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Limited Liability of LLC Members

Limited liability for members and favorable income tax treatment are the two attributes sought by most people when they choose an LLC as a form of business entity. While partnership or disregarded entity treatment is guaranteed for federal income tax purposes unless an LLC makes an affirmative election to be taxed as a corporation, limited liability may not be available unless an LLC is both properly created and properly operated.

The concept of limited liability is based on an LLC's being an entity separate from its members – the LLC as an entity is responsible for the debts and liabilities of its business, and the members are not. If an LLC does not file articles of organization or does so improperly, no separate entity is created, and the members of the LLC are responsible for its debts and liabilities. A properly created LLC may cease to be a separate entity if it fails to file annual reports and pay fees and taxes in accordance with applicable state law.

It is also possible that the separate existence of an LLC will be disregarded under the doctrine of piercing the corporate veil. There are only a few reported cases relating to the application of this doctrine to LLCs, but cases like *Ditty v. Checkrite, Ltd.*, 973 F. Supp. 1320 (D. Utah 1997), indicate that the piercing the corporate veil doctrine is applicable to LLCs as well as corporations. Both corporations and LLC furnish the same type of limited liability to their equity owners, so this seems a logical result.

The piercing the corporate veil doctrine allows the separate existence of a corporation to be ignored if the corporation functions as the alter ego of its shareholders. A corporation may be considered an alter ego of its shareholders if it is not adequately capitalized, it is a mere facade for operations of its shareholders, or if there is a failure to follow proper corporate operating procedures.

In order to avoid an LLC's being treated as an alter ego of its members, it is important for the members of the LLC to contribute sufficient assets to the LLC at the time it is created and for the contributions be documented. An LLC cannot function as a separate entity unless it has its own assets and those assets are adequate for the operation of the LLC's business.

Even if an LLC is adequately capitalized, it may be considered to be an alter ego of its members if the LLC's ownership of its assets is not respected. An LLC should have its own bank accounts, and title to the LLC's assets should be held in the name of the LLC. No funds or assets of an LLC should be transferred to members except in the form of distributions permitted under applicable state law that are documented as such. Assets of the LLC and members should never be mixed, and the LLC should not pay personal expenses of the members. If funds or assets are loaned or leased to the LLC by members or to the members by the LLC, the terms should be fair to the LLC, and the arrangements should be covered by written agreements.

All business should be conducted in the name of the LLC, and the LLC's name should be used on contracts, leases, orders, and other arrangements entered into by the LLC. This name should also be used on all products, signs, advertisements, correspondence, business cards, telephone directory listings, and the like. The LLC should obtain and carry its own insurance and file all required income tax and employment tax returns. When a member or manager acts for the LLC, the documents should make it clear that the member or manager is acting in a representative capacity and not as an individual.

Although LLCs are not required to hold annual meetings like corporations, it is a good idea to document major actions by members or managers in the form of meeting minutes or consents to action. Having an operating agreement may also evidence members' respect for the separate existence of the LLC, and an operating agreement can provide a roadmap operating the LLC as an entity separate from its members.

Client Business Counsel

Suspending limited liability under the doctrine of piercing the corporate veil is an extraordinary remedy, and it occurs in very few cases. But the result can be devastating to equity owners, and many lawyers feel that filing articles of organization and drafting sound operating agreements for their LLC clients is not enough. Our firm likes to provide the principals of the LLC with an explanation of the risks associated with losing the protections of limited liability and outline the steps that can be taken to reduce those risks.

We welcome your input or feedback about this newsletter. Please feel free to reply with any thoughts or requests. Thank you.

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