</sup> 805 ILCS 5/8.65(a)(3).

<sup>24</sup> 805 ILCS 5/8.70.

<sup>25</sup> 720 ILCS 5/29A-1.

<sup>26</sup> 820 ILCS 115/1, *et seq.*

<sup>27</sup> 820 ILCS 115/13.

<sup>28</sup> 820 ILCS 115/1, *et seq.*

<sup>29</sup> *McLean v. Department of Revenue*, 326 Ill.App.3d 667, 674, 761 N.E.2d 226, 233 (1st Dist. 2001).

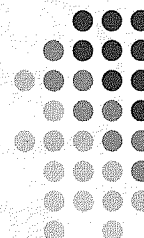
<sup>30</sup> *Id.*

<sup>31</sup> 805 ILCS 5/7.75(d).

<sup>32</sup> 815 ILCS 705/1, *et seq.*; 815 ILCS 705/26.

<sup>33</sup> 820 ILCS 305/4(d).

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