Unexpected Liability For Owners Of Small Businesses

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Small business owners may face personal liability even though they set up a corporation.
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An entrepreneur wants to create a small business. So they set up a corporation or a limited liability company online, because they know that's how you're supposed to do it. That way, your personal assets aren't supposed to be at risk if the business fails. It's a good insurance policy.

A recent New York case demonstrated once again that the corporate-structure insurance policy might not be so good after all.

There, a person named Yuan Sheng Situ (or perhaps Su Hua Situ) apparently created and owned a small corporation that signed a lease as tenant. The tenant took possession of the leased premises but never paid any rent. The landlord sued the tenant on the lease, of course, but also tried to sue the individual owner of the company (the "individual defendant") for the unpaid rent.

The individual defendant presumably argued (or should have argued) that the only tenant on the lease was the corporation, there was no personal guaranty, the landlord had chosen to do business with a corporation, the landlord should have known what a corporation is, and therefore the landlord should only be able to sue the corporation even though the corporation had no assets. Whether based on those good arguments or other arguments, the individual defendant asked to be removed from the landlord's lawsuit.

The court that initially heard the case refused to do that. The appellate court agreed. To the contrary, both courts accepted the proposition that the landlord might very well be able to "pierce the corporate veil" and convert the claim against the corporation into a claim against the individual defendant. That could happen because the individual defendant somehow lost the protection the corporate form was supposed to provide.

Exactly what did the individual defendant do to expose itself to that risk? According to the appellate court, the individual defendant negotiated the lease on behalf of the corporate tenant. The landlord communicated with the individual defendant almost daily to negotiate the lease. The individual defendant was in the leased premises "on almost a daily basis."

All those things are, however, exactly what always happens when someone sets up their own corporation and then runs that corporation's affairs. Those ordinary activities of a corporation's owners are just how any corporation works. The fact that the corporation's owners do things in their role as corporate officers shouldn't create individual exposure. How else are corporations supposed to conduct business?

The court also stepped back a bit and declared that the lease "resulted in inequitable consequences" because the tenant didn't pay rent. In other words, the individual defendant "conspired to perpetrate a wrong by opening a judgment proof shell company" to avoid paying rent. But that's exactly how corporations can work. If the landlord wasn't happy with the credit strength of the corporation, it should have demanded a personal guaranty, a larger security deposit, or a better tenant entity. The fact that it didn't do those things doesn't mean the landlord should have a good claim against the corporation's owner. The landlord chose to deal with the corporation.

Those are great arguments, of course. But the individual defendant remains stuck in this litigation, facing potentially substantial claims. The use of a corporation was supposed to protect the individual defendant from those claims.

An owner of a small business can avoid this sort of problem by making sure that its corporation always pays its debts. But sometimes that doesn't happen. The essential function of the corporate form is to protect the owner of the business. If the facts of this case

are enough to convince a court to remove that protection, then any small business owner shouldn't necessarily rely on the use of a corporation as a way to protect the owner's other assets. Protection may require some further measures.

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