

Veiled Threat:

Making Sure Your LLC *Truly* Limits Your Liability

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For the budding entrepreneur, forming a Limited Liability Company (LLC) seems to be a great strategy. The Pennsylvania LLC offers the asset protection available to traditional corporations, but with more relaxed rules and requirements. In addition, the LLC offers tax advantages to the owner that are similar to a sole proprietorship or an S Corp.

The tremendous growth rate of LLCs over the past ten years is a testament to their appeal. Since 1995 the formation rate of new corporations in Pennsylvania each year has gradually declined – hovering at around 17,000 per year – while the formation rate of LLCs has zoomed from 491 in 1995 to nearly 13,000 in 2002 (an increase of 95%).



Choosing an LLC for your business may seem like a “no brainer” decision. Even the name – “Limited Liability” – suggests that the primary feature of the entity is asset protection. But are the protections and benefits promised by an LLC reliable? Can a creditor of plaintiff in a lawsuit seize your personal assets, despite the supposed protection?

It’s possible. The mere existence of an LLC offers business owners no protection unless and until certain important steps are undertaken to maintain the integrity of the incorporation.

First though, we have to understand how an LLC insulates an owner from the company’s debts and liabilities. Like a corporation, an LLC is an entity (a Latin word describing something that has a separate and distinct existence, in this case separate from the owner of the business). In Pennsylvania corporations and LLCs are empowered to do business, including functions like making agreements, managing money, and incurring debts. However, because the LLC or corporation is a separate entity, the owners and stockholders are typically not held personally accountable for the company’s debts and financial obligations.

Unless of course the owners personally vouch or sign for the company’s debts, which is the subject of a different article entitled “One of the Biggest Mistakes a Business Owner Can Make.”

The principal difference between LLCs and corporations is in the ease with which they are organized and maintained. A corporation is subject to a host of formalities; it must elect a board of directors, draft a charter and articles of incorporation, conduct regular meetings, maintain minutes, acquire insurance, file tax returns, and so forth.

In contrast, the standards for a setting up and maintaining a LLC are intended to be simpler. But, while the expectations for setting up and maintaining an LLC aren't as formal, the owners of the company are nonetheless obligated to maintain some degree of organizational structure.

Because of the simpler organizational requirements, LLCs have proven popular for small businesses, professional practices, subsidiaries, joint ventures and business startups.

Yet, Limited Liability Companies, like other forms of incorporation, may not always shield owners and stockholders from liabilities. Under certain circumstances a court may choose to bypass those protections by declaring the corporation or LLC to be invalid. This process, referred to as "Piercing the Veil" of the corporation, is premised upon the recognition that the owners of the company didn't observe the proper formalities and thus didn't run the business like a real, valid corporation.

Why do courts sometimes choose to take the rather extreme step of "piercing the veil?" In truth, courts are reluctant to take such a drastic step. As attorney Mark C Larson points out, "The general rule in Pennsylvania is that there is a strong presumption against piecing the corporate veil and that the corporate entity should be recognized and upheld unless specific, unusual circumstances call for an exception." (Larson, Mark C., Piercing the Veil of Pennsylvania Limited Liability Companies," Pennsylvania Bar Association Quarterly, July 2004)

So what are those "specific, unusual circumstances?" In general, courts have held that it is appropriate to discard a corporation when the officers of the corporation have engaged in fraud or evaded taxes, eluded creditors, avoid criminal liability or 'defeat public policy.' (Larson, op cit) Naturally, in circumstances where a corporation or LLC has lost a major lawsuit, declared bankruptcy or incurred debts it can't pay, creditors are inclined to go after the officers, owners and stockholders of the business to recover their money. If they can prove that the LLC has violated the formalities or was otherwise operated as a sham, the creditors may be able to seize the owner's assets.

While there is some ambiguity around the formal requirements for maintaining a LLC, there are clearly defined grounds that courts use for declaring a corporation to be invalid. Among the most significant considerations are:

- **Gross Undercapitalization** –While it can become tricky trying to determine what an adequate level of capitalization for a particular corporation might be, if the LLC undertakes a debt obligation that it can't meet, then courts may "pierce the veil" and force the owners to pay the debt.
- **Failure to Observe Corp Formalities** –Unlike traditional corporations, LLCs are not required to conduct annual meetings. The lack of meeting minutes and the failure to elect officers or approve decisions may nonetheless enable a court to invalidate the LLC. The principal here is that the owner of a LLC, or any corporation, is not entitled to treat corporate assets as his or her own, thus ignoring the "separateness" of the corporation. By ignoring these formalities the LLC's creditors can argue that there was, in effect, no "real" corporate entity in the first place. Unfortunately, initiating and maintaining these details can be a burden to small closely held companies and this is one of the first deficiencies a creditor's attorneys may look into.
- **Commingling or Siphoning of Funds** –Likewise, the owners of a LLC are not entitled to treat the company's funds and assets as their personal resources and still maintain the concept of a "separate entity." However, in a small, family owned business it may not be uncommon for an owner to write a company check to cover personal expenses. This may be an innocent transaction, but in extreme cases this may take the form of transferring company assets to owners at less than

fair market value or siphoning off company profits. Poor accounting practices (also not uncommon) could muddy up the waters with regards to the separation of personal and company funds. Courts may permit some flexibility in applying this standard when considering “piercing the veil,” but a serious case of commingled or siphoned funds could be seen as a clear reason by the court to invalidate a LLC.

- **Fraudulent Intent** – The underlying motivation behind a court choosing to pierce the corporate veil is often to expose fraudulent activities. If a creditor can prove a pattern of activities that suggests fraud, such as undercapitalization, inadequate recordkeeping or commingling funds, the creditor stands a greater chance of steering a court into invalidating the LLC. There is just enough ambiguity around the question of when and under what circumstances a corporate veil can be pierced in Pennsylvania to allow an enterprising creditor to allege fraud, even where none exists, in order to recover debts directly from the owners or shareholders.

There are four steps that the owners of a LLC can and should take to preserve their liability protection:

1. Obtain a separate tax identification number for the LLC. Although it is permissible for the owner of a LLC to use his or her social security number or Federal Tax ID number, obtaining a separate ID number for the LLC goes a long way toward establishing an unequivocally separate existence for the entity.
2. Identify the LLC’s status clearly on all company materials and branding, such as stationery, cards, invoices, websites, signs, etc. This reinforces the identity of the LLC further and also precludes any argument that a potential debtor didn’t know they were doing business with a LLC.
3. Observe all corporate formalities. Even though the LLC has fewer requirements, holding annual meetings to appoint officers and approve measures affirms the corporation’s authenticity. Maintain accurate minutes of the meetings to provide the necessary evidence of fulfillment of the LLC’s requirements.
4. Retain accurate and detailed records of the LLC’s operations, including finances, correspondence, taxes and business operations. Be certain to show clear evidence that the LLC’s finances and assets are separate from the officers’, owners’ and stock holders’ finances and assets.

The Pennsylvania Limited Liability Company is an excellent tool to provide entrepreneurs with flexibility in running their businesses along with protection of their personal assets. With nearly 13,000 LLCs placed on the record last year, it’s clear that many entrepreneurs see a great deal of value in this form of incorporation.

But, effective as they may be, LLCs are not foolproof. The owners, officers and stockholders of an LLC are well advised to take steps to maintain the integrity and protection of their chosen business entity. As the continual rise in both bankruptcies and lawsuits demonstrates, there are innumerable creditors looking to pounce on the assets of business owners who let down their guard.

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