One of the primary advantages of incorporating your business, large or small, is to protect your personal assets from business liabilities. When you form a corporation, limited liability company, or similar business entity, a "corporate veil" is created between your personal assets and your business. What most people either don't know or don't take seriously, however, is that you must do more than simply form the corporate entity and register it with the state. The entity must be properly managed to avoid the risks of personal loss through a legal doctrine called "piercing the corporate veil." Simply said, if you don't want your entity disregarded, don't disregard it yourself.

Let me tell you about my friend Steve. He's a great guy, a successful real estate broker and no dummy. During his career he invested wisely in his own real estate portfolio and had significant assets to protect. So, when Steve decided to form his own boutique brokerage, he did the smart thing: he incorporated. He was joined by three real estate agents who were enticed to leave their big-name brokerage because Steve offered them partial ownership in the corporation. They each made a capital contribution to fund the business for a few months until some of their deals closed. In addition to receiving commissions, they split corporate profits at an agreed-upon percentage.

Everything was fine during the real estate market boom. In order to capitalize on the market, they developed the habit of taking almost all the profit out of the business to fund their personal investments. If they ran short, they just pooled the money together to put back into the business to pay the bills. They never found time for meetings or kept corporate records. Then the sudden slowdown came. The market tanked and left the brokerage with a massive debt they couldn't pay because they weren't selling property.

Together they agreed to file corporate bankruptcy. Unfortunately, the bankruptcy judge wasn't buying it. Under the doctrine "piercing the corporate veil", (in bankruptcy it's known as "substantive consolidation") the judge determined that Steve and his friends had so blatantly disregarded the separate corporate entity and used the corporation as a tool for personal business that they were not entitled to protection of their personal assets. Need I go on?

In order to preserve protection against personal liability you must show that you have a real business, not just a sham created to dodge personal liability. While Steve's brokerage was, in fact, real, the courts won't uphold protection when the corporate privilege is misused to protect fraud, misrepresentation or promote other injustice. Such misuses include:

- under-capitalization
- a failure to observe entity formalities
- commingling of funds
- insolvency at the time of a transaction
- siphoning of funds by those owning or controlling the entity
- or the absence of corporate records.

In these circumstances, many courts will deem the corporation to be the “alter ego” of anyone who dominates or controls the corporation’s finances and business practices.

Here are some specific things to do to avoid the law of unintended consequences:

- Comply with all state filing requirements
- Create and maintain all state-required documentation and formalities, including any on-going filing requirements
- Hold regular board meetings and maintain minutes
- Keep adequate business and accounting records
- Adhere to requirements of any by-laws or operating agreements
- Maintain adequate capitalization of the business at all times
- Do not enter into contracts without the current ability to pay
- Maintain a separate business bank account
- Never commingle funds

Interestingly, piercing the corporate veil is the most litigated commercial law issue in the U.S. Because there are many considerations in deciding if the corporate entity is sufficiently intact to shield its owners, the courts rely on a legal doctrine called "the totality of the circumstances."If you are considering incorporation, be sure to consult with your attorney regarding the specific ways to comply with these requirements in order to shield yourself from liability. If you have already incorporated and are concerned that you may not be adequately adhering to necessary business practices, don’t hesitate to review your practices with your attorney now. It is always better to make any changes necessary now sooner than later. Judges are significantly impacted by a show of good faith, and in these cases, the judge will be your best friend or your worst nightmare.