



Corporations Protect Personal Assets

by Perry Safran and Brannon Burroughs

Corporations allow individuals and groups to create a new entity for the purpose of doing business. The corporation shields its creators from liability beyond their investment. If the business goes bad, the corporation takes the fall, not the shareholders. The incorporators may lose their investment in the company, but they do not usually lose their personal belongings. Because the incorporators are protected from complete financial ruin, they are more likely to take calculated business risks. This in turn encourages economic growth and prosperity.

Disappearing Act

From a creditor's perspective, however, corporations can sometimes be used to accomplish an injustice. Such seemed to be the case in *Statesville Stained Glass, Inc. v. Lane Construction*, recently decided by the North Carolina Court of Appeals. Statesville sold stained glass to Lane Construction for use in the construction of two churches. The stock of Lane Construction was owned exclusively by one person, Mr. Lane, who also controlled the company's operations. After completing construction of the churches, Lane Construction paid part of the cost of the glass, but defaulted on the balance. Mr. Lane then dissolved Lane Construction and sold off its assets to pay creditors. At the same time, Lane founded a new corporation, Temple Construction, which he funded with a promise to pay \$4,000. In other words, Lane created a perfectly legal "phantom asset" — the start-up money for Temple wouldn't come out of his pocket until "called" by the new corporation, which Lane controlled. When Temple Construction failed to pay for the glass, Statesville sued Lane Construction, Mr. Lane, and Temple Construction to collect its money.

The trial court held Mr. Lane and his new company liable for the debts of

Lane Construction. It reasoned that Mr. Lane fully controlled both companies, and that he had dissolved Lane Construction and formed Temple Construction to escape liability to Statesville. Since the corporate structure had been used to commit a wrong, the trial court decided that the corporation's founder, Mr. Lane, and its successor, Temple Construction, should be liable for Lane Construction's debt.

Creditors Out of Luck

The North Carolina Court of Appeals was not so sympathetic toward the plaintiff. First, it recited the rule that, when necessary to prevent fraud or to achieve equity, the corporate form may not protect shareholders from liability. The court then held, however, that application of this rule required the plaintiff to prove:

- Domination of the company by its shareholders
- Improper use of the corporation to commit fraud or another wrong
- Direct connection between misuse of the corporate form and the plaintiff's injury

On the issue of control, the court noted that mere ownership of all the corporation's stock did not prove domination by the shareholder. Sole shareholders can play an active role in a small corporation, provided that the corporation maintains an existence separate from its shareholder. This was the case with Lane Construction.

The court also found no evidence that Mr. Lane used Lane Construction for personal business or for personal benefit. For example, the court noted that Lane Construction had paid no dividends to Lane. The court did not address, however, the amount of funds that Mr. Lane drew as salary. But there is no indication in the opinion that such payments were excessive.

Finally, the court noted that the con-

tracts for sale of the stained glass were signed in the name of Lane Construction, not by Mr. Lane personally. The court held that "in cases arising out of contracts with a close corporation, where another party has voluntarily dealt with the corporation, corporate separateness is usually respected." When a creditor has agreed to look only to the corporation for payment of its debts, courts are reluctant to rewrite the contract by making a shareholder personally liable.

Don't Sign Personally

Though the result in this case may seem unfair to Statesville, it is mandated by the requirements of corporate law and its goal of promoting business. If businessmen like Lane were not allowed to limit their personal liability, financial conservatism would discourage risk-taking and hinder economic growth.

But when individuals sign contracts on behalf of corporations, they must take care that they are not signing personally. For example, a signature line that reads simply "ABC Corp." followed by the signature "John Smith" might be construed as a *personal* signature by John Smith. However, if the signature line reads "ABC Corp. by John Smith, President," then it is clear that John Smith is not signing personally.

The result in this case is similar to corporate liquidation bankruptcy, where a corporation sells all of its assets for the benefit of creditors, and then dissolves. As in bankruptcy, the corporate shareholders lose their investment in the company, but they are given a new opportunity to rejoin the business community without the debilitating effect of old debt. ■

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