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Corporate Form Will Not Protect Owners from All Liability

By L. Erik Ringoen, CPA, CFF, CIRA

Simon Mainwaring, a social media specialist and author, has said, "Executives can no longer hide behind the corporate veil. They need to be accountable for what their companies do, because entities are responsible for socially irresponsible behavior." This quote's underlying message is pertinent to this column. An action, or lack of action, by a corporation or limited liability company (LLC) could make its owners liable for the obligations of that company, and I will discuss some of the concepts and issues that could lead to such liability exposure.

"Piercing the corporate veil" is a legal concept whereby a court will hold owners personally liable for the debts or actions of their company. Pennsylvania law has a strong presumption against this, but the combination of a good litigator and forensic accountant may uncover factors that courts have relied on in their decision to pierce the corporate veil.

Properly registered and operated corporations and LLCs can exist independent of shareholders and members, who are not personally liable for the obligations of the company. Therefore, piercing the corporate veil would be an exception to this general rule. Courts have limited exceptions to corporate protections, mostly related to bad actions by owners. Each case has its own unique facts and circumstances. The Pennsylvania Supreme Court case of *Lumax Industries Inc. v. Aultman* considered these factors: undercapitalization, failure to adhere to corporate formalities, substantial intermingling of corporate and personal affairs, and use of corporate form to perpetrate fraud.

Just as in other litigation, a forensic accountant will work closely with counsel to understand the legal concepts of the matter and, at the same time, delve into the details of the corporate records. This

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may mean getting down to examining the debit and credit entries of certain transactions, which can make all the difference.

Undercapitalization

The forensic accountant needs to understand how the company was capitalized during specific times, such as at incorporation or when the company contracted with the other litigant. They should examine accounting and financial records, such as the balance sheet, income statements, statement of cash flows, trial balance, and general ledgers, along with relevant supporting documentation. This analysis seeks to understand the debt and equity of the subject company's capital structure to determine whether the company deliberately undercapitalized to avoid a debt.

Organizational Formalities

Relevant data needs to be examined to determine the actual structure and formalities of the company. As an example, bylaws and amendments provide the company's board of directors and management with guidelines for the operation of the business, such as schedule of board meetings, officers/directors elections, and the keeping of minutes. A company's failure to run the business on a day-to-day basis in accordance with its bylaws, ignoring corporate structure, has been a factor considered by courts when deciding whether or not to pierce the corporate veil.

Intermingling of Assets

To support or refute the abuse of the corporate form for the personal interest of its owners or the commingling of corporate assets with personal funds, the forensic accountant should examine bank and brokerage account statements, canceled checks, or other documents that identify payee, amount, and proof of payment to identify any commingling. In addition, determining how the company records these payments on the general ledger, or if they record them, is critical. Is it a business or personal expense? A loan? A third-party payment? Is there an accounting acknowledgement of the separateness of the transaction? What are the accounting entries for a particular transaction and how is that viewed against the veil-piercing criteria listed above? These documents can provide information related to the commingling or use of corporate funds to pay personal expenses of the owners.

Perpetration of Fraud

The investigative work of the forensic accountant can provide the information and records needed to show how one or more transactions may have resulted in wrongful or inequitable consequences. The causal connection between the abuse of the corporate form as mentioned above and the wrongful conduct for which relief is sought must also be established.

Protecting Against Veil Piercing

It takes more than the filing of incorporation paperwork to limit liability. Business owners need to be organized, keep good records, maintain proper accounting, implement good internal controls, and follow corporate formalities. CPAs can help create a better delineation between the company and its owners by advising clients to do the following:

- Maintain accurate and complete books and records.
- Hold annual board meetings and keep accurate minutes.
- Maintain separate bank accounts for the company.
- Refrain from commingling personal assets with those of business; if they do, record the separation as such.
- Refrain from using corporate assets for personal use.
- Adequately capitalize the company.
- Use full company legal name on all business communications.
- File separate income tax returns.
- Sign company documents in your representative capacity.

Business owners should run their companies with good sense and good intentions. This will help reduce the possibility of losing or impairing the limitations on personal liability, a primary reason for forming a corporation. Should the need arise, an experienced forensic accountant can help assist in gathering evidence to assist the trier of fact understand the manner in which the subject company or companies operated.

L. Erik Ringoen, CPA, CFF, CIRA, is a director with Forensic Resolutions Inc., which has offices in Westmont, N.J., and Philadelphia. He can be reached at eringoen@forensicresolutions.com.