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THE NEED TO FOLLOW "CORPORATE FORMALITIES"

Probably the most important reason for doing business as a corporation is to protect the personal assets of the owners from liability for the ordinary business debts of the corporation. This is possible because the corporation is considered to be a legal entity, separate and distinct from its shareholders, officers and employees. However, the mere existence of the corporation is not enough to shield your personal assets from the debts of the corporation. Instead, certain corporate "formalities" must be followed to make sure that the corporation really is "separate and distinct" from the people involved with the corporation. If these corporate formalities are not followed, creditors of the corporation, including its customers, suppliers, employees, and even the IRS, could attempt to "pierce the corporate veil" and collect the debts of the corporation directly from you.

The "corporate formalities" that must be followed to avoid personal liability for corporate debts generally include the following:

1. **Conduct All Business in the Corporate Name:** You must let everyone who does business with the corporation know that they are doing business with the corporation, and not with you personally. You do that by using the exact, full corporate name on all paperwork, including all advertisements, business cards, stationery, signs, and other written materials involving the corporation. The official corporate name is the name on file with the Secretary of State, and must end with "Inc." or "Ltd." Whenever you sign any contracts, purchase orders, receipts, letters or other documents, you should always print or type the name of the corporation above the signature line, and your corporate title below the signature line. The appropriate form is as follows:

Joe's Garage, Inc.

By _____
Joe Smith, President (or whatever your title is)

The key is to make sure that everyone understands that they are dealing with the corporation, rather than with you personally.

2. **Annual Corporate Meetings:** Illinois law requires that all corporations hold an annual corporate meeting, or that the shareholders and directors at least prepare and sign a written document (called a "Resolution" or "Consent") in lieu of a formal meeting. This is not just a clerical burden; it shows that you are taking the corporate existence seriously, and it can be very important in protecting your personal assets from corporate liabilities. The Minutes of the corporate meeting or the Resolution should address the appointment of the Officers and Directors of the corporation, and things like loans to or from the corporation, and contracts or other transactions outside of the ordinary business of the corporation.
3. **Active Involvement of Officers and Directors:** The "By-laws" of the corporation (which you should have and follow) generally define the roles of the officers and directors in the management of the corporation. It is entirely possible for one person to be the sole shareholder, officer and director of the corporation. However, everyone who is named as an officer or director should, in fact, perform those roles, because the existence of non-functioning corporate officers and directors has been used to pierce the corporate veil.

4. **Capitalization and Issuance of Stock:** When the corporation was formed, stock should have been issued to the shareholders in exchange for some actual payment to the corporation, so that the corporation is adequately funded, or “capitalized.” In order to make sure that you will not become personally liable for the company’s debts, it is important that you invest enough “initial capital” to insure that the company has sufficient income and assets to satisfy its anticipated debts and other obligations. There are no precise rules for how much the owners are required to invest, so I can’t give you a firm figure for what your minimum investment should be, but it must be at least enough to cover the reasonably anticipated expenses of the company until the company is able to generate enough income and assets to pay its own way. Your investment can be in the form of cash or other assets transferred to the company, along with business opportunities, your services, and other things of value. You should keep good records of exactly what your investment consists of, both for tax purposes and in case the initial capitalization of the company is ever questioned by creditors. Although it may not be legally required, it is also important for the corporation to carry liability, worker’s compensation and other types of insurance in amounts sufficient to pay foreseeable casualty and similar losses.
5. **Keep Corporate and Personal Finances Separate:** The bank accounts and finances of the corporation should be kept separate from your personal accounts and finances. Corporate checks should not be used to pay personal expenses of the shareholders. If you use the corporate account as your own personal account, your creditors can claim that you should also be responsible for the corporation’s debts. Similarly, shareholders should not use personal checks to pay the debts of the corporation. If the shareholders need to contribute personal funds to pay corporate debts, the funds should be loaned to the corporation, with written loan documents, and the expenses should then be paid from the corporate account.
6. **Payment of Salary and Dividends:** The officers and other employees of the corporation should receive a regular, reasonable “salary,” and the profits of the corporation should periodically be distributed to the shareholders separately. It is best to have a written corporate Resolution authorizing any distribution of profits to the shareholders, or otherwise note that the payment is a distribution of profits, rather than ordinary salary. Profits must not be distributed to the shareholders if the distribution would leave the corporation without funds necessary to pay the debts of the corporation.
7. **Annual Reports:** The corporation will receive an Annual Report form from the Illinois Secretary of State on a yearly basis. This form must be completed, and a small tax payment must be paid to the Secretary of State. If this is not done, the corporation will be dissolved, exposing the shareholders to personal liability for the corporate debts.
8. **Employment and Sales Taxes:** Even if all the corporate formalities are followed, the failure to pay employment or sales taxes will expose the officers, directors and shareholders of the corporation to personal liability.
9. **Worker’s Compensation Claims:** Some businesses try to avoid liability for Worker’s Compensation claims by calling employees of the business “independent contractors.” This usually does not work, and can create unforeseen Worker’s Compensation claims.
10. **Personal Guarantees:** Of course, shareholders are often asked to personally guarantee debts of the corporation. A personal guarantee is a separate contract between the creditor and the shareholder, and should only be given with caution.

OF COURSE, THESE ARE ONLY GENERAL GUIDELINES ON A FAIRLY INVOLVED SUBJECT. PLEASE FEEL FREE TO CONTACT ME IF YOU HAVE ANY QUESTIONS, COMMENTS OR CONCERNS.

Prepared by James D. Skaar
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