FORMING A CORPORATION OR LLC

Purpose: Limited Personal Liability

The primary reason many people form a corporation or LLC (rather than doing business under a personal name) is to limit their personal liability. Corporate and LLC law provides that a shareholder has limited personal liability and only risks losing the amount he or she has invested in the corporation or LLC, i.e., the value of shares owned. For example, if a shareholder or member invests $10,000 and receives shares of stock in the corporation or an ownership interest in the LLC in exchange, and the business fails, the shareholder or member can only lose $10,000. If the corporation becomes liable to a creditor for $100,000, the shareholder can only lose $10,000 and the creditor cannot look to the shareholder's or member’s personal assets (personal bank accounts, real estate, other investments) to satisfy the $100,000 liability.

A corporation or LLC is treated "as if" it were a separate person with its own separate identity. One court has stated that the purpose of limited liability is to promote commerce and encourage shareholders to voluntarily put capital at risk in the business venture without subjecting their personal wealth to risk. This incentive to business investment has been called "the most important legal development of the nineteenth century."

An Individual Can Be Held Personally Liable For Corporate or LLC Liabilities

Limited personal liability for corporate or LLC actions is the rule, not the exception. However, a shareholder or member can be held personally liable based on two exceptions or two legal theories: 1) "piercing the corporate veil" and 2) the "alter ego" theory. If certain "formalities" or rules are not followed, a creditor may be able to reach a shareholder's or member’s personal assets to satisfy corporate or LLC debts or liabilities. This is a legal theory called "piercing the corporate veil". In the event that a corporation or LLC has liabilities it cannot satisfy from corporate or LLC assets, a creditor's lawyer generally investigates to see whether any shareholders or members have personal assets and whether any basis exists for "piercing the corporate veil" to reach those assets.

A second legal theory which can be used to hold a shareholder or member personally liable for corporate debts is the "alter ego" theory. If a creditor can show that the corporation or LLC is the "alter ego" of a shareholder or member, the shareholder or member can be personally liable. An "alter ego" exists where: 1) an individual shareholder or member has such complete dominion and control that the corporation or LLC had no separate mind, will, or existence of its own, and 2) the control was used to commit fraud or violate a statutory duty or commit a dishonest act.

Corporate or LLC liabilities can include liability for a variety of things, including personal injury (such as a "slip-and-fall" injury at your business premises), failure to perform a business contract, employment matters, or defective products or services. Especially in the case of personal injury, the potential liability can be significant (potentially millions of dollars).

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