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Business Matters

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Closing the Gap.

5 Effective Steps to Help Ensure Your “Incorporated” Business Doesn’t Subject You to Personal Liability.

By Alia Adkins-Derrick

If you have incorporated your business, are a sole proprietor making plans to incorporate, or would like to be a business owner one day, there are post-incorporation precautions you need to take to shield your personal assets.

Most know that forming a LLC, corporation (Inc., C-Corp), partnership (LP, LLP, GP), or other legal entity helps to shield business owners from personal liability and protect the personal assets they worked so hard to acquire. Few business owners, however, realize or consider that failing to take certain post-incorporation precautions in their incorporated business can still leave them personally exposed and on the hook for their business’ debt(s), liabilities, obligation(s), settlement(s), and judgment(s) (collectively “liabilities”). And although most businesses lack the substantial cash or insurance policy coverage needed to pay off the business’ liabilities, many fail to take the additional steps needed to avoid being personally liable for the difference. If you have incorporated your business, are a sole proprietor making plans to incorporate, or would like to be a business owner one day, but fail to take the necessary steps to close the gap between incorporating and personal asset protection, you had better act now.

What’s at Stake in Texas.

After you pay the state’s filing fee and file the requisite documentation to incorporate your business, you need to erect the proper business shield or “corporate veil” to protect your personal assets from business liabilities. The reason is simple: the prevailing law in Texas (as well some other states) may not protect business owners who fail to do so. Quite the contrary, Texas law offers savvy plaintiffs a loop hole they can use to target a business owner’s personal assets if he or she incorporates but then, instead of following the law to fully set up the new entity independent of

the owner, continues operating the business as if the newly incorporated entity didn’t exist.

In Texas, if your business is sued and fraud, for example, is alleged, the plaintiff may seek to “pierce the corporate veil” you incorporated under and make you personally liable again. And if you have not followed all the corporate formalities required by law to run and maintain your company, the plaintiff will likely be allowed to do so. Given this, it is crucial that you take the necessary steps to close the gap to help ensure your personal assets are protected.

Effective Steps to Shield Against Personal Liability.

No matter what your company’s legal entity type (an LLC, C-Corp, other) or your LinkedIn status (e.g., entrepreneur, owner, or aspiring entrepreneur), if protecting your personal assets from company liability is truly a priority, below are several steps you should take now to help ensure your incorporated business does not leave you personally exposed.

1. Prepare Company Agreement(s)

If your company has no company record book, operating agreement, partnership agreement, or other documentation other than a Certificate of Filing or Formation, you had better stop now to get them prepared, executed, and implemented. Why? Because the lack of these crucial documents is proof that your company is really your alter ego which justifies holding you personally responsible for your company’s wrongdoing. Without these documents, it will be nearly impossible for you, as the owner, to prove to a court or jury that your company is not your alter ego but rather is separate and independent of you—which is required to clench the business shield and keep personal assets safely out of a plaintiff’s reach.

At a minimum then, whether a single owner or multiple, you should have a comprehensive company agreement prepared, issue membership certificates, and prepare minutes of meetings. The company agreement should detail, among other things, how the company operates and is run, include important terms like buy-

-sell provisions, as well as provisions to help ensure your company will survive in the event of a divorce from a spouse, a business partner, an investor, a key employee, or even an adult child's soon-to-be ex-spouse. Ultimately, it is a good idea to seek legal help and preparation of the company agreement to ensure no important provisions are inadvertently omitted from it.

2. Run Your Business Properly, Like the Successful Business it Is (Destined to Become)!

Once you have a company agreement in place to help distinguish you from your business, use it! If properly written, the company agreement should be a road map that helps you properly run your business. Additionally, (1) keep up to date with your corporate minutes and resolutions; (2) record any changes with "Articles of Amendment," if legally required; and (3) hold annual meetings of members (LLC) and/or shareholders (C-Corp), when necessary and as required by your company agreement.



3. File Business' Annual Reports & Pay Business' State & Federal Taxes.

Failing to pay Texas franchise taxes or penalties or to file the annual reports, for example, could result in the forfeiture of the company's privileges including your personal asset protection as well as the company's right to sue or defend a Texas lawsuit. If this happens, Texas statutes are clear that the owners are personally liable for any and all company liabilities that are incurred or created from the forfeiture date up until the company privileges are revived. See e.g., Tex. Tax Code § 171.255. To avoid such loss, forfeiture, and penalties, once you incorporate, calendar key federal and state filing deadlines and be ready to file reports and/or pay the appropriate taxes by the deadline.

4. Don't Commingle Personal & Business Assets.

Business owners can also minimize their personal liability by: (1) keeping business assets and liabilities separate from personal property, assets, and liabilities; and (2) paying themselves a good salary, draw, or year-end distribution from the business.

Paying yourself will help avoid (or at least defend against) a claim that you used your business' checking as a personal ATM to make personal purchases or to pay personal bills. Given the hard work you, as the business owner, do to make sure your business not only survives but thrives, you certainly earned your fair share of the company's profits. However, be sure to follow all the necessary formalities for your specific business entity type when claiming it. For example, if you own an LLC pay yourself by taking a member's draw or a year-end distribution and properly recording each member payout in your company's records when paid. Once the member's draw is deposited into your personal bank account, you are free to use it to cover personal expenses as you see fit.

5. Avoid & Limit Personal Guarantees.

Landlords, banks, creditors, lenders, and other third-parties (collectively "lenders") may "require" owners of new businesses to personally guarantee a loan or lease since the businesses probably

lack both sufficient business assets and credit history. If you sign such an agreement, then you will be personally liable for the specific obligations described in the guarantee. Accordingly, you should avoid giving lenders permission to go after your personal assets if the business defaults on its obligations. If it is impossible, however, for you to avoid personal guarantees completely you should at least seek to limit your personal liability under them through negotiations.

Contrary to popular belief, the terms of a personal guarantee may not be set in stone. You should, therefore, attempt to negotiate those terms to your advantage. For example, in exchange for no personal guarantee or a limited one, consider the following: (a) Request that the amount of the guarantee be limited to a specific percentage of the outstanding loan amount or an actual dollar amount. For example, multiple business owners should seek to limit their amount of exposure to their respective ownership percentage. (b) Ask to be fully, or partially, relieved of the guarantee after a certain percentage of the loan has been repaid or after so many years of timely payments. (c) Ask that the personal guarantee be made effective after the occurrence of a certain event. For example, if a certain number of loan payments are missed or the amount of the business' working capital or the net worth falls below a specified amount. (d) Ask whether: (i) you can pay a higher interest rate or pay a higher monthly payment over a shorter loan repayment period; or (ii) you can borrow less money (e.g., seek investors for the difference). Prior to negotiating (d), however, be sure to calculate your business and personal risk tolerance to avoid negotiating and agreeing to a term that later proves too arduous for you to comply with.

A Final Word of Caution: Plan Ahead. As shown above, there are a number of effective ways to erect the "business shield" you need to protect your personal assets from your business liabilities. It is a smart idea for you to seek legal help to put the necessary agreements in place that will ensure your personal assets are protected. Whatever the preventative legal cost —e.g., as low as \$500 - \$1000 for standard, non-elaborate contract preparation or modifications and added costs for more complicated and detailed versions— it is likely to pale in comparison to the lump sum amount you could be ordered to shell out to cover your business' liabilities. Ultimately, then, it is in your best interest to plan ahead and take the necessary steps to minimize your personal liability.



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