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Failing To Follow Formalities:

The Business Owner's Risk of Personal Loss for Corporate Liabilities

If business owners do not set up and operate their corporate businesses properly, the corporate entity may not protect them, and the risk of losing personal assets remains.

Most business owners believe that once they set up a corporation or a limited liability company, they have absolute protection against corporate liabilities and that their own personal assets are safe from corporate creditors. By establishing a business entity to conduct business, a business owner believes he or she can engage in running a business without worrying about losing personal assets. While in general that tenet is correct, that is not always the case. If business owners do not set up and operate their corporate businesses properly, the corporate entity may not protect them, and the risk of losing personal assets remains.

One of the exceptions to the general tenet is that a plaintiff creditor may "pierce the corporate veil" when a business acts as the "alter ego" for the individual business owner. In other words, if a court believes that the individual owner and the business have such a strong unity of interest and ownership that they are essentially the same entity, and that adhering to a separate existence between the entity and the individual would promote injustice or fraud, then the court may pierce the corporate veil and allow a plaintiff to seek the personal assets of that individual.

In determining whether to "pierce the corporate veil," a court will look at a number of factors relating to whether the corporation is being operated as a real corporation and following "corporate formalities." Essentially, the court will review both the manner in which the business owner set up the corporation and the manner in which the owner is operating the corporation to determine whether the owner is treating the corporation as a separate entity.

Some of the critical factors that a court looks at are as follows:

- **Failing to adequately capitalize the corporation.** The courts recognize that it is unfair to a corporation's creditors for an owner to set up a corporation without providing the initial funding necessary for that corporation to pay its bills. The company simply cannot be a shell company with no capital to support its operations. Thus, an owner must risk an initial amount of money sufficient to meet the corporation's initial expenses and liabilities.
- **Failure to issue stock.** Every corporation at its creation must have stock authorized and issued. If the owner has failed to issue stock, this factor can be rectified with the assistance of counsel.
- **Failure to keep corporate records.** Simply establishing the corporate entity is not enough to ensure protection from personal liability for the owners. Every corporation must prepare bylaws, prepare and keep shareholder and director resolutions, prepare resolutions for critical business decisions, and document other business decisions and events during the corporation's existence. The failure to document important business events in the life of the entity reflects the owner's disregard for a separate corporate existence. The business owner should address the obligation to keep the proper corporate records by providing ongoing attention to corporate details and by recording such events with counsel as a matter of habit.
- **Commingling of accounts.** If an owner utilizes the business account as if it were his own funds, then the court is much more likely to find that monies between the corporation and the owner were commingled, and that a separate entity does not exist. The same conclusion may occur if an owner pays the corporation's expenses from a personal account. Clients need to know the proper manner to document and treat any monies which may cross accounts between an entity and an individual.
- **Diversion of corporate assets to shareholders.** When a corporation is suffering financial problems, a business owner sometimes re-pays a loan made by the owner or related entity of the corporation before paying other creditors of the corporation. A preferential payment such as this has a strong, negative bearing on proving that there is a separate existence of the corporation and an owner.

If your business has failed to follow some of the above "corporate formalities," we can assist you in not only rectifying any errors in the setup of your corporation and any shortcomings in record-keeping, but also in establishing proactive measures in ensuring that your corporation follows the necessary corporate formalities in the future. In this way, you can be assured that your personal assets are protected in the best manner possible. ■

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