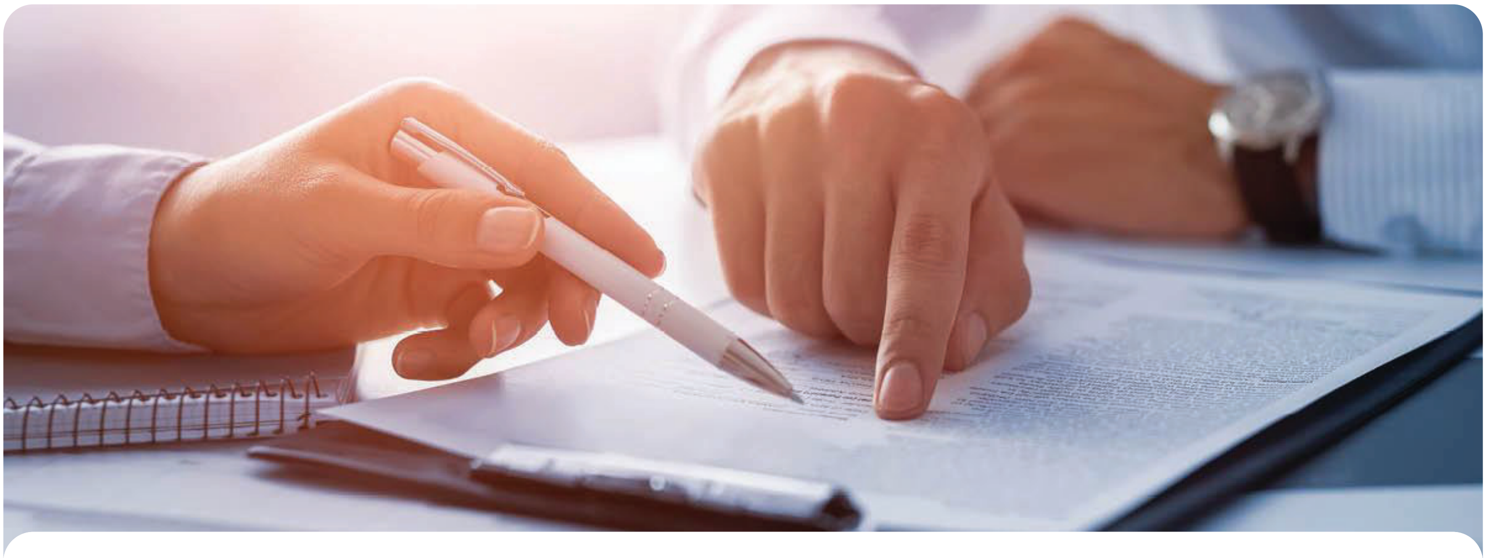
Insight

One Crucial Clause for Every Agreement

No matter what legal agreement you're signing, it probably ought to include a critical chunk of exculpatory text to prevent unexpected liability. Many documents lack it.



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Participants in commercial real estate transactions do business through corporations, limited liability companies and sometimes other entities. (We'll henceforth call all of these entities "companies" for convenience.) The principals of the company don't do business in their own names. Instead, they use companies for many good reasons: to accommodate complex ownership structures, to allocate tax exposures, to define financial rights and obligations and to shield individual principals from liability. That's just how all modern commercial real estate business—and most other business—is done.

Loan agreements often go a step further and say that the lender's shareholders, principals, employees, agents and others in the lender's organization (let's call them the lender's "constituents") will never have any liability to the borrower. That gives the lender's constituents a second layer of protection, going beyond the fact that the lender itself is a company.

What about the borrower's constituents? More generally, what about the constituents of any party to any legal document except a lender whose loan documents expressly protect the lender's constituents? Some contracts specifically state that no constituents of any party will ever have any liability for any claims related to the contract. Many don't state that, however, even though they seem to cover everything else that might ever become relevant—and much that won't.

You might think no one needs to bother to explicitly protect constituents from any liability under a contract. That's because these contracts are invariably signed by companies, not individual people—again, that's how business is always done—

so the fundamental legal structure of each company should insulate the constituents from any claims that creditors might have against the company. You would think each creditor knew from the start that it was doing business with a company whose fundamental structure protected its constituents from liability. The notion of limited liability is baked into the deal structure and known by all, so you shouldn't need to say it again. Unfortunately, you might be wrong about that.

In a big surprise for constituents of any company—not at all what anyone expected when the company signed a contract—creditors can sometimes try to "pierce the veil" that is supposed to protect the constituents from liability. This means the creditors will try to go after a company's constituents to make them pay the company's contractual obligations. Whether a creditor can indeed pierce the veil depends on the facts of each case. It's difficult, fact-sensitive and thus expensive litigation, but highly tempting to a creditor that believes it was wronged.

A company's creditors can argue that the constituents exercised so much control over the company that they were inseparable from it. They might also argue that the company and its constituents mixed their bank accounts and paid little or no attention to who paid which bill or who signed which piece of paper. When a constituent did things for the company—placing orders or signing leases, for example—creditors might claim the constituent didn't adequately announce that the company was doing these things rather than the constituent itself.

> “Constituents often pay little attention to the line between themselves and their company.”

Creditors can cite facts like these, and others, to argue that a court should strip away constituents' liability protection and hold them liable for the company's debts. These arguments often arise long after the underlying dispute with the company began, or the underlying claims arose. That means the constituents are stuck with whatever has already happened. At this point, they have no control over or choice in the matter.

Creditors seeking to pierce the veil and hold constituents liable always face an uphill battle. If the creditor's claim is substantial, however, and the company turns out to be an assetless waif, this battle may be tempting to fight. Facts like those in the previous paragraph can invite creditors to make creative, aggressive arguments against a company's constituents.

In the real world, though, small companies often operate informally. That's just how these things work. Constituents often pay little attention to the line between themselves and their company. It can sometimes be difficult to say whether any particular action was taken by the constituent or by the company, especially if just one constituent owns the whole company. The ordinary operation of a company can entice a creditor to try to pierce the constituents' veil of liability protection. The argument usually fails. Once in a while, however, it succeeds—even though everyone, including every

creditor, went into the legal relationship with the company knowing the company structure existed precisely to protect its constituents from liability.

To prevent any argument that might allow creditors to go after constituents, every legal document a company signs should include language to try to make it impossible to pierce the veil. Each legal document should expressly protect constituents from liability for the company's obligations under any circumstance. This is exactly the language that loan documents almost always include to protect the lender's constituents. Loan documents and all sorts of other contracts don't necessarily give constituents of other contractual parties the same protection. This protection could turn out to be the most important provision in any contract if the company or the transaction ultimately goes sideways—far more important than many other provisions that typically appear in any serious legal document and attract extensive attention and negotiation.

Here is the "full" version of sample language that any company should probably try to include in every contract, including every loan document and lease:

No Constituent of any party to this agreement shall ever have any personal liability or be subject to any recourse, directly or indirectly: (i) under this agreement; (ii) arising from its subject matter or the contractual relationship, or any claim or dispute relating to the agreement, between or among the parties; or (iii) as a result of any action taken on behalf of, or within the scope of responsibility for, any party to this agreement. Each party waives all such personal liability and recourse against

any Constituent. Each party waives any claim for "piercing the veil," "alter ego," or the like, based on any fact or theory whatsoever (whether in contract, in tort or otherwise), including failure to comply with entity formalities; undercapitalization; unity of interest; excessive control or domination; commingling of funds; payment of bills; shared telephone numbers, letterhead or address; acting on behalf of a party to this agreement; or any fact, circumstance or theory that might support consolidation in bankruptcy. That does not limit any person's liability under and limited only to: (i) the law of fraudulent transfers, fraudulent conveyances, or illegal distributions or (ii) the express terms of a written guaranty, indemnity, or other agreement signed by that person. This paragraph shall survive any termination or assignment of this agreement. Every Constituent is an intended third-party beneficiary of this paragraph. "Constituent" means, for any entity that is or was a party to this Agreement, any affiliate, agent, contractor, director, employee, equity holder, manager, member, officer, owner, or principal of that party or of anyone claiming through that party. A party is not a Constituent of itself.

By including language like this in any contract, constituents give themselves a cheap insurance policy against overzealous creditors and against judges whose background often involves "public interest" law or prosecution of criminals rather than commercial real estate transactional law.

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