

# Corporation Owner's Survival Guide

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## 18 Smart Ways to Protect Your Assets from Personal Liability

If you conduct business as a corporation, limited liability company or limited liability partnership, you must realize: These types of business entities may do nothing to protect your personal assets.

Statistically, if you are sued, you're more likely to have to prove the validity of your business entity and its protective corporate veil than any other issue.<sup>1</sup> What's more, over 50 percent of the time, you will lose your protection and the court will hold you personally liable.<sup>2</sup>

Are you really at risk? A Gallup survey commissioned by the National Federation of Independent Business, found that between 1995 and 2000, 24 percent of small businesses either had been sued or were threatened with court action. Today, it is estimated that one in three small businesses are sued each year.

As if the rising tide of litigation wasn't bad enough, don't forget the IRS. Corporations enjoy many more deductions and tax benefits than individuals. The IRS requires that all companies play by the rules. If the IRS comes calling, expect to have to prove that you run your corporation or LLC by the book and keep corporate formalities.

If you're a small business, you are most at risk. The corporate veil is pierced most often in close corporations or within corporate groups.<sup>3</sup> In fact, as the number of shareholders *decreases*, the likelihood of piercing the corporate veil *increases*.<sup>4</sup>

Here are "18 Smart Ways to Reduce Your Personal Liability and Protect Your Assets:"

### **Smart Way #1:**

**Make sure you set up your business entity properly.**

This means that you must make sure that the entity's structure is **well** documented -- and **correctly** documented -- to demonstrate that it is an individual entity. Your documentation should include articles of incorporation or articles of organization, the bylaws or operating agreement, minutes and resolutions of all shareholder and directors meetings, including organizational meetings, appropriate state and federal tax identification numbers, state and local business licenses, financial institution authorizations, a list of corporate assets and liabilities, a corporate stock ledger, a buy/sell or stock redemption agreement, assignments of corporate interests, corporate annual reports, bank account records, corporate financial books, and more. Failing to maintain these records undermines the validity of your separate business entity and will lead a court to pierce the veil and find the owners personally liable.<sup>5</sup>

### **Smart Way #2:**

**Make sure the articles of incorporation or articles of organization are properly filed before you do business.**

If you fail to do this, you will certainly be held personally liable for all actions taken before the articles were properly filed.

### **Smart Way #3:**

#### **Make sure you keep the business adequately capitalized.**

This means, don't start a company that requires a great deal of money with initial contributions of only \$500 or \$1000. The corporation's capital must realistically reflect the needs of this type of business, both when the company is formed -- and as long as it operates. An obvious inadequacy of capital is a leading factor in piercing the veil and holding owners personally liable.<sup>6</sup>

### **Smart Way #4:**

#### **Make sure you properly convene and document *shareholder/member* meetings.**

At least one shareholder/member meeting must be held annually to elect board members. Before meeting, make sure you check the company's bylaws. They may require that you send timely notices, waivers and proxy statements. The bylaws may require that you prepare and keep proper agendas -- and that you propose, vote on, record and sign resolutions. Even if you are the sole shareholder in the business, you must still send meeting notices, hold meetings, and elect board members. This shows that you are drawing a clear distinction between your personal identity and the identity of your business entity. Failure to follow corporate formalities by having proper shareholder meetings is a leading factor in piercing the veil and holding owners personally liable.<sup>7</sup>

### **Smart Way #5:**

#### **Make sure you properly convene and document *director/manager* meetings.**

As with shareholder meetings, director/manager meetings should be held at least every year. If you hold these meetings more than once a year, you further reduce your risk of being held personally liable. As with shareholder meetings, a proper director's meeting may require timely notices and waivers. Remember to check the company's bylaws. In addition, you must keep and sign minutes and resolutions relating to important matters. Failure to follow corporate formalities by having proper director/manager meetings is a leading factor in piercing the veil and holding owners personally liable.<sup>8</sup>

### **Smart Way #6:**

#### **Make sure you hold and document special meetings of both shareholders and directors when you need to address important matters.**

These include opening any kind of banking account or getting a company credit card, when the company enters into a new lease, enters into a funding or lease commitment, enters into key contracts, changes an officer's salary, fills a vacancy on the board, enters into an important new venture, considers selling business assets or acquiring new debt, and hundreds of other actions that should be documented.<sup>9</sup> It is widely believed that the more documentation you have the thicker your shield protecting your personal assets. The rule of thumb here is...You can never have too much documentation.

### **Smart Way #7:**

#### **Make sure the directors/managing members play an active role in deciding important matters such as major capital expenditures and other fiscal matters (in writing).**

The more a dominant shareholder appears to be in control of the company's fiscal matters, the more the business entity appears to be a sham. If you bypass the directors, the court could easily conclude that your so-called directors are directors in name only. This means that the corporation is in fact, controlled by one person, whom it then holds personally liable. This is compounded if the dominant shareholder is siphoning earnings and profits of the corporation for personal use.<sup>10</sup>

### **Smart Way #8:**

#### **Make sure you issue company stock or LLC membership units -- and record those transactions.**

In many cases, the corporation's failure to issue stock contributed to the court's conclusion that the company and the owner had the same identity. It's easy to issue stock and record it -- but it's seldom done. Do it!<sup>11</sup>

### **Smart Way #9:**

**Make sure you issue stock only to people who intend to be true owners.**

In some cases, your lawyer, accountant or some other individual may agree to be shareholders in name only. If the court sees shareholders who have no intention of being true owners, the court can conclude that you've committed fraud and find the corporation's true owner to be personally liable.<sup>12</sup>

### **Smart Way #10:**

**Make sure you follow the bylaws or operating agreement.**

Remember, bylaws and operating agreements are binding contracts between shareholders/members. If the shareholders/members disregard the contract, they are -- in so many words -- admitting the entity doesn't exist apart from themselves. If the shareholders/members don't respect the entity's individuality, neither will the court.

### **Smart Way #11:**

**Make sure you pay dividends to shareholders.**

If the corporation doesn't pay dividends, it reinforces the appearance that the company's funds are the owner's funds. This makes it easy for the court to conclude the company does not exist as a separate entity.<sup>13</sup>

### **Smart Way #12:**

**Make sure you file annual reports in The State you are incorporated AND in any state you are doing business as a foreign corporation.**

This simple chore can be your Achilles' heel. Failure to file annual reports in the state in which the company is incorporated, and in each state in which it is registered as a foreign corporation, suspends the validity of your business entity and destroys the corporate veil. In other words, the separate entity ceases to exist. This means if you are sued, the law will consider you and your business the same person and all of your personal assets will be considered assets of the business and you will have absolutely no protection from the corporate veil. **Even if you bring your company current by filing a late report, you will still have this "gaping hole" in your corporate veil, and you will be personally liable for any act or incident that occurred during the time period when you were not registered. Based on the statute of limitations, this exposure could last for as long as 6 years if the incident involved a contract.** In some states, more than 50 percent of the registered business entities are delinquent for failing to file annual reports.<sup>14</sup>

### **Smart Way #13:**

**Make sure you keep accurate corporate records.**

This means you must not only hold meetings, but you must also keep accurate records of those meetings. What's more, you must keep those records available so you can reference them at any time.<sup>15</sup> It's the diligent keeping of these records that helps create and maintain the corporate veil that protects the personal assets of the shareholders, directors, officers, or members. This is true even when a single person wears all hats and holds every office of the corporation. Think of it this way: ***your corporate veil is only as thick as your corporate record book.*** Your Board Minutes and Resolutions provide documented proof of a proper chain of command for your company's decisions and actions. What should you document? Easy. Whatever you don't want to be personally liable for. If you're acting on behalf of your company in any major action, you should get written board authorization-even if you're the only board member.

### **Smart Way #14:**

#### **Make sure you document loans between the company and shareholders/members.**

Proper documentation includes formal promissory notes with reasonable interest rates, security agreements, personal guarantees, and other related documents. If you fail to document loans, you're inviting the court to conclude that you're commingling funds, which is a common reason to declare you personally liable.<sup>16</sup>

### **Smart Way #15:**

#### **Make sure your business earns a profit.**

I know, easier said than done. But courts have held that showing ongoing losses year after year is reason enough to hold the owner personally liable. Courts look to see who benefits from a company's loss. If the business doesn't turn a profit, courts can conclude that this is for the business owner's benefit, making him personally liable.

### **Smart Way #16:**

#### **Make sure you use the corporation for proper business purposes.**

Your company must conduct business as stated in the articles of incorporation or articles of organization. If you use the company as a means of moving funds from another business entity or as a façade for personal business, you will be held personally liable.<sup>17</sup>

### **Smart Way #17:**

#### **Make sure you carry reasonable insurance on the company that relates to the company's business risks.**

Without proper insurance, the court might conclude that the company has no interest in protecting itself, holding the owner personally liable.

### **Smart Way #18:**

#### **Change the way you view your company.**

The most important thing you can do to protect your assets from personal liability is to think of your company as a separate entity. Without this fundamental change in thinking, you will not have the commitment necessary to maintain the separateness crucial to protecting your personal assets. Keep in mind "if the shareholders themselves, or the corporations themselves, disregard the legal separation, distinct properties, or proper formalities of the different corporate enterprises, then the law will likewise disregard them."<sup>18</sup>

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# 16 Costly Mistakes That Cause Courts to Hold You Personally Liable for Your Company's Debts

## **Costly Mistake #1:**

**Believing that LLC's don't have to follow the same rules as a Corporation -- or that LLC veils have never been pierced.**

The fact is LLC's are being pierced under the same rules as a corporation and just as often. The myth started back in 1994 with a *George Washington Law Review* article that stated, "no court has pierced the veil of a domestic LLC."<sup>19</sup> This was indeed true at the time it was written, but not anymore. Some states, such as Colorado, have mandated through legislation that courts are to apply corporate case law to an LLC when determining the circumstances when the veil will be pierced and members held personally liable.<sup>20</sup> Other states, such as Minnesota, North Dakota, and Illinois have enacted statutes that follow a similar line.<sup>21</sup> The absence of statute, however, does not relieve an LLC member from personal liability. Most courts seem willing to apply corporate veil piercing principles to LLC members whether or not the jurisdiction has enacted legislation directing courts to do so.<sup>22</sup> The use of corporate veil piercing principles may actually lead to higher likelihood of a successful veil piercing of an LLC due to people's mistaken belief in the myth that an LLC is not required to follow the same rules as corporations such as keeping diligent corporate records.

## **Costly Mistake #2:**

**Entering into contracts that the company has no possibility of completing -- or while the business is bankrupt.**

## **Costly Mistake #3:**

**Overlapping different business entities.**

Do not house different companies in the same office. Do not have different companies with the same directors, officers, employees or bank accounts. If you want the courts to see your business entities as separate, you must make clear distinctions among them.

## **Costly Mistake #4:**

**Misrepresenting or misleading other people or companies to believe that your company is one type of business entity when, in fact, it is another type of business entity.**

You cannot have the liability protection afforded by a business entity if you misrepresent the type of entity. Any use of the corporate entity in promoting injustice or fraud will support a successful veil piercing.<sup>23</sup>

## **Costly Mistake #5:**

**Identifying a person or company as an owner of your company, when they are not.**

Never misrepresent the identities of your company's owners. If you do, the court could find that you defrauded other people or companies when they were deciding whether to do business with your company. The result? You're personally liable.

## **Costly Mistake #6:**

**Operating a business only to acquire the debt and liabilities of another business.**

Courts determine whether to hold you personally liable based on fairness. In the court's eyes, operating a business for the purpose of acquiring debts or liabilities is an obvious injustice. As a result, they can hold you personally liable.

### **Costly Mistake #7:**

#### **Mixing personal assets or shareholders' funds with the company's assets or funds.**

Any time you commingle personal and business funds; you're looking for trouble. If you use company funds to pay for something that has a personal purpose, you can expect the court to hold you personally liable.<sup>24</sup>

### **Costly Mistake #8:**

#### **Siphoning or draining money from the company for your personal use.**

Diverting funds is when you purposely direct money out of the company for your personal benefit. In most cases, the court will hold you personally liable for the funds.<sup>25</sup>

### **Costly Mistake #9:**

#### **Representing that you are (or will be) personally responsible for the company's liabilities or debt.**

This admission clears the way for the court to hold you personally liable.

### **Costly Mistake #10:**

#### **Signing checks without adding your title -- or that you represent the company.**

If the check does not have the name of the corporation on it, ALL states agree that you are personally liable if you sign it without designating the fact that you are signing it as an agent of the corporation. A signed check is just another form of a binding contract. If the company's name is on the check...but there is no clear indication that it is a corporation and no entity type is shown (LLC, C, S, LP, etc.), all states except the state of Utah hold that there is personal liability. The best way to protect yourself is to have your checks imprinted with the words, "signature of authorized corporate agent," underneath the signature line. This way, even if you forget to add your title when signing the check, it is still clear that you are signing as an authorized corporate agent.

### **Costly Mistake #11:**

#### **Losing S corporation status.**

Electing "S Corporation Status" with the IRS allows small business owners to avoid being doubly taxed on profits earned by the corporation. **The most common way of losing this preferred tax status is by failing to make the election in the first place.** This election must be made with the IRS following your incorporation on the state level. Certain restrictions apply to corporations that wish to make the "S" election. This is a very complex area of the law, for more information regarding the "S" election; you should consult a tax professional. Failure to comply with IRS rules could lead to the loss of this election and to large tax liabilities and penalties.

### **Costly Mistake #12:**

#### **Using the company to intentionally defraud others or to conduct illegal activity.**

The Bylaws and Operating Agreement allow only legal business activities. Any intentional fraud or illegal activity will certainly negate any protection for the business owners.

### **Costly Mistake #13:**

#### **Signing a contract -- or entering into an agreement in your personal capacity.**

Whenever you sign a contract or sign any type of agreement on behalf of the company, make sure your signature includes both, your name and corporate title. Make sure that the company has taken the appropriate actions to document and approve those contracts and agreements and has authorized your officers to execute them on behalf of the company.

### **Costly Mistake #14:**

#### **Negotiating business transactions between the company and a shareholder with a built-in bias or favoritism.**

When you enter into any business agreement or transaction with a shareholder, make sure you do so at "arm's length." A court may interpret this as self-dealing and disregard the business entity.

### **Costly Mistake #15:**

#### **Issuing orders in a name other than the company's name.**

Issuing company orders in the name other than the company's name will not alleviate the liabilities associated with those orders, when discovered. The intent for such actions will be the determining factor.

### **Costly Mistake #16:**

#### **Using a DBA that you have not registered with the state in which you're doing business.**

Companies must file as a foreign corporation. Or when the company's name is unavailable in a certain state, you must file a DBA (Doing Business As) with that state indicating you are doing business under that name in the state. This serves to protect the identity of the company within the state.

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<sup>1</sup> See ROBERT B. THOMPSON, *Piercing the Corporate Veil, an Empirical Study*, 76 Cornell L. Rev. 1036, 1991.

<sup>2</sup> *Id.* at 1055.

<sup>3</sup> *Id.* at 1039.

<sup>4</sup> *Id.* at 1054-1055.

<sup>5</sup> See *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987); *Brigg's Transp. Co., Inc. v. Starr Sales Co., Inc.*, 262 N.W. 2d 805 (Iowa 1978); *Colman v. Colman*, 743 P.2d 782 (Utah 1987).

<sup>6</sup> See *Refco, Inc. v. Farm Production Ass'n, Inc.*, 844 F. 2d 525 (8<sup>th</sup> Cir. 1988); *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987); *J.L. Brock Builders, Inc. v. Dahlveck*, 391 NW.2d 110 (Neb. 1986); *Lucas v. Texas Industries, Inc.*, 696 S.W.2d 372 (Tex. 1984).

<sup>7</sup> See *Lakota Girl Scout C., Inc. v. Havey Fund Raising Mfg., Inc.*, 519 F.2d 634, 638 (8<sup>th</sup> Cir. 1975)(corporate formalities were not followed); *Harrison v. Puga*, 480 P.2d 247, 254 (Wash. 1971)(since the defendants disregarded the corporate formalities, they could hardly complain if the court did likewise).

<sup>8</sup> See *Lakota Girl Scout C., Inc. v. Havey Fund Raising Mfg., Inc.*, 519 F.2d 634, 638 (8<sup>th</sup> Cir. 1975)(corporate formalities were not followed); *Harrison v. Puga*, 480 P.2d 247, 254 (Wash. 1971)(since the defendants disregarded the corporate formalities, they could hardly complain if the court did likewise).

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<sup>10</sup> *Amoco Chemicals Corp. v. Bach*, 567 P.2d 1337, 1341 (Kan. 1977); *Colman v. Colman*, 743 P.2d 782 (Utah 1987).

<sup>11</sup> See generally, L.C. Di Stasi, Annotation, *Failure to Issue Stock as Factor in Disregard of Corporate Entity*, 8 A.L.R. 3d 1122, 1126 (1966); See also; *Laborers Clean-up Contract Administration Trust Fund v. Uriarte Clean-up Service, Inc.*, 736 F.2d 516 (9<sup>th</sup> Cir. 1984); *C. Mac Chambers Co., Inc. v. Iowa Tae Kwon Do Academy, Inc.*, 412 N.W.2d 593 (Iowa 1987).

<sup>12</sup> See e.g.; *Colman v. Colman*, 743 P.2d 782 (Utah 1987).

<sup>13</sup> *Schoenberg v. Benner*, 59 Cal. Rptr. 359 (Cal. App. 1967); *Colman v. Colman*, 743 P.2d 782 (Utah 1987); *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987)

<sup>14</sup> See Florida Secretary of State internet site (visited May 3, 2004) <<http://www.sunbiz.org/scripts/cornamelis.exe>.

<sup>15</sup> See generally, L.C. Di Stasi, Annotation, *Failure to Issue Stock as Factor in Disregard of Corporate Entity*, 8 A.L.R. 3d 1122, 1126 (1966); See also; *Laborers Clean-up Contract Administration Trust Fund v. Uriarte Clean-up Service, Inc.*, 736 F.2d 516 (9<sup>th</sup> Cir. 1984); *C. Mac Chambers Co., Inc. v. Iowa Tae Kwon Do Academy, Inc.*, 412 N.W.2d 593 (Iowa 1987).

<sup>16</sup> See *Stillman v. Tempo Carpets, Inc.*, 329 S.E.2d 197, 198 (Ga. 1967); *McCombs Const., Inc. v. Barnes*, 645 P.2d 1131, 1135 (Wash. 1982); *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987).

<sup>17</sup> See *Stillman v. Tempo Carpets, Inc.*, 329 S.E.2d 197, 198 (Ga. 1967); *McCombs Const., Inc. v. Barnes*, 645 P.2d 1131, 1135 (Wash. 1982); *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987).

<sup>18</sup> See I W. FLETCHER, *Cyclopedia of the Law of Private Corporations* §41.10 (Perm. Ed.).

<sup>19</sup> See ERIC FOX, *Piercing the Veil of Limited Liability Companies*, 62 George Washington L. Rev. 1143, 1144 (1994).

<sup>20</sup> COLO. REV. STAT. '7-80-107 (Supp. 1990).

<sup>21</sup> MINN. STAT. ANN. § 322b.303(2); N.D. CENT. CODE § 10-32-29(3); ILL. REV. STAT. Ch. 805 para. 180, 10-10; see also *Tom Thumb Food Markets, Inc. v. TLH Property*, C9-98-1277, 1999 WL 31168 (Minn. App. Jan. 26, 1999) (unpublished).

<sup>22</sup> See *Howell v. Orleans Regional Hospital*, 217 F.3d 379, 385-88 (5<sup>th</sup> Cir. 2000); *Ditty v. Checkrite*, 973 F. Supp.1320, 1335-36 (D. Utah 1997); *Hamilton v. AAI Ventures*, 768 So. 2d 298 (La. Ct App. 2000); *People v. Garban*, 1999 WL 496182 (N.Y.Sup. Ct. June 17, 1999) Just to name a few!

<sup>23</sup> See e.g.; *Colman v. Colman*, 743 P.2d 782 (Utah 1987).

<sup>24</sup> See *Stillman v. Tempo Carpets, Inc.*, 329 S.E.2d 197, 198 (Ga. 1967); *McCombs Const., Inc. v. Barnes*, 645 P.2d 1131, 1135 (Wash. 1982); *Bergen v. F/V St. Patrick*, 816 F.2d 1345 (9<sup>th</sup> Cir. 1987).

<sup>25</sup> *Amoco Chemicals Corp. v. Bach*, 567 P.2d 1337, 1341 (Kan. 1977); *Colman v. Colman*, 743 P.2d 782 (Utah 1987).