A Reprint from *Tierra Grande*, the Real Estate Center Journal

Piercing the Corporate Veil

By Judon Fambrough

Incorporating in Texas is viewed as a means to con duct business without endangering personal assets. The corporate entity shields, so to speak, the shareholders, directors and officers from personal liability. But exceptions exist.

"Piercing the corporate veil" is a legal phrase referring to instances when the corporate entity can not protect the personal assets of stockholders, officers and directors. To keep the corporate shield intact, the distinction between the corporation and the individual must be scrupulously maintained. When an individual uses the corporation to conduct personal business or a tortious or fraudulent activity, the distinction is destroyed. The individual then becomes personally liable.

Corporate shareholders, directors and officers also may face personal liability for the breach of contracts or tortious activities described in the statutes and the case law. Both criminal and civil penalties may be imposed for statutory breaches.

Stockholders

The Texas Business Corporation Act (TBCA) as amended effective September 1, 1993, specifies only four instances when liability may be imposed on a stockholder or owner of a beneficial interest in shares:

- the full purchase price of the shares has not been paid,
- the corporation is used as an alter-ego to perpetuate a fraud or sham from which a direct personal benefit is derived (see *definitions*),
- a personal assumption or guarantee of a corporation obligation is made and
- personal liability is imposed by the TBCA or by other law.

Note: The first two listed above are exclusive and preempt any other liability that may be imposed on the stockholder for that occurrence under the common law or otherwise. The same preemptive mandate applies to the following rule. A stockholder is never liable for any contract obligation of the corporation when the corporation failed to observe any formality required by law, by the articles of incorporation or by the bylaws.

Instances of liability imposed by other laws include: the corporation begins business before becoming a legally recognized entity, the shareholder is sued in the capacity of an officer or agent of the corporation or the shareholder personally participates in a wrongful act on the corporation's behalf.

For example, in the latter instance, personal liability attached when a stockholder helped publish a newspaper containing libelous statements. On the other hand, no personal liability existed when the stockholder did not physically participate in the wrongful removal of timber from a plaintiff's land.

Officers

Personal liability is imposed on officers when: the officer personally assumes a corporate obligation, the rules of agency create the liability, the officer personally participates in a tortious act on behalf of the corporation, the officer violates a statutory obligation or the officer breaches a duty as trustee.

An officer's liability for personal assumption of a corporate debt, either by co-signing a note or guaranteeing it, is self-evident. However, the rules of agency are less obvious.

A director's mere presence at a board meeting where a wrongful distribution is voted presumes the director assented.

An agent who contracts with a third party without disclosing either the facts of the agency or the name of the principal assumes the same liability as the principal. Also, a corporate officer who contracts beyond the scope of given authority is personally liable. In the latter instance, the liability is based on the breach of an implied warranty of authority. If uncertain, an officer should consult the bylaws and also obtain a resolution from the board of directors.

Conversion and the misappropriation of private property are examples of tortious activities. An officer is personally liable to anyone who tenders purchase money to the corporation for shares if the officer then refuses to issue stock certificates.

Three laws apply to the statutory liability of officers. First, according to the TBCA, the officer in charge of the share transfer records (generally the secretary) is required to prepare a list of stockholders eligible to vote, keep the list on file for ten days prior to the stockholder's meeting and keep the list available for inspection throughout the meeting. If the officer fails to do so after receiving adequate advance notice, the officer is personally liable for damages suffered by shareholders.

Second, a corporation may exist as long as it pays its annual state franchise tax. If the corporation's right to do business is forfeited for failing to file or report or pay the tax, **both** the officers and directors are personally liable for any corporate debt, including taxes and penalties,

incurred after the corporation forfeits its right to conduct business. However, officers or directors who show that the debt was created over their objections or without their knowledge are not personally liable.

Third, using the terms *corporation, incorporated,* or an abbreviation of either term in the name of a business not incorporated in this or another state violates the Deceptive Trade Practices Act. This could occur either before incorporating or after the corporation's right to do business has been forfeited for failure to pay franchise taxes.

Finally, in the latter situation, an officer may become personally liable either by participating in the breach of trust or by neglect of duty in the proper disbursement of trust funds. However, the last case decided on this issue was in 1909. Generally, any violation for the breach of trust will be handled under the Texas Penal Code discussed later.

Officers and agents can face criminal penalties in addition to personal liability for certain activities. For instance, any officer or agent of a corporation who violates the Texas Securities Act faces the penalties imposed by the Texas Revised Statutes. Any officer or agent who fails or refuses to cooperate with the Texas Attorney General in the examination of the corporate books or records may be fined and imprisoned.

In addition, officers may be punished for deceptive advertising, misapplying fiduciary property or property of a financial institution and for violating the Texas antitrust statutes.

Directors

Personal liability is imposed on directors when they assume corporate debt, act outside the scope of authority or participate in or sanction tortious activities. The list is similar to that of officers. However, because directors hold a position of special responsibility, they are subject to a higher degree of scrutiny.

Most cases holding directors personally liable for tortious acts involve the publication or representation of false statements of corporate financial integrity. For instance, the directors of a corporation have been held personally liable for false financial statements issued to induce deposits in a failing bank. In another case, the directors issued false statements to be used by their employees to obtain credit for the corporation. Directors cannot defend a lawsuit on the basis that they were not aware of the inaccuracy of the statements when the exercise of ordinary care would reveal the truth.

Likewise, directors are personally liable for violating the following statutory prohibitions.

- Voting for or agreeing to a distribution of corporate assets not permitted by the articles of incorporation or by the TBCA. According to the TBCA, the directors' personal liability extends only to the corporation and then only to the amount in excess of the distribution permitted by law. A suit against the directors must be brought within two years.

Basically a distribution is prohibited when it will render the corporation insolvent or exceed the surplus of the corporation. There are exceptions for distributions involving the purchase or redemption of the corporation's shares for specific reasons enumerated in the TBCA.

Corporate Primer

Corporation. A corporation is a separate legal entity or person, distinct and apart from its owners, directors and officers. Its existence depends upon compliance with the laws of the state in which it incorporates.

Incorporation. To incorporate in Texas, the applicant must submit the articles of incorporation to the secretary of state along with a $300 filing fee. The corporation may begin business after it receives a certificate of incorporation and $1,000 for the issuance of stock. Then, the corporation theoretically exists forever as long as it pays the annual Texas franchise taxes.

Bylaws. The corporation's internal rules for regulating and managing its business affairs. Initially, they are adopted by the shareholders but may be amended later.

Composition. A corporation is composed of stockholders (shareholders), a board of directors and officers. The stockholders own the corporation as evidenced by the shares or stock certificates issued. (The shares show ownership of the corporation, not its property.) A change in its shareholders does not affect the corporation's existence. The stockholders receive dividends and elect the board of directors.

One-person corporation. In Texas, one person may form a corporation. The same person can be the incorporator, the stockholder, the sole board member and the only officer who must serve as both the president and secretary. Anyone establishing a one-person corporation risks personal liability under the *alter-ego doctrine*.

Alter-ego doctrine. The alter-ego doctrine fastens personal liability on individuals who use the corporation as a sham to conceal personal business operations. The personal liability hinges on the fraud perpetrated on third parties.

Authority. The board of directors is in charge of all the corporation affairs. Authority comes from both the Texas statutes and the corporate bylaws. All corporate powers are exercised by and under the board's authority. The board declares dividends and appoints or elects the corporate officers.

Officers. In Texas, a corporation must have at least two officers–a president and a secretary. It may have other officers, assistant officers and agents as the board declares necessary. The same person may hold two or more offices, including those of president and secretary. The officers manage the corporation based on the authority granted by the bylaws and board resolutions consistent with the bylaws.

Foreign corporation. A corporation organized in another state, better known as a *foreign corporation*, may do business in Texas after a certificate of authority is obtained from the secretary of state. Currently, the fee is $1,250.

A director's mere presence at a board meeting where a wrongful distribution is voted presumes the director assented. The presumption can be overcome by entering the director's dissent in the minutes, by filing a written dissent with the secretary before the meeting adjourns or by forwarding the director's dissent to the secretary by registered mail immediately after the meeting adjourns.

The director is not liable for a wrongful distribution if the vote was exercised with ordinary care and based on good faith reliance on statements and other relevant data prepared and presented by officers and employees of the corporation, legal counsel, public accountants, CPAs, investment bankers or a committee of the board of which the director is not a member. However, reliance in good faith can not be claimed on matters in which the director has personal knowledge to the contrary.

Even though a director may be personally liable for a wrongful distribution, the director is entitled to reimbursements from the other directors who consented and also from the shareholders who received the distribution with knowledge of its impropriety.

- Voting for or agreeing to beginning business before the corporation receives $1,000 for the issuance of stock certificates. The consideration may be cash, labor or property. The director's personal liability is limited to the corporation and then only for the deficit amount. Once the required $1,000 has been received, the personal liability vanishes. A suit against the directors must be brought within two years.

- Voting for or agreeing to loan or otherwise financially assist an employee, officer or director when the action does not directly or indirectly benefit the corporation. Before a 1987 amendment to the TBCA, corporations were absolutely prohibited from making any loan to an officer or director.

The corporation can assist its directors, officers, agents or employees facing personal liability. Corporations are authorized to indemnify the individuals and maintain liability insurance on their behalf. Prior to 1987, this was not allowed.

Corporations can, to some degree, lower their directors' exposure to liability for acts or omissions. According to the Texas Miscellaneous Corporate Laws Act, the articles of incorporation may provide that a director is not liable, or is liable only to the extent provided in the articles, to the corporation or its stockholders for any act or omission in the capacity of a director. However, the articles can not eliminate or limit the director's liability for:

- a breach of the director's duty of loyalty to the corporation or its shareholders or members,

- an act or omission not in good faith that constitutes a breach of duty of the director to the corporation or an act or omission that involves intentional misconduct or a knowing violation of the law,

- a transaction from which the director received an improper benefit, whether or not the benefit resulted from an action taken within the scope of the director's office or

- an act or omission for which the liability of a director is expressly provided by an applicable statute.

Currently, it is unclear whether the dissolution of the corporation removes the personal liability of its shareholders, directors and officers. Prior to 1987, the corporation, its shareholders, directors and officers were clearly liable for three years after the corporation dissolved. Now the statute names only the corporation as liable during the three-year period. No mention is made of the shareholders, directors and officers.

A recent Texas appellate case casts some light on the issue. In *Curtis v. Morgan*, the plaintiff sued a corporation in 1983. The plaintiff discovered, after a judgment was rendered in 1988, that the defendants had dissolved the corporation in 1984.

The plaintiff then sued the shareholders and directors of the dissolved corporation to collect the judgment. They defended on the grounds that the three-year statute of limitations had expired. The appellate court ruled against the defendants.

The TBCA requires a corporation to notify each known claimant by registered or certified mail of its intent to dissolve. The defendants had not complied with this requirement. Hence, the court ruled that the three-year statute of limitations did not begin until the notice was given.

This article is for information only; it is not a substitute for legal counsel.

Fambrough is an attorney, member of the State Bar of Texas and a senior lecturer with the Real Estate Center at Texas A&M University.

REAL ESTATE CENTER

©1996, Real Estate Center. All rights reserved.

Director, Dr. R. Malcolm Richards; Associate Director, Gary Maler; **Chief Economist,** Dr. Ted C. Jones; **Senior Editor,** David S. Jones; **Associate Editor,** Dr. Shirley E. Bovey; **Assistant Editor,** Kammy Senter; **Art Director,** Robert P. Beals II; **Circulation Manager,** Gary Earle; **Production Assistant,** Emma Kubin; **Typography,** Real Estate Center; **Lithography,** Williamson Printing Corporation, Dallas.

Advisory Committee: Conrad Bering, Jr., Houston, chairman; John P. Schneider, Jr., Austin, vice chairman; Michael M. Beal, College Station; Melissa C. Cigarroa, Laredo; Dr. Donald S. Longworth, Lubbock; Carlos Madrid, Jr., San Antonio; Andrea Lopes Moore, Houston; Kay Moore, Big Spring; Gloria Van Zandt, Arlington; and Pete Cantu, Sr., San Antonio, ex-officio representing the Texas Real Estate Commission.

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115.

Subscriptions are free to real estate brokers who provide their name, address, telephone, and license numbers to Department JS at the address given. Other subscribers, $25 per year. **Views expressed** are those of the authors and do not imply endorsement by the Real Estate Center, the College of Business Administration and Graduate School of Business, or Texas A&M University.