Corporate and LLC “Participation” Liability

By EDWARD T. BUTKOVITZ, ESQUIRE,* Philadelphia County
Member of the Pennsylvania Bar

INTRODUCTION

A corporation is a legal entity designed to limit the liability of the directors, officers, and shareholders who compose it. Limited partnerships and limited liability companies (“LLCs”) are intended to afford similar protection. When one of these entities engages in wrongful conduct, a cause of action is generally thought to lie only against the entity itself. When a corporation is unable to pay a potential judgment, however, a plaintiff may attempt to recover from the entity’s constituents. This article will discuss a little known theory of liability which allows an action to proceed against wealthy, controlling members of business entities despite having properly observed all the legal formalities of operating under protective business forms.

The most common technique used to impose personal liability for a corporation’s tortious acts is the “veil-piercing doctrine.” But “veil-piercing” can only occur if it can be proven that an officer, director, or controlling shareholder has abused the protections of the corporate form. There is no definitive test for when the corporate veil will be pierced; a court must determine, in the exercise of its equitable powers, whether an individual’s traditional insulation from personal liability should be disregarded. Traditionally, personal liability is imposed only when the individual has

* Edward T. Butkovitz is an associate in the litigation department of Kleinbard Bell & Brecker LLP. He previously served as a judicial law clerk for the Honorable Mark I. Bernstein in the Commerce Court of the First Judicial District of Pennsylvania.

1. Courts have used different terminology to describe this same doctrine. It is often described as “piercing the corporate veil” or “disregarding the corporate form.” This article refers to the concept as “veil piercing,” because the same principle has been applied to limited liability business forms other than corporations. See Advanced Telephone Systems, Inc. v. Com-Net Professional Mobile Radio, LLC, 846 A.2d 1264 (Pa. Super. 2004) (applying veil-piercing doctrine to claims against a defendant LLC).

2. The “veil-piercing” doctrine allows for imposition of personal liability against directors and officers, in addition to shareholders. First Realvest, Inc. v. Avery Builders, Inc., 600 A.2d 601, 603 (Pa. Super. 1991) (“Shareholders, officers and directors are not held liable for the corporation’s breach of a contract, absent . . . the successful assertion of the equitable doctrine of piercing the corporate veil.”).


failed to comport with the legal requirements or “formalities” of the legal form he purported to operate under.\(^5\)

A lesser-known legal doctrine permits recovery against business insiders even when all business formalities have been scrupulously observed. This doctrine, formally adopted into Pennsylvania law in 1943,\(^6\) is the “participation theory,” which stands for the “general, if not universal, rule . . . that an officer of a corporation who takes part in the commission of a tort by the corporation is liable therefor.”\(^7\) The “participation theory” is distinct from veil piercing and requires different elements:

Where the court pierces the corporate veil, the owner is liable because the corporation is not a bona fide independent entity; therefore, its acts are truly his. Under the participation theory, the court imposes liability on the individual as an actor rather than as an owner. Such liability is not predicated on a finding that the corporation is a sham and a mere alter ego of the individual corporate officer. Instead, liability attaches where the record establishes the individual’s participation in the tortious activity.\(^8\)

Pennsylvania caselaw has thus far applied the “participation theory” only within the corporate structure. This article discusses the reasonable extension of the “participation theory” and its application to LLCs, particularly as it is likely to apply to fiduciary duty claims. It will first analyze the “participation theory” under current Pennsylvania law. Then it will explore how the “participation theory” applies to fiduciary duty claims against insiders with ostensibly limited liability. Finally, this article will suggest that the Pennsylvania Supreme Court will expand the “participation theory” to LLCs.

**DISCUSSION**

**Business Forms**

Before the advent of the corporation, there were two primary business forms; sole proprietorships and general partnerships. Individual owners have unlimited personal exposure for all debts of the business regardless of their role in incurring the liability in both these forms. Liability is imputed because of the individual’s status as “owner.”

By contrast, a corporation is a legal person, with rights and responsibilities similar to a natural person.\(^9\) Because it has its own legal identity, the corporation’s debts are its own and the actions of officers and directors are imputed to the corporation, not to each other, thereby protecting shareholders, directors, and officers.

The purpose of the corporate structure was to limit liability by eliminating personal liability for the actions of others. It was not intended to immunize individuals who engage in wrongdoing simply because they act on behalf of a corporation. The

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6. See *Chester-Cambridge & Trust Co. v. Rhodes*, 31 A.2d 128, 131 (Pa. 1943) (explaining that a corporate officer or director may be personal liable when he knowingly participates in a wrongful act). Although *Rhodes* was the first case to enunciate the “participation theory,” the court acknowledged a long line of cases which stood for the same principle, noting it has always been Pennsylvania law.
8. *Id.* at 89-90.
“participation theory” maintains this basic distinction, recognizing that a corporate actor is legally responsible for his substantial contribution to a corporation’s wrongdoing.

**What is the “Participation Theory”?**

Few appellate decisions discuss the “participation theory” by name. Nonetheless, the general principle that personal liability can be imposed against a corporate officer or director who substantially participates in a corporation’s wrongful, injury-producing act is firmly established. The theory is grounded in the basic agency law principle that “an agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal.” This concept is the mirror image of respondeat superior, which confers liability on a corporation for the actions of its employees, but does not address the liability of the employees.

Individual liability under the “participation theory” depends solely on whether the individual “participated” substantially in a corporation’s wrongdoing. Whether the individual’s “participation” occurred “within the course of his or her employment” is irrelevant:

“The fact that an officer is acting for a corporation also may make the corporation vicariously or secondarily liable under the doctrine of respondeat superior; it does not however relieve the individual of his responsibility.” Whether an employee is or is not acting within the scope of his or her employment, therefore, is only relevant in determining whether the employer can be secondarily liable for the employee’s tort. In either case, the employee himself remains liable for his own torts.

It is substantial individual participation which results in liability. It is not a defense that the individual’s “participation” was done in good faith or solely for the corporation’s benefit.

**What Constitutes “Participation”?**

There is no precise definition of substantial participation because it encompasses a broad spectrum of conduct. On one end, there is the performance of an improper act. For instance, a corporation’s president who embezzles corporate funds has engaged in “misfeasance.” On the other end, there is “nonfeasance,” the omission of an act which a person ought to do. This would include the director who inadvertently fails to prevent the president from embezzling. As the Supreme Court explained in *Wicks v. Milzoco Builders, Inc.*, liability attaches only for misfeasance:

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14. *Shonberger v. Oswell*, 530 A.2d 112, 114 (Pa. Super. 1987) (holding that personal liability under the participation theory “may exist even though the agent or officer derived no personal benefit, but acted on behalf, and in the name of, the corporation and the corporation alone was enriched by the act”).

15. Of course, the president in this example would be personally liable to the corporation, even without the “participation theory,” because he has directly committed a tort against the corporation.

An officer of a corporation who takes part in the commission of a tort by the corporation is personally liable therefor; but... An officer of a corporation who takes no part in the commission of the tort committed by the corporation is not personally liable to third persons for such a tort, nor for the acts of other agents, officers or employees of the corporation in committing it, unless he specifically directed the particular act to be done or participated, or cooperated therein. 17

The line between what will and what will not constitute substantial participation is unclear. To determine whether participation is substantial, three considerations should be weighed: 1) how did the defendant contribute to the corporation’s tortious act, 2) how much corporate control or influence did the defendant exert, and 3) how much did the defendant know about the surrounding circumstances? The more involved an officer or director is in a corporation’s tortious act, the less knowledge and corporate control must be found to impose personal liability. Conversely, the further removed an officer or director is from a corporation’s tortious act, the more knowledge and corporate control the individual must have.

When there is a close nexus between an individual defendant’s action and the injury inflicted by the corporation, the defendant will generally be held liable under the “participation theory.” Knowledge of the precise circumstances which make his acts wrongful is not required; it is sufficient that he clearly should have discovered the circumstances. In Bank of Landisburg v. Burruss, 18 a corporation was liable for conversion because it sold cattle without the permission of a third party that held a security interest. Even though he had no knowledge of the security interest, the corporation’s president was held personally liable under the “participation theory” because he directly negotiated the sale and arranged delivery of the cattle on the corporation’s behalf. Before selling the cattle he failed to search public records which could have revealed the third party’s security interest. 19 Since the president participated directly in the corporation’s misconduct, he was held personally liable, even though he lacked actual knowledge of any wrongdoing.

Officers and directors generally manage corporations without having discrete tasks to perform, such as a corporation’s accountant or truck driver. Therefore, they are likely to be removed from a corporation’s tortious act. Rather, their involvement is more likely the failure to prevent harm, which normally constitutes nonactionable “nonfeasance.” Nevertheless, “participation theory” liability may attach for a failure to prevent harm if an officer or director has actual knowledge of a corporation’s impending tortious action and, having the power to prevent the harm, fails to intervene. In Wicks v. Milzoco Builders, Inc, 20 the plaintiffs had purchased homes in a development. Water drainage problems in the development caused personal injuries and property damage. The complaint generally alleged that the corporate officers allowed the construction and sale to proceed despite their specific knowledge that the development’s terrain would cause drainage problems. The trial court sustained a demurrer. The Supreme Court reversed this decision and held that the complaint adequately stated a claim for individual liability under the “participation theory.”

By contrast, when a corporation’s officer or director’s only involvement in a corporation’s misdeed is the failure to exercise authority to prevent its occurrence he will not be personally liable under the “participation theory.” The key difference is specific knowledge. In Brindley v. Woodland Village, 21 the plaintiff slipped and fell due to water in a restaurant bathroom. The plaintiff sued both the restaurant and the restaurant’s owners individually, based on their failure to keep the restaurant’s restroom safe. The Superior Court rejected the claim against the owners, concluding

17. Wicks, 470 A.2d at 90.
that “there was no evidence . . . that the condition existing in the restroom was a result of an active, knowing participation by [the owners].”22 The mere authority to prevent a corporation from causing harm does not constitute substantial “participation.”

Because “participation” encompasses such a broad spectrum of conduct, with so many considerations, a plaintiff must present specific evidence that an individual defendant was either actively involved in a corporation’s tortious act or had specific knowledge of impending harm and the power to avert it. A plaintiff cannot rely on the inference that an individual defendant must have participated in some way by virtue of his status in the corporation.23 In Shay v. Flight C Helicopter Services,24 the plaintiff’s husband was killed in a helicopter crash caused by negligent maintenance performed by a corporate employee. The plaintiff sued the aircraft mechanic who performed the helicopter maintenance. The plaintiff also sued corporation’s president individually under the “participation theory.” The Superior Court first determined that the only tortious conduct was the improper installation of a part. Although the president’s day-to-day duties generally included supervising mechanics, there was no evidence that he was actively involved in the particular maintenance work at issue. The general power to supervise or prevent the improper installation, without knowledge that it had occurred, was insufficient participation.

In Kaites v. Commonwealth, Department of Environmental Resources,25 a coal mining corporation was sanctioned for failing to comply with an order issued by the Department of Environmental Resources. In addition, the Environmental Hearing Board found that the defendant, the corporation’s president and chief executive officer, was individually responsible for complying with the order. On appeal, the Commonwealth Court reversed the decision, holding that there was insufficient evidence to establish the defendant participated substantially in the corporation’s misconduct. The court explained:

[The individual defendant’s] position as a corporate officer cannot, in and of itself, lead to the imposition of personal liability for the tortious conduct of [the corporation]. By the same token, we do not believe that liability may be imposed by inferring that given [the defendant’s] managerial position he is necessarily responsible for any statutory infractions committed by [the corporation].26

**Does the “Participation Theory” Apply to Limited Liability Companies (“LLCs”)?**

Since 1994, Pennsylvania has recognized the Limited Liability Company (“LLC”) as a form of business endeavor. The LLC, like the corporation, is a business form that offers limited liability to investors and those in management positions. The LLC is essentially a hybrid form, combining the limited liability of a corporation with the preferential tax treatment of a partnership. The basic structure of an LLC is virtually identical to a corporation, despite its different terminology. While corporations have “articles of incorporation,” “bylaws,” “directors” and “shareholders,” LLCs have “certificates of organization,” “operating agreements,” “managers” and “members.”27 Members of an LLC may manage the LLC’s business and affairs, or they can designate one or more “managers.”28 Members, like their corporate shareholder counterparts, enjoy limited liability.29

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22. Brindley, 652 A.2d at 870 (emphasis added).
25. 529 A.2d 1148 (Cmwlth. 1987).
27. 15 Pa.C.S. §8943.
28. 15 Pa.C.S. §§8941. A manager need not be a member of the LLC or a natural person. 15 Pa.C.S. §8941(c)(1).
29. 15 Pa.C.S. §8922(a).
The Pennsylvania legislature has defined member liability by statute. The Limited Liability Company Law of 1994 states that “the members of a limited liability company shall not be liable, solely by reason of being a member, under an order of a court or in any other manner for a debt, obligation or liability of the company of any kind or for the acts of any member, manager, agent or employee of the company.”  

Businesses can be run by other businesses. A corporation can be the general partner of a limited partnership and a corporation can manage an LLC. Through these types of sophisticated arrangements, an individual can hold dual roles within a business; he can invest in a business in his personal capacity and simultaneously operate the business through a separate, wholly-owned business. Such “layering” is attractive to individuals who want to control a business while limiting, or totally eliminating, personal liability, even for breaches of fiduciary duties to co-investors.  

To understand how an individual may try to limit his liability for fiduciary breaches, and how the “participation theory” can slice through these protections, consider the following scenarios. Scenario 1: a limited partnership is formed to develop a piece of property. The limited partnership has two limited partners, “Mr. Big,” who invests millions of dollars in the business, and “Tiny Tim,” who makes a modest investment, and a separate general partner. Since Mr. Big invests so much in the limited partnership, he demands and receives control of the limited partnership’s affairs. However, after meeting with his personal attorneys, Mr. Big decides that it would be better if he did not directly control the limited partnership as the general partner. Instead, Mr. Big establishes a legitimate corporation, which observes all corporate formalities, to act as general partner. Mr. Big is the sole officer, director, and shareholder of this corporation. This scenario can be diagramed as follows:

The real estate market starts to decline and Mr. Big and Tiny Tim disagree about the property’s future. Concerned that he could lose his life savings, Tiny Tim wants to sell the property immediately. Mr. Big, however, knows the property can still be developed into a hugely profitable project because he is actively negotiating with a prominent shopping center, a fact he conceals from Tiny Tim. Mr. Big sees an opportunity to boost his profits by eliminating Tiny Tim. He causes the general partner to auction the property without disclosing his personal negotiations. At the auction, a different limited partnership, also wholly owned and operated by Mr. Big, purchases the property. The next day, Mr. Big’s new limited partnership announces that it has reached a lucrative agreement to develop the property. Incensed, Tiny Tim sets out to sue.  

In a limited partnership, the general partners owe a fiduciary duty to the partners and the limited partners. However, limited partners do not owe fiduciary

30. 15 Pa.C.S. §8922(a).
31. E.g., In re Estate of Hall, 535 A.2d 47, 50 (Pa. 1987) (explaining that a general partner, who is ordinarily exposed to unlimited personal liability for the debts of a limited partnership, can avoid this exposure by forming a corporation to act as general partner). This article refers to this arrangement as “layering” because the individual is protected against third party plaintiffs by the first business entity. At the same time, the entity through which the individual controls the other entity provides a layer between the investors and the managing entity, or a second layer between a third party plaintiff and the individual.
duties to each other or the limited partnership.\(^{32}\) Therefore, Tiny Tim can sue the corporate general partner for breaching its fiduciary duty, but he cannot sue Mr. Big, who is only a limited partner, even though he caused the general partner to breach its duty and personally benefited from the breach.

The “participation theory” closes this legal gap. Through the “participation theory,” Mr. Big would be personally liable for the general partner’s fiduciary breach because he substantially participated in the corporation’s wrongdoing. Despite having followed all legal formalities to avoid personal liability, thereby avoiding any possible veil piercing, Mr. Big is still liable because his actual personal control and direction of the corporate general partner, coupled with his knowledge of the surrounding circumstances, would clearly constitute substantial in the corporation’s tortious activity.

In Scenario 2, the circumstances are the same, except instead of a corporation, Mr. Big has established a legitimate LLC to act as the limited partnership’s general partner. This scenario can be diagrammed as follows:

In Scenario 2, it is unclear whether Mr. Big can be held individually liable for causing the LLC to breach its fiduciary duty to Tiny Tim, because the “participation theory” has never been applied to LLCs in Pennsylvania.

Despite the dearth of precedent, two seemingly on point cases are mistakenly cited for the proposition that the “participation theory” has been applied to non-corporate businesses. In *Alpart v. General Land Partners*,\(^ {33}\) plaintiffs and defendants were limited partners in a limited partnership. A corporation was the general partner. The defendant limited partners were neither officers nor directors of the general partner corporation. The general partner transferred partnership property to an entity owned by the limited partner defendants for less than fair market value, in violation of the general partner’s fiduciary duty to the limited partners. The plaintiffs asserted breach of fiduciary duty claims against the corporate general partner and also the limited partner defendants individually. The limited partner defendants moved to dismiss all claims because of their limited partner status.

The *Alpart* court denied the motion to dismiss plaintiffs’ claims because, at that early stage in the litigation, the defendants’ role in the limited partnership had not yet been clarified by discovery:

The plaintiffs argue that the defendants were “actively involved in the management of the LC Partnership, and their participation in the control of the business of such entities was substantially the same as the exercise of such powers by the general partners of such entities.” The plaintiffs further argue that in this capacity as general partners, the limited partners breached a fiduciary duty owed to the plaintiffs. The participation of the limited partners in the alleged breaches of fiduciary duty is unclear at this point in the litigation. Therefore, the motion to dismiss these claims is denied without prejudice to be raised again at a later stage in the litigation.\(^ {34}\)

34. *Alpart*, 574 F.Supp. 2d at 501.
The *Alpart* court recognized that the “participation theory” had previously only been applied to corporations. The opinion seems to have extended the concept to a limited partnership because the court reasoned that there was no material difference between the role of a limited partner and that of a corporate shareholder, noting that both are investors who have limited liability and no voice in the business’s operations. Because of these similarities, the court implicitly predicted that Pennsylvania courts would extend the “participation theory” to limited partnerships disputes.

The *Alpart* court’s well-reasoned decision, although decided under Pennsylvania substantive law, did not explicitly hold that the “participation theory” applies to non-corporate businesses in Pennsylvania because that proposition was not essential to the ruling. Procedurally, all the allegations of the complaint had to be accepted as true. The complaint alleged that the defendant limited partners exercised so much control over the limited partnership that they were the de facto general partners. Thus, the defendants could be held individually liable, not on any “participation theory,” but because they were not really limited partners, they were general partners who owed fiduciary duties directly to the plaintiffs. Since there was a direct claim against the defendants as de facto general partners, the court’s “participation theory” discussion was not part of its holding. The ruling did not necessarily adopt the “participation theory” because, at such an early stage, other theories of liability existed that required denial of the motion to dismiss.

In *Harbor Hospital Services, Inc. v. Gem Laundry Services, LLC*, an LLC member sued a co-member for breach of fiduciary duty based on the defendant’s misappropriation of LLC property. The defendant preliminarily objected based on his member status. OVERRULING the objection, the Philadelphia Common Pleas Court found that a member might owe a fiduciary duty to a co-member under the circumstances presented. If the member breached that fiduciary duty, he could be individually liable. The court correctly noted that there was no per se prohibition against imposing individual liability on an LLC member.

The early procedural rulings in *Alpart* and *Harbor* do not necessarily provide affirmative support for the proposition that Pennsylvania law accepts the “participation theory” in the LLC setting. However, since neither judge saw any obstacle to its application in a non-corporate context, these cases certainly suggest that an extension may be reasonably anticipated.

One federal district court has actually applied the “participation theory” to an LLC, although it is easy to overlook because it did not announce that its ruling was novel. In *L.R. McCoy & Co., Inc. v. Beiler*, the plaintiff sold fencing materials to the defendant, an LLC, based on the LLC’s promise to pay for the materials after it resold them. Contrary to the promises, it never paid. Plaintiff sued two of the LLC’s members for conversion. The individual defendants moved to dismiss the conversion claim based on their member status. The district court denied the defendants’ motion to dismiss because the complaint alleged that the conversion of the plaintiff’s property was personally perpetrated by the individual defendants. Emphasizing the similarities between corporations and LLCs, the court imported the “participation theory” from corporate law. The *Beiler* court explained that “members of a corporation who personally direct or participate in a wrongful act may be held individually liable.” This decision directly, albeit implicitly, predicts that the Pennsylvania Supreme Court will apply the “participation theory” to the LLC business structure.

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When presented with an appropriate case, the Pennsylvania Supreme Court will likely apply the “participation theory” to LLCs. Such application is consistent with the Pennsylvania legislature’s intent in enacting the Limited Liability Company Law of 1994. The law states, “the members of a limited liability company shall not be liable, solely by reason of being a member, under an order of a court or in any other manner for a debt, obligation or liability of the company of any kind or for the acts of any member, manager, agent or employee of the company.”38 Since the “participation theory” imposes liability only for substantial personal participation in a business’s wrongdoing, and not based on one’s status in the business, it is consistent with the statute.39

When the Limited Liability Company Law of 1994 was enacted, the legislature intended to confer the same protections established in the corporate context. Nothing suggests that they intended to confer any additional protection. In both business forms, the legislature recognized that passive investors give up the right to participate in the business’ operations in exchange for liability limited to the amount of their investment.40 If an investor disregards this arrangement and chooses to participate substantially in the business’s tortious conduct, it is neither unreasonable nor unfair that he should forfeit his protection from liability.

There is also statutory support for extending the “participation theory” liability beyond the traditional corporate setting. Section 110 of the Associations Code,41 which governs all business forms in Pennsylvania, including LLCs, states: “Unless displaced by the particular provisions of this title, the principles of law and equity, including, but not limited to, the law relating to principal and agent, estoppel, waiver, fraud, misrepresentation, duress, coercion, mistake, bankruptcy or other validating or invalidating cause, shall supplement its provisions.”42 Although rarely cited, this provision has served as the basis for extending the “veil-piercing doctrine,” a traditionally corporate principle, to the LLC structure.43 The “participation theory,” like the related doctrine of piercing the corporate veil, is a “principle of law and equity” that may and very well should be held to supplement the provisions of the Liability Company Law of 1994.

CONCLUSION

The Pennsylvania Supreme Court has yet to address whether the “participation theory” applies to LLCs. When an appropriate case reaches the Supreme Court, it may very well apply the “participation theory” to the LLC form of business. There is no valid policy reason why it should not, given the many similarities between corporations and LLCs.

The possibility, indeed the likelihood, that the Pennsylvania Supreme Court will apply the “participation theory” in the LLC context presents many opportunities for plaintiff attorneys representing limited partners. It also represents new challenges for transactional lawyers.

38. 15 Pa.C.S. §8922(a).
39. Harbor Hosp. Servs., Inc. v. Gem Laundry Services, LLC, 2001 Phila. Ct. Com. Pl. LEXIS 38 (July 18, 2001) (“A reasonable interpretation of [15 Pa.C.S. §8922(a)] does not connote that members are immune from liability, in all circumstances, but means that members are not liable simply because of their status as members.”).
41. 15 Pa.C.S. §101 et seq.
42. 15 Pa.C.S. §110 (emphasis added).
43. See, e.g, Advanced Telephone Systems, Inc. v. Com-Net Professional Mobile Radio, LLC, 846 A.2d 1264 (Pa. Super. 2004) (applying veil-piercing doctrine to claims against an LLC defendant; 15 Pa.C.S. §8904, Committee Comment, 1994 (explaining that the Limited Liability Company Law of 1994 is subject to general principles of equity under 15 Pa.C.S. §110, and thus contemplates “that in the appropriate cases the doctrine of piercing the corporate veil will be applied to a limited liability company”).