Weekly Information Sheet 10

CORPORATE LIABILITY

Piercing the Corporate Veil:

Definitions:

Piercing the Corporate Veil Defined: Black's law dictionary defines the term piercing the corporate veil as:

"The judicial act of imposing personal liability on otherwise immune corporate directors, officers and shareholders for a corporation's wrongful acts.

Meaning: The meaning of removing the limited liability of a corporation is as follows:

Causes: Limited liability can tempt insiders to exploit the corporation's creditors. Insiders can use their control to create a false appearance of corporate solvency, engage in self-dealing transactions, distribute corporate funds to themselves, or gamble on high-return corporate projects. In each case, insiders pass (externalize) risks to outsiders, with the gains accruing to the insiders and—because of limited liability—any losses falling on outside creditors.

Prevents Insider Abuse: As a protection against insider abuse, courts sometimes disregard the rule of limited liability and "pierce the corporate veil" to hold shareholders, directors, and officers personally liable for corporate obligations. Piercing is different from other protections afforded corporate creditors. In a piercing case: the business has been properly incorporated, the corporation is obligated to the creditor, and any distributions to shareholders have been statutorily proper.

Accountability:

Holding a Corporation Accountable by Removing Limited Liability:

An Extreme Remedy Not Readily Given: Ordinarily a corporation is regarded and treated as a separate legal entity, and the law does not look behind a corporation to see who owns or controls it.

The fact that two corporations have identical shareholders does not justify a court's regarding the two corporations as one.

Similarly, the fact that there is a close working relationship between two corporations does not in itself constitute any basis for ignoring their separate corporate entities when they in fact are separately run enterprises.

Piercing the Corporate Veil:

Accountability Continued:

Piercing the Corporate Veil:

When A Corporation Should be Held Accountable: A court may disregard the corporate entity, or figuratively "pierce the corporate veil," when exceptional circumstances warrant.
The decision whether to disregard the corporate entity is made on a case-by-case basis, weighing all factors before the court.

Factors that may lead to piercing the corporate veil and imposing liability on its owners (the shareholders) are:

- ***The failure to maintain adequate corporate records and the commingling of corporate and other funds;***
- ***Grossly inadequate capitalization;***
- ***The diversion by shareholders of corporate funds or asset;***
- ***The formation of the corporation to evade an existing obligation;***
- ***The formation of the corporation to perpetrate a fraud or conceal illegality, and***
- ***A determination that injustice and inequitable consequences would result if the corporate entity were recognized.***

Other Exceptions to Limited Liability:

Improper or Incomplete Corporate Formation: Liability may also be imposed on a shareholder as though there were no corporation when the court ignores the corporate entity either because of the particular circumstances of the case or because the corporation is so defectively organized that it is deemed not to exist.

Wage Claims: New York State law also provides that the shareholders shall have unlimited liability for the wage claims of corporate employees. This exception is limited to the ten largest shareholders, pursuant to section 630 of the New York State Business Corporation Law.

Unpaid Subscriptions: Most states prohibit the issuance of par value shares for less than par or except for "money, labor done, or property actually received." Whenever shares issued by a corporation are not fully paid for, the original subscriber receiving the shares, or any transferee who does not give value or who knows that the shares were not fully paid for, is liable for the unpaid balance if the corporation is insolvent and the money is required to pay its creditors.

Liable Parties – Directed Responsibility and Scope of Liability:

General Issues:

- Because a corporation is an artificial person, it can be both civilly and criminally liable for actions carried out on its behalf.
- Directors are personally liable for breaches of their duties and any economic injuries to the corporation that result from their negligence.
- Shareholders who seek losses for business deals that never materialized must prove that the failure to consummate the deal rests squarely with the negligent officer before the court will entertain any action for indemnification for possible lost profits.
- The core responsibility of directors (under the Business Judgment Rule) is to weigh risk against reward. This is an art, not a science.

Liable Parties – Directed Responsibility and Scope of Liability:

The Business Judgment Rule:

- ***What The Business Judgment Rule Is:*** The business judgment rule is a case law-derived concept in corporations law whereby the "directors of a corporation . . . are clothed with [the] presumption, which the law accords to them, of being [motivated] in their conduct by a bona fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge" (See Gimbel v. Signal Cos., 316 A.2d 599, 608 (Del. Ch. 1974);
- ***Burden of Proof:*** To challenge the actions of a corporation's board of directors, a plaintiff assumes "the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty good faith, loyalty, or due care".
- ***Must Constitute Waste:*** Failing to do so, a plaintiff "is not entitled to any remedy unless the transaction constitutes waste . . . [that is,] the exchange was so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration".
- ***Risk vs. Reward:*** The Business Judgment Rule has at its core, a responsibility of directors to weigh risk against reward. This is an art, not a science.
- ***Protects Officers and Directors:*** The business judgment rule protects corporate officers and directors from being sued when their business judgments turn out to be incorrect.
- ***Keeps Courts From Interceding in Corporation's Business:*** The business judgment rule not only insulates officers and directors from lawsuits from shareholders, but it also keeps courts out of the business of monitoring business decisions.
- ***Doesn't Protect When Authority Exceeded:*** When corporate officers or directors exceed their authority, the business judgment rule no longer protects them. Such acts are deemed to be ultra vires (a Latin phrase meaning "beyond the powers" – meaning the board of directors has exceeded or gone beyond their legal authority).
- ***Ultra Vires:*** Only shareholders or others who have a direct interest in the corporation can raise a claim of ultra vires.

Liability of Directors:

- ***Fiduciary Role:*** Directors act in a fiduciary capacity in dealing with the corporation.
- ***Good Faith and Reasonable Care:*** Pursuant to the Business Judgment Rule, Directors who act in good faith and have exercised reasonable care.
- ***Fraud:*** Courts will not interfere with the board's judgment in the absence of unusual conduct such as fraud.
- ***Conflicts of Interest:*** A director is disqualified from taking part in corporate action when the director has a conflict of interest.
- ***Sarbanes Restrictions:*** Pursuant to the Sarbanes Oxley Act, all direct and indirect loans to directors are prohibited.
- ***Suits against Directors:*** Action against directors can be brought by the corporation, while Shareholders can bring a derivative suit.

Liable Parties – Directed Responsibility and Scope of Liability Continued:

Liability of Officers:

- ***Officers and Agents:*** Officers, as agents generally of the corporation, are personally responsible for any torts or crimes they commit, even if they act on behalf of the corporation. If they act on behalf of the corporation, then the corporation may be liable as well.
- ***Corporate Opportunity:*** Officers may also be liable for taking advantage of a corporate opportunity.
- ***Conflicts of Interest:*** An officer is also disqualified from taking part in corporate action when the officer has a conflict of interest.
- ***Sarbanes Restrictions:*** Pursuant to the Sarbanes Oxley Act, all direct and indirect loans to officers are prohibited.
- ***Question of Liability:*** In determining liability, the threshold question is: was there a breach of fiduciary duty?

Liability to Third Parties:

Generally:

- Shareholders enjoy limited liability.
- Generally, directors and officers are not liable for corporate obligations or debts.
- A corporation is civilly liable to a third party if one of its agents causes injury.

Liability of Management to Third Persons:

- Generally not liable for economic consequences if decision made in good faith.
- Generally not liable to third parties for poor decisions (but there may be a derivative suit).

Criminal Liability:

- Criminal Liability is pursuant to the Responsible Corporate Officer Doctrine: Control and Knowledge of the Violations.

Insider Trading

Definitions:

Insider Trading Defined: Black's law dictionary defines the term insider trading as:

"The use of material, non public information in trading the shares of a company by a corporate insider or other person who owes a fiduciary duty to the company."

Insider Trading Continued:

Meaning:

State vs. Federal Law: State corporate law mostly accepts the principle of unfettered share liquidity and only narrowly regulates the trading of company stock by insiders. The real law of insider trading is federal—an offshoot of Rule 10b-5 under the Securities Exchange Act of 1934.

What Constitutes Insider Trading: The paradigm case of insider trading arises when a corporate insider trades (buys or sells) shares of his corporation using material, nonpublic information obtained through the insider's corporate position.

Exploitation of Insider Information: The insider exploits their informational advantage (a corporate asset) at the expense of the corporation's shareholders or others who deal in the corporation's stock. The insider can exploit his advantage whether undisclosed information is good or bad.

Good News Trades: If *good news,* the insider can profit by buying stock from shareholders before the price rises on the favorable public disclosure. (An insider can thus garner an even greater profit on a smaller investment by purchasing "call options" on an options market that give him a right to buy the shares at a fixed price in the future.)

Bad News Trades: If *bad news,* the insider can profit by selling to unknowing investors before the price falls on unfavorable disclosure. (An insider who does not own shares can also profit by borrowing shares and selling them for delivery in a few days when the price falls, known as "selling short," or by purchasing "put options," which give him the right to sell the shares at a fixed price in the future.)

Liability:

Trading on Insider Information:

When Liability Occurs: Illegal insider trading occurs when a person who owes a fiduciary duty to a company buys or sells a security while in possession of material, nonpublic information.

Enforcement: Enforcing insider trading laws is a high priority for the SEC. In recent years, the SEC has pursued insider trading cases against financial professionals, hedge fund managers, corporate insiders, and attorneys.

Penalties and Sanctions: Section 10(b) and Rule 10b-5 form a basis for imposing penalties and sanctions for trading on **insider information.**

Those accused of insider trading may face both criminal and civil actions.

The Insider Trading and Securities Fraud Enforcement Act of 1988, which amended the 1934 act, gave the SEC authority to bring an action against an individual purchasing or selling a security while in possession of material inside information.

Persons who "aid or abet" in the violation may also be held liable under the act.

Individuals convicted of criminal insider trading may be sentenced up to 20 years in prison per violation and can face fines of up to $5 million or twice the gain from the offense.

In a civil action by the SEC, an individual may have to **disgorge any profits** from the offense and may have to pay **fines not to exceed the greater of $1 million or three times the amount of the profit gained or loss avoided.**

Individuals can also be barred from serving as an officer or a director of a public company, or from acting as a securities broker or an investment advisor.

Attorneys and accountants may be barred from serving before the SEC.