

Can an LLC protect your assets?

Frequently in my practice, I am asked whether a limited liability company, commonly called an LLC, is an effective way to protect assets. My immediate response is that it can be when it has been properly structured and administered.

However, I typically temper my response by explaining that asset protection planning, in any form, is most effective when done in advance.

After all, the whole point of such planning is to prearrange one's affairs so as to weather the storm of an unexpected claim better than one otherwise would.

With this in mind, I think it is very useful to understand what asset protection an LLC actually offers.

There are basically two forms of general asset protec-

tion available through a properly drafted and administered LLC. I will discuss them one at a time.

Entity shield

The first form of protection is the entity liability shield statutorily created under Idaho's LLC legislation. This shield insulates each owner of the LLC from claims asserted by any creditor of the LLC, except where a particular owner has personally guaranteed an obligation to a particular creditor of the LLC. Under Idaho law, an LLC owner should only be at risk to lose the amount invested in an LLC. However, this type of protection can be eroded, or even eliminated altogether, through several ways. Here are some real cases illustrating some of the pitfalls to avoid:

In California, one court expressly held that no liability shield existed for a single member LLC, because California's LLC statute requires at least two members. Although Idaho's LLC legislation clearly permits a single member LLC, this decision and its reasoning cannot be ignored in light of the potential "full faith and credit" argument that could be made in an interstate transaction involving an Idaho LLC doing business in California.

The extent of control exerted by a member over the LLC is also a key factor. In a New York case involving claims for breach of contract, copyright infringement and unfair competition, the controlling member argued that as a matter of law, the LLC liability shield protected him from personal liability and that the case should be dismissed. In denying the controlling member's motion for dismissal, the court noted that the only other members in the LLC under attack were the spouse and two children of the controlling member.

Distributions made to a member under a creditor's attack can be called into question by a court deciding whether to permit an LLC's veil to be pierced by the creditor, particularly where the member is controlling the LLC's finances and management decisions. For example, in a Connecticut case, the court ignored the fact that certain distributions were made

on a regular basis to a controlling member as salary at a time when the LLC was current on its obligations to an attacking creditor.

In another Connecticut case, the attorneys defending the LLC's controlling member, in a cavalier fashion, instructed the trial court that the whole purpose of forming the LLC was to avoid any personal liability on the LLC's contractual obligations. During one of the meetings between the parties, these same attorneys taunted the other party's legal counsel to "go ahead and sue" the LLC, since there was "no money" in the LLC. Based on this evidence alone, the court indicated that there was an issue of fact to be decided by the jury on the veil piercing theory.

These types of cases are often called "veil piercing" cases because the LLC's creditors are permitted to "pierce" through the liability shield statutorily created for all LLC owners and seize their personal assets.

Charging order

The second form of protection arises from another statutorily created concept called the charging order.

This type of protection shelters the LLC as an entity from the liabilities of its owners. In other words, the creditors of a particular individual LLC owner should not be able to reach into an LLC and seize its assets to satisfy that owner's obligations. Instead, such a creditor must wait until a distribution is made to that owner and then seize the distribution similar to a garnishment of wages. This form of protection also has some traps for the unwary. Here are a few:

■ In a Colorado case, the court, using equitable principles, creatively included very severe restrictions on any distributions to the other members not under attack by a creditor, and absolutely prohibited the transfer of any LLC assets to any other person, unless and until all claims of the creditor attacking a member under the court's charging order were paid in full. No such remedy exists under Idaho's LLC statute.

■ In an Ohio case, the court

LLC's

looked through an LLC to the LLC's major asset, an option on a valuable parcel of real property, and indicated that the member under a creditor's attack owned 50 percent of the LLC's option simply by virtue of the member's 50 percent interest in the LLC. This holding is contrary to the law in Idaho and most other jurisdictions.

■ In a California case, the court ignored statutory provisions limiting the remedies for a creditor attacking a member to a charging order and required the LLC to distribute sufficient assets held in the LLC to the member under the creditor's attack for garnishment by the creditor. Once again, Idaho's LLC statute does not create such a remedy for a disgruntled creditor of a particular LLC member.

Courts may also appoint a receiver to run an LLC. In New York, a court even applied this rarely used remedy in a judgment against a Professional Limited Liability Corporation (PLLC) practicing law. Obviously, this remedy raised issues relating to confidentiality and other obligations involved with the attorney-client privilege, but a court of appeals panel reviewing the trial court's order merely instructed the trial court to consider the impact of these issues on remand.

Protective steps

With these pitfalls and traps in mind, here a few steps that can be taken to help strengthen an LLC's liability shield and charging order protection:

■ Follow all LLC formation formalities imposed under the applicable jurisdiction, including filing the articles of organization with the appropriate authorities in the requisite format.

■ Complete all LLC capitalization funding in accordance with the governing operating agreement provisions and applicable law.

■ Maintain all LLC records required by applicable law, including any member lists, tax returns, annual meeting minutes, etc.

■ Keep all LLC funds separate from the personal funds of all members and managers.

■ Divide the LLC's management responsibilities when pos-

sible.

■ Disclose the LLC's existence in all contractual arrangements and to the public in general.

■ Sign the LLC's contractual arrangements in the appropriate capacity.

■ Keep all LLC transactions at "arm's length."

■ Avoid too much interrelationship and too many connections between the LLC and any controlling owners and their other entities if possible.

■ Dissolve any LLC in strict accordance with applicable statutory provisions, including filing the articles of dissociation or dissolution with the appropriate authorities in the requisite format.

■ Fictitious business names, otherwise known as "dba's," are dangerous. There is a whole series of cases holding LLC members personally liable for failing to disclose the LLC actually conducting business in the fictitious name.

In one case, a court in Colorado rejected an argument that the LLC's filing with the proper Colorado authorities constituted constructive notice to a creditor pursuing two of the members personally on a breach of contract claim.

Personal liability may also arise independently from a manager's malfeasance and negligence. The difference here may be an allegation of "fraud" in contrast to an allegation of "alter ego." However, in either situation, no liability shield will be available.

If you are wondering whether you should consider forming an LLC for your asset protection needs, or whether an existing LLC owned by you has been properly structured and administered, you should consult with a qualified professional.

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