

Why Your LLC May Not Protect You

By William Gibney, Esq.

Imagine paying regular premiums on what you believe to be a good automobile insurance policy --- only to learn it offers no coverage when you have a serious car accident. All of your claims for medical expenses, car repairs, and liability coverage are denied. What seemed like a good security blanket turns out to be a worthless piece of paper.

False Sense of Security

Your limited liability company (LLC) could give you a similar false sense of security. Few would disagree that the LLC is the most effective means of protecting assets, but if not carefully structured and implemented, it might offer no protection at all.

Operating Agreement: Errors and Omissions

A poorly executed operating agreement (or the absence of an operating agreement) is the most common mistake undermining the effectiveness of an LLC. This document holds the power of the LLC. Similar to a corporation's by-laws, the operating agreement spells out the management structure, rights and powers of members and managers, and how the LLC will be taxed. While Arizona's LLC Act provides some default provisions, case law has proven that these basic provisions don't provide adequate protection in most cases. Because every LLC has different circumstances, one size does not fit all. An operating agreement should be customized to address such issues as: (1) whether certain interests in the LLC are held by members or economic interest holders; (2) whether all interest holders will participate in contributions, allocations, and distributions; (3) when a manager should immediately resign; (4) what to do if a judgment creditor comes knocking; and (5) terms of dissolution. A well-drafted operating agreement provides for contingencies such as death or incapacity of members and managers, lawsuits, divorce, and bankruptcy, as well as buy-sell provisions and retirement of members and managers.

Single-Member LLCs

I form single-member LLCs for many clients who want to protect real estate and securities, but an operating agreement is just as important for these entities as those with two or more members. Without certain provisions for "peppercorn" interest holders, single-member LLCs are easier for creditors to pierce than LLCs with more than one member. Another common, but serious mistake made with single-member LLCs is the commingling of assets. This failure to maintain an entity's autonomy can also invalidate the LLC's asset protection powers.

Articles of Organization

Critical mistakes are even made in the basic application to form an LLC—the Articles of Organization. Many people (even some attorneys) who don't understand the difference between member-managed and manager-managed LLCs, make the wrong choice of management structure, then fail to operate the LLC according to the way the LLC was initially set up. This error can facilitate a creditor's access to the LLC's assets.

LLC Ownership

Another common mistake is how LLC membership interest is held. Often, it's advisable for a living trust to own the LLC, yet in some cases, it may be best for one spouse to own the LLC as sole and separate property. Sometimes an LLC should be owned by another LLC. I often advise clients to establish minority economic interests for certain family members, without the rights and powers of membership.

Acquisition of Assets

Determining which assets will be held in an LLC is also critical. While virtually any asset from antiques to securities to real estate can be protected by an LLC, certain assets should never be held in the same LLC. Sometimes a single LLC provides ample protection, while multiple LLCs may be necessary in other instances.

No Substitute for Ethical Behavior

Finally, don't expect an LLC to be your ticket to abdicate your moral responsibilities. Arizona's LLC Act was intended to level the playing field between debtors and creditors, plaintiffs and defendants. Creditors may target the limited liability company which holds the asset that caused the injury or owes the debt, but cannot launch an artillery attack on an entire estate to recover damages. If you have harmed another party, you should accept responsibility for the damages. I recommend purchasing a good umbrella insurance policy to cover the smaller claims. But for those claims not covered by insurance or which exceed the policy limits, a well-structured LLC with a sound operating agreement provides the strong shield of protection we all need in today's litigious society.

Whether you already have one or more LLCs or you're interested in establishing LLC protection, don't be lulled into thinking that an LLC is a bullet-proof shield. Make sure you understand the importance of the operating agreement. On the surface, it appears to be a simple, straight-forward legal entity. But don't be lulled into thinking it's a bullet-proof shield for your assets. Omissions, inconsistencies, or unlawful provisions in the operating agreement could nullify the LLC's powers. Make sure you consult an attorney who is knowledgeable and experienced in LLC asset protection.

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