

## **DOES YOUR CORPORATION OR LIMITED LIABILITY COMPANY PROTECT YOU?**

By  
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The whole idea of using a corporation or limited liability company is to provide protection for the owner from the creditors of the corporation or limited liability company. The law says you are not personally liable for your corporate or limited liability company debts just because you are an owner. That means you are safe and your personal assets are not at risk, right?

NOT ALWAYS. Under certain circumstances, creditors of your corporation or limited liability company can pierce your corporate veil making the owner liable personally. The good news is that Virginia is one of the hardest states in the country to succeed in piercing the veil. The bad news is that there are cases in Virginia where the courts have allowed it and it is always based on a totality of circumstances with no bright line test upon which one can weigh the risk in advance.

The courts in Virginia apply a two (2) part test, and your conduct or lack thereof will determine the results of each of the two (2) parts. To make the owner liable, the creditor must prove both parts of the test. What are they?

The creditor must establish:

- (i) that you, the owner, exercise so much control that you use the entity for your own purposes and ignore the business as a separate entity; and
- (ii) you perpetrated a fraud, committed an injustice or gained an unfair advantage.

To determine whether you exercise too much control or dominion, courts look at whether the owner and corporation or limited liability company are one and the same. Sometimes courts use phrases like “alter ego” or “sham.” The failure to follow corporate formalities increases the chance of you losing on this part of the test. Examples include, but are not limited to, not having board meetings, not having minutes, co-mingling personal and business assets or paying personal debts with corporate funds. The absence of functioning officers and directors is also a factor. Remember however, no one factor is controlling. The courts always consider the totality of all facts and circumstances.

The second part of the test looks for some kind of impropriety, which may involve fraud, committing an injustice or just gaining an unfair advantage. Forming a corporation to evade personal liability on a preexisting known liability has been found sufficient regarding this part of the test. Initial undercapitalization has been considered as one factor that could be considered as an indicator of improper purposes. The cases where piercing were allowed usually involved

egregious circumstances where the court believed an injustice would occur unless the veil was pierced.

The test should be the same whether you have a corporate or limited liability company. There are, however, some situations where there may be more risk. Sole shareholder corporations and one member limited liability companies are at more risk. Also cases where governmental entities are attempting to pierce veils have been more successful. The IRS has won veil piercing cases against Family Limited Partnerships.

Is there anything you can do to improve your protection? Maintaining corporate formalities and records can make a difference, even if you are the only owner. Keep personal matters separated from business matters. All corporate income must be deposited to your corporate bank account and only corporate expenses paid from that account. Similarly, personal income must be deposited in a separate personal check account and all your personal expenses paid from that separate account. Failure to adhere to this formality can create not only loss of limited liability but also loss of tax deductions. Other formalities include but are not limited to:

- Keep corporate records.
- Have meetings of directors and shareholders if a corporation or managers and members if a limited liability company and record minutes.
- Always have annual minutes.
- Keep a minute book.
- File annual reports with the SCC.
- Issue stock certificates if a corporation or certificates of interest if a limited liability company.
- Keep records of all transfers of ownership.
- Sign only in your corporate capacity.
- If you loan money to your entity, have a promissory note.

It is very easy to overlook some of these formalities. Our firm provides annual corporate services which includes not only serving as registered agent but also automatically preparing annual minutes and sending you the annual renewal form to be filed with the SCC. If you are unsure whether you can do more to protect yourself with your entity or would like a review of your business practices, contact Ron Gates at (757) 470-5564.

**\*\*Legal notes are not legal advice. Because legal problems are factually intensive, the reader must always consult their counsel before acting on any legal matter.**