HOW TO AVOID POTENTIAL PERSONAL LIABILITY FOR COMPANY OBLIGATIONS—PREVENTING OTHERS FROM PIERCING THE CORPORATE VEIL

Roofing contractors take large risks and face substantial liabilities. By going into business as a corporation (whether a “C” corporation or a subchapter “S” corporation) or as a limited liability company (LLC), the owners of a roofing company are able to shield themselves from personal exposure for most of the company’s obligations and liabilities. However, the “corporate shield” can be shattered if the owners do not follow legally necessary requirements or fail to treat the company as a separate entity. Often, legal and business advisers do not follow through with the owners to make sure the corporation or LLC is properly set up and operated to avoid potential risk of personal liability. Because the potential consequences of failing to follow the rules or take necessary steps are so dire, owners should make sure their companies are organized and operating properly to have the benefit of the corporate shield.

ORGANIZATIONAL FORMALITIES

The “corporate veil” exists and protects owners’ personal assets because of a concept created under the law that regards the corporation as a separate “person” from its shareholders. As such, a liability of the corporation remains separate from the assets and liabilities of the shareholders. So, in the event of a serious business loss or severe financial
problems for the company, including bankruptcy and lawsuit judgments, owners can—if certain circumstances are met—have their personal assets shielded from the efforts of creditors of the company. However, in order to be treated as a separate person, the entity needs to be properly formed and needs to observe the formalities necessary to continue to be treated as separate. Measures must be taken to avoid any possibility of a creditor successfully arguing that the business entity is merely the “alter ego” of its owner. The goal is to shield personal assets by organizing the business and owners’ personal affairs to clearly distinguish personal from business assets.

The same considerations apply when the business is organized in the form of an LLC. An LLC is not the same as a corporation, but it can provide the same type of protection for personal assets if the proper formalities are observed. LLCs are sometimes preferable when there are several owners or if the owners will have unequal ownership of the company. Although most states require fewer formalities with respect to LLCs than corporations, the same basic concepts concerning formalities apply. LLCs need to be properly formed and operated to maintain the liability shield.

To establish and maintain protection of personal assets, the corporation or LLC must be properly formed and organized in the first place. Proper formation requires complying with the law of the state in which the entity is established, filing the proper papers and paying the appropriate filing fees. This is usually the easy part, and many owners believe that once - more -
this is accomplished, the corporation is formed and they can go on about the business of running
their roofing company. However, it is a mistake, to assume that merely filing the necessary
paperwork to form the corporation is enough. A corporation must also have an
organizational meeting, with minutes prepared to reflect that the bylaws were adopted, officers
elected, shares issued and other organizational actions have been taken. Stock certificates should
be prepared and issued, and a record of the issued shares should be kept. The corporate minute
book should not contain a number of forms with blank lines.

**ONGOING FORMALITIES**

For a corporation, required ongoing formalities include holding annual meetings of
shareholders and directors. Directors must be elected at the annual shareholders meeting, and
officers must be elected at the annual directors meeting. The actions of the officers and directors
since the previous annual meeting must also be ratified and approved. Minutes of these meetings
must be prepared, signed and placed in the corporate minute book. In many states, LLCs are not
required to have annual meetings of their members, but owners should confirm the requirements
in their state before assuming that their LLC does not need to prepare annual meeting minutes.

Owners who have not conducted annual meetings or have not prepared minutes of annual
meetings for a number of years (or perhaps never) should still contact their legal counsel and
have minutes prepared reflecting the actions that have been taken during that time

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period. Having the minutes in the minute book will provide a much greater degree of protection than having no minutes even if owners had to “catch up” for a substantial period. Owners should also check to confirm that the people named as officers and directors in older minutes are still the ones who can and should be continuing to serve.

In addition, a corporation or LLC must maintain its annual registration in the state in which it was formed and in every state in which it is qualified to do business. These filings are often simple and require nominal fees, but the failure to keep up with them can mean that the state could dissolve the corporation or LLC (or “disqualify” it if the company is doing business in a state other than the one in which it was formed), which can be disastrous in terms of maintaining the liability protection of the entity. If an owner is not sure whether this has been done, most states make it possible to check the status of the corporation or LLC via the Web site of the secretary of state for the particular state. In most cases, the owner can verify that the company is in good standing or, if not, what steps need to be taken to bring it back into compliance. Owners can also have their legal counsel assist them in making sure that their company is in good standing and qualified to do business in all the states in which the business is operating.

Although not strictly required for protecting the corporate veil, any corporation with more than one shareholder and any LLC with more than one member should seriously consider adopting a shareholders agreement (corporation) or operating agreement (LLC) to govern the rights of the shareholders or members and provide for buy-sell arrangements.
These agreements protect the owners and their families from disputes in the event of the death of an owner; provide detailed rules for the operation of the company; and can set the value for the company’s shares in a variety of circumstances. Avoiding disputes in the operation of the company and sale of interests in the company can be valuable in the ongoing operation of the business and can serve to protect each individual owner’s investment in the business.

FINANCIAL AND DAILY OPERATIONS

Beyond the basic formalities with respect to the structure of the legal entity, formalities must be observed in the everyday operation of the business, whether as a corporation or an LLC. Contracts, work orders, purchase orders, checks and other business papers need to be signed in the name of the company by an authorized person with the capacity of that person listed. The company must have a separate bank account established in its own name. A check from the company’s bank account should never be used to pay a personal expense, and vice versa. Company documents should never be signed by an individual without a designation that the person is signing on behalf of the company.

Any time the owners “borrow” money from the company or lend money to the company, proper documentation should be prepared. So if the owners contributed money to help the business get started and those contributions are not all treated as equity capital in the business, a promissory note should be prepared. The same thing applies, in reverse, with respect to funds withdrawn from the company during the year but not treated as salary, bonus

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or distributions. Preparing these promissory notes may not always be possible as each transaction occurs, but at the very least, updated promissory notes should be prepared at the close of each year to reflect the proper balance and the terms of repayment of any loans to and from owners. Of course, any transaction with the owners must also be properly entered in the company’s accounting system, but these entries alone may not be enough to clearly demonstrate the separate nature of the entity without preparing documents such as promissory notes, as well. As with annual minutes, if a loan transaction occurred several years ago without proper documentation, you can and should prepare promissory notes and other documents to reflect those past transactions.

The same sort of documentation should be put in place when there are transactions between affiliated companies because the corporate veil between companies can also be pierced if the companies are all treated as one big operation. Any arrangement for sharing of employees, purchase of inventory from affiliated companies or even having management personnel perform services for an affiliated company should be documented with separate agreements.

**REAL ESTATE TRANSACTIONS**

Many privately owned businesses operate on real estate that is owned by one or more of the owners of the business or some related entity. There are good and valuable reasons for doing this, but the relationships should be properly documented. If the company is leasing
real estate from one of its owners, a formal written lease should be prepared setting forth the rent, term of the lease and other reasonable provisions that would occur in an arms-length transaction. Taxes should be paid by the owner of the real estate unless the lease calls for the tenant to make those payments directly. Rent should be paid and properly documented as the lease provides. If more than one business is using the property, separate leases should be prepared for each business.

CONCLUSION

Maintaining the protection of the corporate veil is not necessarily difficult, but it does require some attention. Too often, a good roofing contractor is focused on running the business and does not take the time to make sure all the formalities are followed. However, these formalities are critical to maintaining protection of personal assets, which is the reason for forming a corporation or an LLC in the first place. The owners of a business need to organize and operate it so any potential creditor of the business would not even attempt to pierce the corporate veil and try to recover their personal assets. Following these basic rules can help prevent the liability shield from being shattered.