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Is Your Liability Really Limited?

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Legal Aid for New Entrepreneurs (Chicago)
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Is Your Liability Really Limited?

What Every Entrepreneur Should Know About LLCs and Personal Risk

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The Question Every Entrepreneur Asks

If I form an LLC, am I protected?

The lawyer's answer: *Protected from what?*

Most entrepreneurs form LLCs because they want protection.

- What is an LLC protecting?
- Who is actually protected?
- When does the protection disappear?
- How can you preserve it?

Four Common Misconceptions

True or False?

1. Nobody can sue me.
2. My assets and my house are always protected.
3. LLC takes responsibility for everything, even my own misconduct.
4. Taking the first step of forming the LLC provides its protections.

Today's Topics

- Throughout: Best Practices
- What Limited Liability means and what it does *not* mean
- Ensuring Limited Liability
- Importance of the Operating Agreement
- Separateness versus Loss of Protections
- Personal Liability Traps and Limitations
- Advanced Structures
- Summary
- Questions

LLC Liability Basics

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Why LLCs Exist

A long, long time ago…

- Separate legal entity
- Protects against status-based liability

- Historically:
  - Sole Proprietorship: Owner = Business
  - General Partnership: Partners personally liable
- LLC: The business is a separate legal entity
  - Know your dance partner
  - Core Shield of an LLC: **Owners/members are not liable for LLC debts solely because of ownership/membership.**

The LLC is a *Separate Legal Person*

- An LLC can:
  - Own property
  - Sign contracts
  - Sue and be sued

- The LLC is *not* its owners

- Example: ABC LLC defaults on a lease. Who is liable?
  - The LLC ✓
  - Not the owner 🚫

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Limiting Liability and Agreements

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LLCs Are Not Magic

- An LLC is:
  - A shield
  - A flexible business vehicle for management and ownership structures

- An LLC is not:
  - Insurance
  - Immunity
  - Fraud protection
  - Asset concealment

Most Important Rules

- LLCs eliminate status-based liability
- LLCs do not eliminate conduct-based liability

To enforce the separation between the LLC and You and liabilities:

- LLCs and company formalities must be respected and followed
- Assets must be separate
- Conduct must be separate

Owners/members are not liable for LLC debts **solely** because of ownership/membership.

Your Creditors vs. Company Creditors

- Company creditor:
  - Vendor
  - Landlord
  - Customer
  - Employee
- Personal creditor:
  - Divorce judgment
  - Personal guaranty claim
  - Individual judgment
  - Credit Card

Operating Agreement Is King

"LLC Agreement" "Company Agreement" "Operating Agreement"

- Delaware (and LLCs) have strong freedom of contract, but the contract must be followed.
- Follow your agreement.
  - Adherence informs whether the actions are company actions or personal actions.
- Lawyers and courts focus on the Operating Agreement.
- Certificate of Formation is only Step 1; Operating Agreement is Step 2.

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Contractual / LLC Flexibility Is Powerful

- Great flexibility in how management and risks are structured
- LLCs may be:
  - Member-managed
  - Manager-managed
  - Board-managed
  - And more…
- Flexibility = Opportunity = Risk
  - Follow the Agreement.
  - *Or amend to something you like.*

Dangerous Sentences

“It's my company, I can do whatever I want.”

“The LLC protects me”

- You must follow and respect:
  - The Law
  - LLC Agreement
  - Contracts
  - Fiduciary Obligations (duties of a business leader)
  - Separateness

True Separateness

Separateness Is In Your Self-Interest

Respect the entity: *Why should a court respect your LLC and its protections if you don't respect the LLC?*

- Separate business:
  - Accounts
  - Records
  - Contracts
  - Taxes (unless filing as a 'disregarded entity')
  - Decision-making process
  - Contact information, letterhead, emails
- *All in the name of LLC*

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Single-Member LLC Trap

A single member LLC has only 1 member owning 100% of the LLC.

"It's just me so it doesn't matter"

"I am the LLC"

- Do not be careless.
- Being sole owner does not remove separateness requirements.
- The easy way will result in hard consequences.

Common Red Flag: Commingling Funds

- Examples:
  - Mortgage payments from LLC account
  - Vacation from LLC account / credit
  - Personal bills and expenses from LLC account / credit
  - Meals, gym, clothing, etc.
- Unsure?
  - Charge to your personal funds first, and then submit to your LLC for reimbursement of expenses with evidence of charges. Record on the books.
- The LLC is not a piggybank or ATM.
  - To take money from the LLC, declare and record a profit distribution, or establish a salary.

Business Records Matter

- Maintain records and approvals:
  - Tax records
  - Finance records
  - Operating Agreement and amendments
  - Minutes of Meetings
  - Important approvals and consents
  - Correspondence
- Good records = Credibility
- Good records = Evidence of respecting separateness requirement

Fraudulent Transfers

- LLCs are not creditor-avoidance devices
- Can I move assets into an LLC after I get sued or to protect from personal creditors?
  - Unlikely
- Courts routinely disregard transactions intended to hinder creditors.

Can Courts Ignore the LLC Shield?

"Piercing the Veil"

- Courts can sometimes ignore the LLC and go after the assets of its owners.

- When?
  - Is the LLC merely an instrumentality of its owner?
  - Is the LLC not a true separate legal person?

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Seven Signs of Piercing Danger

1. Commingling
2. Fraud
3. Undercapitalization / lacking appropriate funds
4. No / lacking formalities and governance
5. No / lacking independence
6. Lack of arm's-length dealings

   Is the agreement with a friend/family too good of a deal for them?
7. Alter ego conduct / unity of interest
8. Inequitable conduct; injustice; unfairness

Piercing Example

- Bob the Builder built a house that fell down 3 weeks later.
- Bob the Builder has an LLC, but:
    - Pays personal expenses from LLC account
    - Accepted payment by check to his name
    - No records
    - No votes
    - Uses his personal email address
    - An insurance policy, but Bob is primary policyholder and only named insured

- *Would you want to be Bob?*
- *Would it be fair to Bob's customer?*

Personal Liability Traps

Common Waiver of Shield: Personal Guarantees

Personal guarantees are guarantees that you are asked to provide in your own name in order to obtain something for the LLC.

- They are legitimate, common, and they do not destroy separateness.
  - Examples: Leases, Loans, Vendor Credit
- But: They are an agreement to personally take on liability outside of the LLC.
  - The LLC's liability shield does not matter if (and to the extent that) you agree to separately guarantee repayment in your name.

A Tort Is A Tort, And It Is Your Tort

What is a "Tort"?

- A wrong creating harm.
- Torts are causes of action based in common law and in written statute law

You are liable for your own conduct.

Tort Examples

- LLC employee is driving an LLC-leased van and an accident occurs
  - The driver and the LLC may both be liable
- Personal Fraud
- Harassment
- ‘Negligent Hiring’ or Supervision
  may create personal liability for:
  - Poor hiring decisions
  - Poor supervision
  - Ignoring obvious risks

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Fiduciary Duties

Generally, you and your LLC owe fiduciary duties to the LLC and its stakeholders and creditors.

- State law sets a minimum and default standard, but the operating agreement can have higher or lower standards.
  - *The standards are lower than for corporations.*
- LLC Managers owe duties of loyalty and care unless eliminated by the operating agreement.
  - *Exculpation language is tricky. Consult an attorney.*
- Always (unwaivable): Good Faith and Fair Dealing. No self-dealing.

Sign Contracts Properly

Name + Title + LLC

- Bad: *John Smith*
- Better: *John Smith, Manager*
- Great: *John Smith, Manager, ABC Ventures, LLC*
- Best: ABC VENTURES, LLC
  By: *John Smith*________
  Name: John Smith
  Title: Manager

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LLC Existence Is Not Enough

4 Layers of Liability Protection

1. LLC
   - State law protections
   - Members / owners are bound by the operating agreement
2. Contracts
   - Yourself
   - Employees and officers
   - Vendors / creditors
   - Customers
3. Insurance
   - Yourself and the LLC
4. Governance
   - The “formalities” and “separateness”

Insurance Matters

Better Safe than Sorry…

- Primarily:
  - General liability
  - Professional liability
  - Cyber coverage
  - Property
  - Officers and Executives
- Many more available, depending on business strategy and the marketplace

Advanced Matters

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Down the Rabbit Hole: Series LLCs

- Usually unnecessary for early stage. Not available in every state.
- Registered Series versus Protected Series
- Use case: a primary head LLC with series each holding an asset
  - Little difference to simply having standalone LLCs
- Same separateness issues.

Down the Rabbit Hole: Board Managed LLCs

- Avoid unintended "corporification“
  - The use of corporate concepts and principles in LLCs

- Overusing corporate concepts may create unexpected consequences.
  - Confusion (risk) over the extent to which it is intended to adopt and use corporate concepts.
  - Duties of corporate officers and directors are higher.
  - Voting interests are different in corporations.
  - The law has many more rules regarding corporate governance.

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Key Takeaways

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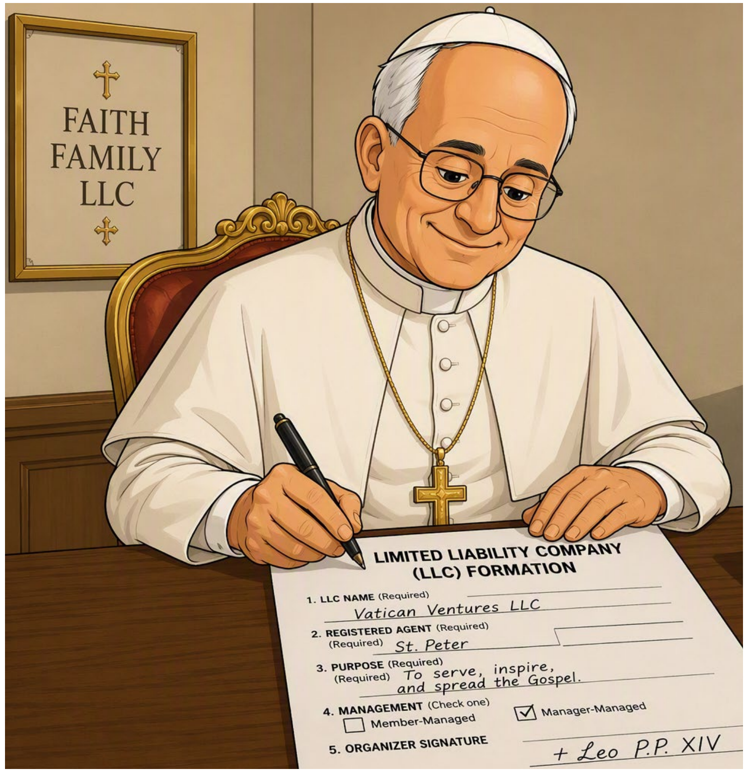
Three Rules to Remember

1. Respect Separation and Formalities
2. Follow Operating Agreement
3. You are liable for your own conduct



Chicago-based guidance – Ask yourself:

What would Pope Leo's LLC do?

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What To Do Now?

Check on the following:

1. Form the LLC properly
2. Maintain separate accounts and records (no piggybank)
3. Follow the operating agreement
4. Sign contracts correctly
5. Buy insurance
6. Avoid personally guarantee obligations unless necessary

Remember that you are always liable for your own misconduct.

Final Thoughts

An LLC is a strong shield, not a magic spell.

Liability is limited, not eliminated.

The better you follow the rules, the stronger your shield.

Understand where the shield begins and where it ends.

Consequences? Your assets can be on the table.

The LLC and its liabilities are only as separate from you and your assets, as you are separate from the LLC.

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