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IN BRIEF

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This is the first installment of MSC's Small Business Check- Up Series- a series of articles highlighting issues of common concern to our business clients. These articles are intended to alert you to issues that we commonly encounter in servicing our business clientele and to advise you of other current issues of concern.

The Necessity of Organizational and Operational Formalities for Corporations and LLC's

The primary benefit of doing business in a corporate or limited liability company form is the owner's ability to shield his or her personal assets from liabilities arising out of the corporation or LLC's actions or obligations.

However, in order to ensure that this liability protection will be recognized, certain formalities should be routinely followed in the organization and operation of your business. In our practice, we encounter a number of businesses who filed articles of incorporation or LLC articles of organization without the assistance and input of legal counsel. In most of these cases, important governing documents such as corporate bylaws, minutes and stock records or LLC operating agreements are often not in place. The failure to have this documentary framework in place could have serious consequences if the limited liability protection of your corporation or LLC is ever challenged in a court proceeding.

The "Piercing the Corporate Veil" doctrine is a well established part of the common law of corporations in Illinois and most states. Under this doctrine, a court may, in limited circumstances, disregard the limited liability protections of a corporation or LLC and impose personal liability on the Shareholders or Members for the business' obligations or liabilities. In matters of federal labor law, such as suits for enforcement of wage payments or contributions under a

collective bargaining agreement , there is federal common law as well recognizing, and in some cases expanding upon, this doctrine.

Generally, courts are reluctant to pierce the corporate veil and impose liability on individual owners, but in order to assert a piercing the corporate veil claim, the following two items must be established:

- The existence of factors that indicate that the separation of the corporation and the individual owner(s) do not exist; and
- That continuing to recognize the separate corporate existence would further a fraud or injustice.

Factors that a court may examine in establishing that there is no separation between the corporation and the owners include inadequate capitalization, the failure to issue stock, the failure to observe corporate formalities, failure of officers and directors to carry out assigned functions under governing documents, the absence of corporate records, commingling of funds, any diversion of assets or the failure to maintain arm's length relationships among related entities.

The theory also has application to LLC's with certain modifications. For example, under Illinois law and the Uniform Limited Liability Act, the failure to observe corporate formalities is not a ground for imposing personal liability upon the LLC's members or managers. However, the other factors that justify veil piercing for corporations will continue to be examined by courts that apply the doctrine in an LLC setting.

In order to protect against this type of challenge, all corporations and LLC's should take steps to address the following operational and organizational concerns:

- **Capitalize Your Business.** The organization must be adequately capitalized at the time of formation and thereafter. The determination of adequate capitalization is somewhat subjective, but should be undertaken with input from your legal and financial advisors, based on the particular risks and capital needs of your business. All capital contributions to a corporation or LLC should be documented;
- **Issue Stock Certificates.** For all corporations, make sure stock certificates are issued or, alternatively, that the articles and bylaws clearly provide for uncertificated shares;
- **Prepare Records of Corporate or LLC Actions.** For Corporations, prepare annual minutes of corporate meetings or take action annually by consent to reappoint officers and directors. In addition, any major corporate actions such as the

granting of bonuses, the approval of major purchases or contracts or the assumption of financial obligations should be approved by formal action in corporate minutes. We recommend that LLC's also adhere to these recordkeeping guidelines to provide documentary evidence that the business is maintaining its separate status and not serving as the members' or manager's alter ego;

- **Ensure Appointed Officers Perform their Duties.** Involve all officers, directors or members in the corporation or LLC's decision making processes to the extent required by the corporate articles and bylaws or by the LLC's operating agreement. Corporations should not install officers for purely ceremonial purposes that do not plan to be actively involved in the operation of the business;
- **Keep Corporate Business Separate.** Keep the identity of the corporation or LLC clearly separated from the identity of its owners or any related entities. Use business letterhead and make sure that any contracts or documents relating to the business are executed by an individual in his business capacity on behalf of the Corporation or LLC. (for example, President of the Corporation or Manager or Managing Member of an LLC) ;
- **Maintain Separate Financial Arrangements.** Maintain separate bank accounts and do not commingle funds or permit withdrawals by shareholders or members outside the course of usual business and payroll activity;
- **Deal Fairly with all Creditors.** Don't favor inside or related creditors over any unrelated third party creditors of your business.

While this is not intended to be an exclusive list of best practices for corporations and LLC's, following these guidelines should give you a good start towards developing an effective corporate or LLC governance process.

Please contact us if you have any questions or if we can assist you or your business in any way.

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The Law Firm of Mahoney, Silverman and Cross, LLC strives to provide superior legal representation with the objective of exceeding our clients' expectations. Each member of our firm is committed to utilizing critical analysis and innovative approaches to achieve timely resolutions with the best possible results for our clients.

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