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?

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.

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This article appeared in the Winter 2006 issue of the GR Review.