

How Business Owners Can Protect Their Personal Assets

By Raymond P. Kolak

You recently started a construction company which builds custom homes. One of your first projects was improperly designed by the property owner's architects, and you unfortunately had the privilege of building the house. The owner is furious, and threatens suit against every member of the construction industry who ever passed within a mile of the house. If you're sued, you can at most lose your new company, which has built up little going concern value, anyway, but you can't lose your personal assets like your own house and investments, right? Right?

In my experience as a practicing attorney for 27 years, *right in most cases*. If your attorney organized you in one of the limited liability legal formats, if you signed the construction contract properly, and if you followed the legal formalities, your liability is limited to the amount you invested in your business venture, and your personal assets are protected.

Protection from individual liability is available if your business is structured as a corporation (either a subchapter C or subchapter S corporation for tax purposes), a limited liability company, or a limited liability partnership. Most all businesses with active operations should be in one of these three forms. Limited liability is not available if you operate as a sole proprietorship or general partnership. Sole proprietors and general partners are each individually liable for all of the debts and obligations of the business. In a limited partnership, the limited partners have limited liability, but the general partner (there must always be at least one) is individually liable for the debts and obligations of the limited partnership. You shouldn't be using a limited partnership for a construction company. In a limited liability partnership, no partner is individually liable.

OK. You operate as a corporation, limited liability company, or limited liability partnership, but did you sign the construction contract properly? A proper signature for a legal entity like a corporation, limited liability company, or limited liability partnership consists of three things:

The full legal name of the entity (if a corporation, include "corporation", "company", "incorporated", "limited" or an abbreviation; if a limited liability company, include "limited liability company" or an abbreviation; and if a limited liability partnership, include "limited liability partnership" or an abbreviation)

Your signature or the signature of an authorized officer

Your title in the organization (President, CEO, etc.)

This seems so obvious, but you would be surprised at the number of ways that business people do this wrong. Suppose you sign "Ray Kolak, President", but without mentioning

the name of your corporation. Is your corporation bound, or does this make you individually liable? Some judges have ruled that the corporation only is bound, and others that you alone are liable. This is a simple point, so don't miss it. You sign your name on behalf of your business many times each day. Always include the three elements: the name of your business, your signature, and your title.

Under the laws of most states, the existence of your business as a corporation started when your Secretary of State issued your certificate of incorporation. I'll assume in this article that you had that done correctly, and we'll talk only about corporations, although the rules for limited liability companies and limited liability partnerships are similar. Unfortunately, many start-up business owners think that's all there's to it, and they do nothing more about the legal aspects of their business structure. In my home state, Illinois, you can start a corporation by filling out a simple two-page form, and sending it to Springfield with a check for \$150. You don't need a lawyer to do it. My guess is that many owners of new corporations do only that, and assume that they are all right.

If that's all you have done, then you may be exposing yourself to individual liability for all of the debts and obligations of your corporation anyway. Lawyers have a favorite term for this. It's called "piecing the corporate veil". It means that you end up losing your house and personal investments, even though you sent the incorporation papers with your check, and received the certificate of incorporation.

Successfully piercing the corporate veil is relatively rare, and it involves a judgment call by the court hearing the case. There are a number of factors to be considered.

The first is whether you have observed all of the legal formalities. For example, has your corporation actually issued stock? I mean an actual stock certificate, printed out with your name as the shareholder, and properly signed. You may have been treating yourself and your partners as stockholders, but you need to issue the physical stock certificates themselves.

Stockholders elect the board of directors, and the board adopts the corporate bylaws, and elects the officers. Have you done that? This can be done with a formal meeting, documented by minutes prepared by the corporate secretary, or by simple unanimous written consents of the shareholders and directors. Do you need this if you are the sole shareholder and director? Yes. It's important to put this in writing even if you are "agreeing with yourself", because you don't have another person to verify that the meeting was held.

The corporation laws of all states require that you hold an annual meeting of shareholders and directors, in which the shareholders elect the directors as necessary and the directors elect the officers. Before you make any substantial decision for the corporation, that decision should be approved by your board of directors. What is

“substantial” depends on the corporation. Usually a business loan or real estate lease would be considered substantial.

Each state has annual fees to maintain your corporation. If you don't pay the fees, your Secretary of State usually has the right to dissolve your corporation after further notice to you. This notice consists of an innocent-looking form which you ignore at your peril.

A second test for piercing the corporate veil is intermingling the corporation's money and your money. You need a separate bank account for your corporation, with a separate tax i.d. number. Do not pay your household expenses from the corporate bank account. Do not deposit checks payable to the corporation in your personal account.

The third test is inadequate capitalization or financing. This test is generally not applied much today, since you can form a corporation in most states with stated capital of as little as \$1,000.

You may think of your business as you, and that you are your business. The law does not. A corporation is a separate “legal person” from you. So long as you keep it separate, and fulfill its legal needs, you can enjoy the privileges of limited liability for its debts and obligations.

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