

Learn how to protect your assets and loved ones by limiting your liability exposure.

BURNS AND BURNS, P.C. IS AN AV RATED LAW FIRM THAT REPRESENTS MULTI-GENERATIONAL FAMILIES AND BUSINESS OWNERS WITH THEIR ASSET PROTECTION, REAL ESTATE, AND ESTATE PLANNING NEEDS.

Limited Liability in a Limited Liability Company

Understanding Limited Liability

Simply defined, limited liability means that a stockholder, director, manager, member or owner of a business entity will NOT be held personally liable for business obligations. In practice, the business entity's, stockholder, director, manager, member or owner will only be liable for the amount of money they already provided to the business entity. However, issues of fraud or 'piercing the corporate veil' may come into play which could, in certain circumstances, create personal liability issues above the capital contribution.

For example: A member of an LLC has \$10,000 in their personal bank account while the LLC has \$0.00 in its bank account. If the creditor has a judgment against the LLC for \$5,000, generally, the creditor cannot collect the \$5,000 owed by the LLC out of the LLC's member's personal bank account or other assets.

In contrast, for business entities that *do* not provide limited liability protection, (i.e. a partnership or sole proprietorship) the creditor may be able to pursue the judgment of \$5,000 owed to them from the member's personal bank account or assets.

Arizona Business Entities Providing Limited Liability Coverage

The Arizona business entities that provide limited liability to its members, managers, shareholders or directors include:

- Limited Liability Company (LLC);
- Professional Limited Liability Company (PLLC);
- Corporations (Corp. & Inc.);
- Limited Liability Partnership (LLP) (as to limited partners but not general partners); and
- Limited Partnership (LP) (as to limited partners but not general partners)

Business Entities Not Providing Limited Liability Coverage

The Arizona business entities that do not provide limited liability to its members, managers, shareholders or directors include:

- Sole Proprietorship; and a
- Partnership.

“Piercing the Corporate Veil”
Exceptions to the General Rule of
Limited Liability Coverage

Business entities that provide limited liability are designed to shield their members, managers, shareholders and directors from personal liability from business obligations. However, under certain circumstances, the court may hold the members, managers, shareholders or directors of a business that provides limited liability personally liable for the obligations of the business.

When this action is taken by the court, it is often referred to as “piercing the corporate veil.” Limited liability companies are said to provide a veil of protection against personal liability to their members, managers, shareholders, and directors. Therefore, when a member, manager, shareholder or director is found personally liable, the veil of protection is said to have been pierced, which gives rise to the phrase “piercing the corporate veil.”

A court may pierce the corporate veil of a validly formed business under, but not limited to, the following circumstances:

Failure to Follow Corporate Formalities

The failure to follow corporate administrative requirements may result in the members, managers, shareholders or directors being held personally liable for business obligations or debts.

Generally, failing to follow administrative requirements includes:

- Using business assets for personal use;
- Using business funds to pay personal debts;

- Commingling business funds with personal funds, failing to keep accurate business records; and
- Failing to keep business and personal accounting records separate.

Corporations are specifically required to hold annual meetings, maintain annual corporate minutes and file an annual report with the Arizona Corporation Commission. Although not required by Arizona law to file annually with the Arizona Corporation Commission, an LLC that documents its company dealings by preparing minutes or holding annual meetings will assist in reducing an LLC member’s exposure to personal liability.

Not Sufficiently Funding the Operating Costs of the Business

The failure to properly fund a business with the financial capitalization necessary to meet business expenses or pay business debts when they become due may result in a court imposing personal liability on the business’ members, managers, shareholders or directors.

For example: On Monday, Bob forms a home repair company named Bob’s Home Repair, LLC. On Tuesday, Bob has his newly formed LLC purchase a \$50,000 truck on credit. Bob’s company never makes a payment on the truck and his company never had the money to purchase the truck or even make a payment on the truck. When the truck company sues Bob for payment, Bob may NOT be able to avoid personal liability for the car payments arguing the car payment was only an obligation

of his company. The reason for this is because Bob's company did not have the financial resources to payoff its debts when they become due. Thus, Bob could be held personally liable for the truck payments.

A Negligent Act

A member, manager, shareholder or director who performs a negligent act may be held personally liable for such negligent act. Negligence is defined as a breach of a duty owed to an individual or entity.

To Prevent Fraud

The court may disregard the business entity and pierce the corporate veil in order to look to the individual members of the company to prevent a fraud upon third parties.

Administrative Steps to Avoid Personal Liability

An LLC generally provides limited liability to its members and managers. However, the members and managers may be held personally liable for the LLC's debts and obligations, if the members and managers fail to maintain certain corporate formalities. While it is not required by Arizona law to file annual reports with the Arizona Corporation Commission, maintaining accurate and detailed business records are important if a lawsuit arises. Further, it is important that any documents be signed on behalf of the LLC and not the individual!

Liability for False Statements in the Articles of Organization

In addition to the LLC being responsible, the person who executes the articles of organization, articles of merger or articles of termination or causes another person to execute these articles on their behalf and *knows or* should have know that a statement within the articles was false when the articles were executed or any person who reasonably should have known the statements to be false, will be exposed to liability.

Further, a person who knows or should have known that an arrangement or other facts described in the articles have changed (making the statement in the articles inaccurate in any respect) and a sufficient amount of time has passed to enable the person to amend the articles, will be liable. Liability will also be imposed for the losses suffered by an individual or entity that relied on the false statements contained in the articles.

About the Author Scott F. Burns, Esq.

Scott F. Burns, Esq. is an Arizona attorney whose clientele include professional athletes, business owners, and families desirous of protecting their personal and professional legacies through the use of asset protection strategies, estate planning and business consulting.

For Additional Information
www.B-BLAW.com

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BURNS AND BURNS, P.C.

Asset Protection, Estate Planning, and Real Estate Law
www.B-BLAW.COM – Phone: 602.264.3227 Fax: 602.274.0103