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Owner Participation in Tortious Conduct of LLC: The Potential for Individual Liability

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This is one participation trophy you do not want.

Your clients are investors in a limited liability company (LLC) who come to you after being served with a lawsuit—stunned that their individual names appear among the several defendants. They are surprised because one of the benefits of investing in an LLC was the purported protections of the LLC veil. They come to you for advice, fearful that this lawsuit risks making their financial records discoverable to the crusading plaintiff's attorney, who is looking for any source of additional leverage at the settlement table. Your clients ask you if you can have the case against them dismissed based upon the LLC veil.

The answer to the question (of course) is that it depends, and ultimately distills to one question: How involved in the LLC are your clients? Are they arms-length investors whose only involvement is little more than attending annual meetings, or are they active participants in the LLC's daily activities? If the latter, they risk personal liability in New Jersey for tortious conduct exceeding ordinary negligence.

LLCs have become increasingly attractive to business owners who appreciate their easy formation and maintenance. Not only do they limit liability to their owners and offer pass-through tax treatment, but they also afford owners the freedom to construct the entity by agreement instead of statute, and the flexibility to choose management structure. As compared to corporations, however, because of the tendency of LLCs to be smaller in size and feature more active owners in the entity's daily activities, LLC owners are more susceptible to one potential pitfall—the owner's active participation in the LLC's tortious conduct.

Courts in New Jersey (and most states) treat LLCs similarly to corporations and look to corporate law to adjudicate LLC disputes. It is fundamental that a corporation is a separate entity from its shareholders. A primary reason for incorporating is the shareholders' insulation from the corporation's liabilities. Except in cases of fraud, injustice or the like, courts will not pierce the corporate veil to hold the shareholders liable for the actions of the entity. A party seeking to pierce the veil must establish: (1) that the entity was dominated by the individual owner, such that there was "no separate existence" from the individual owner, which is how the "alter ego" theory gets its name; and (2) that adherence to the fiction of separate corporate existence would perpetrate a fraud or injustice, or otherwise circumvent the law. Verni ex rel. *Burstein v. Harry M. Stevens*, 387 N.J. Super. 160, 199-200 (App. Div. 2006) (citing *State Dep't of Environmental Protection v. Ventron Corp*., 94 N.J. 473, 500-01 (1983)).

Courts will consider the day-to-day involvement of the owners in the entity's affairs, as well as such factors as undercapitalization, insolvency, the absence of separate records and accounts, and the failure to comply with the necessary corporate formalities.

In New Jersey, LLCS are afforded the same veil protections afforded to corporations. In lockstep with corporate law, central to New Jersey's Revised Uniform Limited Liability Company Act (RULLCA) is that the liabilities of an LLC "are solely the … liabilities of the company" itself and "do not become the … liabilities of a member or manager solely by reason of the member acting as a member or manager acting as a manager." See N.J.S.A. 42:2C-30(a). Courts will, however, pierce the LLC veil, just like its corporate counterpart, where warranted. Lawyers are probably familiar with the traditional veil-piercing factors courts employ in their "alter ego" analysis such as undercapitalization, insolvency, the absence of separate records and accounts, and the failure to comply with business formalities. These factors are weighed slightly differently for LLCs versus corporations. N.J.S.A. 42:2C-30(b) ("[t]he failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company").

There is, however, one potential pitfall with which lawyers may not be so familiar: the "participation theory," a theory predicated on the day-to-day involvement of the owner in the activities of the LLC. *Breglia v. Norman & Luba*, No. A-2772-03, 2005 N.J. Super. Unpub. LEXIS 108, at *14-15 (App. Div. Dec. 9, 2005). In large corporations, it is extremely unlikely that shareholders will actively participate in the corporation's day-to-day affairs. This is in contrast to LLCs where owners may be active in the LLC's daily activities, especially in small LLCs with only a few employees.

According to the participation theory, owners who actively participate in the misconduct of the LLC may be held personally liable for that misconduct. *Saltiel v. GSI Consultants,* 170 N.J. 297, 303 (2002). This evidence must be proven by the heightened clear-and-convincing evidentiary standard in order to overcome the veil protections. *Id.* at 304. In 2002, the New Jersey Supreme Court adopted the operative definition of the participation theory:

An officer of a corporation who takes part in the commission of a tort by the corporation is personally liable for resulting injuries; but an officer who takes no part in the commission of the tort is not personally liable to third persons for the torts of other agents, officers or employees of the corporation. Officers and directors may be held individually liable for personal participation in tortious acts even though they derived no personal benefit, but acted on behalf, and in the name of, the corporation, and the corporation alone was enriched by the acts.

[…]

An officer may be personally liable for a tort to a third person where the corporation owed a duty of care to that person, the duty had been delegated to the officer, and the officer breached this duty through personal fault causing injury. If the defendant's duty had been delegated with due care to some responsible subordinate, the defendant was not at fault and will not be held liable and the defendant knew or should have known of its nonperformance or malperformance and did not cure the risk of harm.

Id. at 303 (citing 3A William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 1137 (rev. perm. ed. 1994)).

The dispositive question of liability "turns only on … whether there was actual participation in allegedly tortious conduct rather than the nature of the conduct." *Saltiel*, 170 N.J. at 307. In other words, the participation theory's essence is that owners may be personally liable for the entity's tortious conduct if the they are sufficiently involved in that conduct. While crafted as a theory for tort liability in the context of a corporation, the Appellate Division has applied the participation theory to officers of limited liability companies. E.g., *Breglia*, 2005 N.J. Super. Unpub. LEXIS 108, at *1.

New Jersey law requires proof of intentional conduct before individual liability will attach: "New Jersey cases that have applied the participation theory to hold corporate officers personally responsible for their tortious conduct generally have involved intentional torts." *Saltiel*, 170 N.J. at 304. Although the *Saltiel* court discussed in dicta the potential applicability of the participation theory in cases of negligence rather than intentional conduct, it declined to hold one way or the other and acknowledged the law in this state is unsettled on this issue. *Id*. at 307; but see *Estate of Canavan v. Nat'l Healthcare Corp*., 889 So. 2d 825, 826-27 (Fla. App. Ct. 2004) (overturning the trial court's determination that a president of a company could not be held personally liable because a jury could find his negligence constituted tortious conduct).

While it is unclear what "active participation" means, it generally means the conduct must be intentional. See, e.g., *Charles Bloom & Co. v. Echo Jewelers*, 279 N.J. Super. 372 (App. Div. 1985) (holding owners personally liable for active participation in the conversion of diamonds); *Breglia*, 2005 N.J. Super. Unpub. LEXIS 108, at *1 (determining LLC owner may be personally liable if the trial court determines he actively participated in the fraudulent sale of a foreclosed property); *Metuchen Sav. Bank v. Pierini*, 377 N.J. Super. 154 (App. Div. 2005) (holding an owner personally liable for conversion of a check he personally authorized his employee to deposit); *Kort v. Van Aswegen*, No. A-2645-10, 2011 N.J. Super. Unpub. LEXIS 2746, at *9 (App. Div. Nov. 1, 2011) (finding owner's active participation in regulatory violations made him personally liable); *Ying v. Li*, No. A-5728-09, 2013 N.J. Super. Unpub. LEXIS 400, at *6 (App. Div. Feb 22, 2013 (deeming defendant personally liable for his company's CFA violations because he performed the work and failed to obtain the proper licenses).

To summarize briefly, lawyers may want to advise their clients to delegate their day-to-day involvement in the LLC's business to the extent feasible. Where delegation is not feasible, the lawyer's warning about the threat of personal liability should provide further incentive to the prudent LLC owner to navigate clear of tortious conduct.

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