



THE IMPORTANCE OF CORPORATE FORMALITIES IN PROTECTING OFFICERS AND SHAREHOLDERS FROM PERSONAL LIABILITY

By Shannon L. Clark

You are an experienced businessperson who owns a number of closely held businesses with your spouse. You are the president and 50% shareholder of Red Corporation and White LLC, and president and 50% shareholder of the corporate general partner of Blue L.P. Your spouse owns the remaining 50% of each corporate entity. To cover a short-term cash flow problem at Blue L.P., Red Corp. loans Blue L.P. \$25,000. Blue L.P. then sells \$25,000 worth of goods to White LLC. Instead of White writing a check to Blue for the goods, and Blue writing a check to Red for the loan, Red "assigns" the loan to White, which White takes as a credit against payment for the goods. Blue has received payment for the goods it sold, and because you and your wife own 100% of Red and White, you simply shifted some of your money from one pot to the next. No problem, right? Not until a third-party sues Red, White, or Blue.

Although there is a growing trend to hold officers and directors of corporate general partners personally liable for the acts of the general partner, Illinois continues to protect officers of corporate general partners from unlimited individual liability as fiduciaries.

See Franz v. Calaco Development Corp., 352 Ill. App. 3d 1129 (2d Dist. 2004); compare *Bankard v. First Carolina Comm., Inc.*, No. 89 C 8571, 1991 WL 268652 (N.D. Ill. Dec. 5, 1991) citing *State v. Seay*, 44 N.C. App. 301 (1979) (holding defendant-officers of a corporate general partner liable as fiduciaries of the limited partners under NC law) and *In re USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991). Knowing this, you set up a corporation — which has limited liability — to act as the general partner of Blue. But what you didn't know is that you and your spouse still run the risk of unlimited *personal* liability for Red, White, and Blue's debts because you failed to observe corporate formalities.

What did you do wrong? The no-interest loan from Red Corp. to Blue L.P. was not an arms-length transaction. Neither was Red Corp.'s gratuitous assignment of the loan to White LLC. Did White LLC get the best deal in the marketplace on the goods it bought from Blue L.P.? Were the loan and assignment properly documented in Red, White, and Blue's corporate books?

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A Newsletter from
the Law Firm



The GR Review is published by the law firm of Gould & Ratner to update clients and friends on legal trends and developments of interest.

The material contained in this newsletter is only a synopsis of recent cases and legislative developments and is not legal advice. If you have a question or an individual claim involving a topic covered in this newsletter, you should seek a legal opinion based on the law as a whole and the facts of your particular case.

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COURTROOM HIGHLIGHTS

Chris Horvay and **Mark Abraham**, on behalf of a client tire distributor, successfully annulled an automatic stay in a Chapter 13 bankruptcy proceeding. Following an evidentiary hearing, the court adopted Gould & Ratner's position in the case and retroactively validated four years' worth of collection work by the client, despite the then-existing automatic stay.

In a breach of contract action, **Shannon Clark** successfully represented an industrial real estate property owner at the trial and appellate levels. She obtained a monetary judgment, including attorneys' fees, in favor of our client against the former tenant. On appeal, the Illinois Appellate Court affirmed the trial court's award of rent, holdover rent, late fees and attorneys' fee to Gould & Ratner's client.

Paul Carroll and **Mark Abraham** obtained summary judgment on behalf of a defendant in a real estate purchase contract dispute, successfully barring the plaintiff from recovering the liquidated damages specified in the contract.

Bob Carson and **Ted Kommers** defended a suit brought against several corporate defendants and individual officers and directors of the defendant companies alleging multi-million dollar fraud and civil RICO violations in Federal District Court. Bob and Ted successfully defended against the plaintiffs' motion for a temporary restraining order seeking to freeze various assets and accounts. Shortly after denial of plaintiffs' motion, plaintiffs voluntarily withdrew and dismissed their suit.

Christina Conlin successfully negotiated a favorable settlement, in the early stages of litigation, on behalf of a transportation company which had been sued by four plaintiffs in a tort action. A codefendant, not represented by Gould & Ratner, paid approximately 90% of the total settlement amount.

Chris Horvay and **Mark Abraham** successfully defended a Mississippi company and a Nevada corporation in two separate adversary proceedings in

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REG. D – MORE POPULAR THAN EVER?

By John Washburn and David Brown

In 1982, the Securities and Exchange Commission issued a regulation to provide safe harbors to issuers of stock and other securities who desire to avoid having to register the securities under the Securities Act of 1933. More than 20 years later, this regulation, known as Regulation D or Reg D, still serves an important function in allowing entrepreneurs to raise money for new projects relatively inexpensively. Reg D allows an issuer of securities who follows certain rules to bypass the necessity of a full fledged SEC registration - often a long and costly process.

Perhaps the most popular feature of Reg D is the exemption provided for raising money from "accredited investors." Rule 506 under Reg D is particularly appealing to investors because there is no dollar limit on the amount that can be raised when utilizing this exemption. Although 506 limits the number of purchasers to 35, "accredited investors" do not count towards reaching that limit. The definitions are somewhat technical but basically, any natural person, (i) whose net worth exceeds \$1,000,000 or (ii) whose individual income exceeded \$200,000 in each of the two most recent years (or joint income with his spouse in excess of \$300,000 in each of those two years) and who has a reasonable expectation of reaching the same level in the current year qualifies as an accredited investor. Whereas the dollar limit might have been fairly restrictive in 1982, the ability to solicit funds without registration from any number of investors with net worths in excess of \$1,000,000 makes this an extremely useful provision for the entrepreneurs today.

The key to utilization of the 506 exemption is taking reasonable steps in the document to assure that the investors are accredited. Rule 506 may be used with up to 35 non-accredited investors whom the issuer reasonably believes are "sophisticated," but many funds avoid the difficulty of determining who is sophisticated and who isn't by restricting their offering to accredited investors.

In addition to the exemptions for individual accredited investors, entities may qualify as accredited investors if they meet certain thresholds in terms of total assets.

Although Reg D does not limit the number of investors under a Rule 506 offering, the Investment Company Act of 1940 can come into play if the number of investors is over 100. Since it is often desirable to avoid characterization as an "investment company," the 100-purchaser limit needs to be taken into account. Thankfully, the Investment Company Act allows for "qualified purchasers" to invest and not be counted against the 100-member cap. A qualified purchaser can be thought of as a "super accredited" investor. Such investor must have investable assets in excess of \$5,000,000. Together with the Rule 506 exemption itself, the qualified purchaser provisions of the Investment Company Act are very useful to hedge funds and other entrepreneurs raising significant amounts of cash in the current marketplace.

Equally important to Rule 506's appeal is the federal preemption provided for by the 1996 National Stock Market Improvement Act (NSMIA), which overrides most state registration requirements for Rule 506 offerings, thereby offering a streamlined approach to raising capital.

Although registration is not required, utilization of Reg D requires the filing of Form D with the government. This form is rather simple and does not require much in the way of lawyer time to prepare and file.

Two general caveats are required in connection with considering the use of Reg D exemptions to raise money: First, the exemptions from registration do not exempt issuers from the general anti-fraud provisions of the federal securities laws, commonly referred to as "10(b)(5)," or their state law equivalents. Even though registration is not reviewed and approved by the SEC, disclosure documents need to be carefully prepared in order to protect the issuer from future fraud claims by disgruntled investors since securities fraud standards are less stringent than common law fraud standards. Secondly, even if federal registration is not required and preempts state registration requirements under state "blue sky laws," a simple notice filing must still be provided to the SEC and, in some cases, to certain state securities officials.

POST-KATRINA CLEAN-UP

By Laura Bacon, Law Clerk

In early January, I had the opportunity to travel to New Orleans as a part of DePaul Law's Service Immersion trip. I, along with thirty other DePaul law students, traveled by bus to New Orleans to spend the final week of our winter break volunteering for Hurricane Katrina relief. We were to spend four days there, splitting our time between working on legal issues with a group called Common Ground and doing manual labor for Catholic Charities. Although the legal needs in the region are immense, it was difficult for us to get involved given the brevity of our stay. Instead, we spent our four days gutting two homes that had been flooded after the hurricane, in hopes that the homeowners could begin to rebuild.

No amount of media coverage could have prepared us for what we would see. The breadth of the devastation cannot be captured on film. Over 80% of the residences in the city were damaged, entire neighborhoods are deserted, and the smell of mold is overwhelming. We had the opportunity to drive through the Lower Ninth Ward – the area most severely damaged by the flood and a whole community

that cannot be salvaged. The flood water picked up entire homes and carried them into the street. Cars are stuck in trees. Personal articles, muddied by the flood, are strewn everywhere.

But even residents of the parts of the city that were not as severely damaged are not able to go about life as it once was. Simple errands like buying gas or groceries can become all-day affairs. Businesses and restaurants open and close sporadically as they cannot hire enough employees to work regularly. People live every day with a feeling of uneasiness and uncertainty.

What we experienced certainly resulted in a feeling of disbelief that this was how the city still looked four months after the hurricane hit. If progress continues to be as slow as it is now, it will take five to ten years to rebuild the city. Our work seemed insignificant in light of what remains to be done. But we felt that our mere presence, and that of the many volunteers coming from around the country, helped to remind the people of New Orleans that they have not been forgotten.

ATTORNEYS IN THE SPOTLIGHT

Paul Carroll, Partner in Gould & Ratner's Litigation Group, and **Virginia Harding**, Of Counsel in the Real Estate Group, are set to speak at a seminar entitled "Law of Easements: Legal Issues and Practical Considerations in Illinois" on March 7, 2006, in Chicago.

John Mays, Partner in Gould & Ratner's Real Estate Group, will speak on "Successful Strategies for Getting Projects Approved," at the Midwest Builders Show® & Conference on March 15, at the Donald E. Stephens Convention Center in Rosemont, Illinois.

Mark Leipold, Partner in Gould & Ratner's Creditor's Rights and Bankruptcy Group is set to moderate a panel for DePaul University College of Law/Commercial Law League of America in April. Also, Mark is participating on a panel for the Commercial Law League of America on Bankruptcy and Pension in April. Additionally, a chapter written by Mark, "Proofs of Claim, Priorities, and Distribution," will appear in the 2006 edition of *Business Bankruptcy* to be published by IICLE.

Fred Tannenbaum, Partner in Gould & Ratner's Corporate and Commercial Group, was

re-elected President of the Temple Shalom Brotherhood Chapter of about 100 members. He also wrote an article appearing in February's *Illinois Bar Journal*, Young Lawyer's Division, on the exercise of judgment in negotiating a business transaction, and will be speaking on April 11 to the Chicago Bar Association Business Arts and Theatre Section on Financing Theatrical Productions.

Howard Turner, Of Counsel in the Litigation Group, will speak at the March 29 meeting of The Door and Hardware Institute of America, Great Lakes Chapter, in Elmhurst, Illinois. His presentation is entitled "How to be a Subcontractor and Not Go Broke: A Practical Program Designed for Non-Lawyers." Howard was also the featured speaker for the Commercial Law Committee of the Chicago Bar Association regarding legal issues specific to construction litigation. Howard's article, "The 2005 Amendments to the Illinois Mechanics Lien Act," was published in the December 2005 *Illinois Bar Journal*. Howard was a member of the committee that drafted the 2005 amendments to the Act discussed in the article.

COURTROOM HIGHLIGHTS (CONTINUED)

which the bankruptcy trustee sought to recover prior payments made to them by the debtors. In both actions, Chris and Mark established new value and ordinary course defenses and obtained dismissals of the claims against our clients.

In a breach of contract and fiduciary duty action, **Shannon Clark** defeated a plaintiff's attempt to add two real estate development entities as defendants in a pending lawsuit. She also defeated the plaintiff's attempt to add additional claims against existing parties in the case, and obtained summary judgment on all claims in favor of the principals in the defendant partnership.

The United States Bankruptcy Court for Delaware granted a motion for remand, filed by **Bob Carson**, **Chris Horvay** and **Christina Conlin**, to return a breach of contract and fraud case back to the Lake County Illinois Circuit Court, where it was originally filed. Gould & Ratner defeated the defendants' argument that the case should be heard by the Bankruptcy Court because it could impact a national recreational vehicle distributor's bankruptcy estate.

In an action to enforce collection under a promissory note, **Shannon Clark** obtained a judgment in favor of our client, a real estate developer, which included substantial interest, penalties and attorneys' fees.

Ted Kommers obtained the dismissal of construction defect claims brought against Gould & Ratner's client, a suburban general contractor, brought by the owner of a warehouse.

Louis Bernstein, **Karin O'Connell** and **Christina Conlin** were recently retained to represent a court-appointed Receiver in multiple, high-profile cases involving landfill methane gas-to-energy contract rights.

Ted Kommers was recently engaged by a rural cellular telecommunications carrier to evaluate potential claims against a nation-wide carrier concerning its pre-emption of first rights to service roaming calls in various geographic territories.

THE IMPORTANCE OF CORPORATE FORMALITIES IN PROTECTING OFFICERS AND SHAREHOLDERS FROM PERSONAL LIABILITY (CONTINUED)

In deciding whether to pierce a corporation's veil and impose personal liability on the officers and primary shareholders, courts look at a number of factors, including: whether a corporation is adequately capitalized; whether it has issued stock and observed corporate formalities such as keeping minutes, holding shareholder meetings, and issuing corporate resolutions; whether it has paid dividends to shareholders and maintained corporate records; whether it has commingled the funds of the corporation with the funds of the dominant shareholders or other entities owned by the dominant shareholder; whether it has maintained arm's-length relationships among related entities; whether the other officers or directors are functioning; and whether the corporation is a mere facade for the operation of the dominant shareholders. *Cosgrove Distributors, Inc. v. Haff*, 343 Ill. App. 3d 426, 428-420 (3d Dist. 2003).

Consequently, even though you and your spouse own 100% of Red and White, and 100% of the corporate general partner of Blue, you must treat them as legally distinct not only from each other, but from you and your spouse, if you want to be immune from unlimited personal liability.

Shannon Clark is an Associate in Gould & Ratner's Litigation Group. For further information, she may be reached at 312.899.1634 or by email at sclark@gouldratner.com.

REG. D – MORE POPULAR THAN EVER? (CONTINUED)

In summary, Regulation D provides a useful mechanism for raising substantial sums to provide the necessary financial life blood for new projects and expansion. Some legal expense and time is required to provide proper disclosures to investors. Yet, for those circumstances where there is an identified group of accredited investors who would be interested in the opportunity to be part of new projects or business, Regulation D is an attractive alternative to borrowing from an institution or a public offering.

The following members of Gould & Ratner's Corporate/Commercial Department would be happy to be of assistance to those interested in

further information about Reg D private placements:

Fred Tannenbaum (312.899.1613 or ftannenbaum@gouldratner.com), David Brown (312.899.1694 or dbrown@gouldratner.com), or John Washburn (312.899.1609 or jwashburn@gouldratner.com).

John Washburn is the Chair of Gould & Ratner's Corporate and Commercial Group and Co-Chair of the Finance Group. David Brown is an Associate in the Corporate and Commercial Group.

INFLATION ADJUSTED PLAN CONTRIBUTIONS AND SOCIAL SECURITY WAGE BASE

For calendar year 2006, the maximum contribution to retirement plans and health savings accounts have been increased to the limits described below. In addition, the application of employment taxes on earned income have been extended as outlined below.

	2005	2006
Defined Benefit Plans		
Maximum Annual Pension	\$170,000	\$175,000
Defined Contribution Plans		
Maximum Annual Contribution	\$42,000	\$44,000
401(k) Maximum Deferral	\$14,000	\$15,000
401(k) Catch-up Contribution	\$4,000	\$5,000
Maximum Compensation	\$210,000	\$220,000
IRA Plans		
Deductible Contribution Limit (<age 50)	\$4,000	\$4,000
Catch-up Deferrals (age 50+)	\$500	\$1,000
Health Savings Account		
Single *but not greater than deductible	\$2,650*	\$2,700*
Family *but not greater than deductible	\$5,250*	\$5,450*
age 50+ an additional	\$600	\$700
Social Security/Medicare		
Social Security Rate	6.20%	6.20%
Social Security Wage Base	\$90,000	\$94,200
Maximum FICA Tax	\$5,580.00	\$5,580.40
Medicare Wage Rate	1.45%	1.45%
Medicare Wage Base	All Wages	All Wages

If you have any questions concerning the 2006 limits, please contact David Arnburg, Partner in Gould & Ratner's Tax and Financial Group at 312.899.1600 or by email at darnburg@gouldratner.com.