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LIMITED LIABILITY & YOUR LLC

Limited Personal Liability

Like the shareholders of a corporation, all LLC owners are protected from personal liability for business debts and claims arising out of the activities of the LLC. This means that if the business itself can't pay a creditor -- such as a supplier, lender or landlord -- the creditor cannot legally come after the LLC member's home, car or personal possessions. Since only the LLC assets can be used to pay off the legal obligations of the business, a claim based on the activities of the LLC stays "inside" the LLC. LLC owners only stand to lose the money they've invested in the LLC and any appreciation in value of the LLC during its existence. This feature is often called "limited liability."

Exceptions to Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, it is important to realize that this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he or she:

- negligently injures someone and/or their property while on LLC business
 - personally guarantees a bank loan or a business debt on which the LLC defaults
 - fails to deposit income taxes withheld from an employees' wages
 - intentionally or maliciously violates certain criminal, or consumer protection laws
 - conspires with others to violate certain anti-trust or anti-racketeering laws
 - commits a fraudulent act which results in injury to the LLC
 - transfers all of the assets out of the LLC to avoid reasonably foreseeable future obligations,
- or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

This last exception is the most important. In some circumstances, a court might say that the LLC doesn't really exist and find that its owners are really doing business as individuals, who are personally liable for their acts. To keep this from happening, make sure that you and your co-owners:

- Act fairly and legally. Do not conceal or misrepresent material facts or the state of your finances to vendors, creditors or other outsiders.
- Fund your LLC adequately. Invest enough cash into the business so that your LLC can meet foreseeable expenses and liabilities.
- Keep LLC and personal business separate. Get a federal employer identification number, open up a business-only checking account, and keep your personal finances out of your LLC accounting books.
- Create an operating agreement. Having a formal written operating agreement lends credibility to your LLC's separate existence.
- Obtain adequate liability insurance. A good commercial general liability insurance will protect the business, its owners, and managers from a long list of potential catastrophes.

Shelter from Personal Obligations. The above discussion involved claims arising “inside” the LLC. However your LLC can also furnish some protection for claims arising “outside” its activities. If you are personally liable a creditor can obtain a judgment and court order to seize your assets. Your ownership interest in the LLC is an asset. However over the years the states and courts have devised many limitations on this. They include:

- Separating Membership & Economic Interest. Most states now allow LLC members to retain their voting membership & control and assign their economic interest to a third party, including a creditor.
- Restrictions on Access to the Asset. In most state the “primary remedy” of a creditor is to obtain a Charging Order against the cash distributions actually paid to the debtor owner. But the LLC’s managers are not legally required to make any distributions.
- Preventing a Foreclosure. A few state laws [Not Wash] say that a charging order is the “exclusive remedy” and a creditor can’t foreclose on the debtor’s LLC membership, or interest. The creditor must patiently wait until money is actually distributed to the interest owner. This encourages creditors to make a deal, and settle for a discounted amount.

Most state laws address the above issues with default rules, and then expressly allow the LLC members to vary them in a written LLC Operating Agreement. This gives us flexibility to craft your asset protection against “outside claims”. But you can’t vary their foreclosure rule.

Single Member LLCs. LLCs with a single member may have less protection against “outside” claims. A Federal Bankruptcy court in Colorado ruled in 2003 that the assets of the debtor’s LLC were available to all of his creditors because there were no other LLC members to protect. The court disregarded a Colorado law requiring charging orders. In a community property state an LLC owned by the marital community is considered a single member LLC.

The Phantom Income issue. Some states allow a Charging Order against an LLC interest to be levied against the interest owner’s annual allocation of profits or losses. An owner’s allocation is what he reports to the IRS on his 1040. If an LLC does not actually distribute any cash the owners must pay their tax bills with cash from other sources. Some people believe the IRS will interpret an old Revenue Ruling [77-137] to require a creditor with a Charging Order to pay the debtor member’s income taxes, even if the creditor does not receive any cash distributions. Other commentators [including this scribe] are skeptical. However the prospect has discouraged some creditors from seeking Charging Orders.

State Shopping. Since state laws vary an obvious solutions is to form your new LLC in the most debtor friendly state and pay their annual fees. But that is not easy to do. You will have to spend a great deal of time & money consulting attorneys in multiple states to find the ideal one for you. If your business will be operated in a 2nd state you will also have to register your LLC there and pay that state’s annual fees. If a claim arises in your operating state its courts may choose to apply their own laws on collecting debts and LLC foreclosures. They will argue that you submitted to their laws when you registered and conducted business there. For a high risk business it may be worth the cost to engage in state shopping. Keep in mind that the more significant contacts you can create with the state of formation the better your chances that its law will be applied in a collection action.