



Go Forward Guide to Care and Feeding of your LLC

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Limited Liability: Why you formed an LLC in the first place.

The beauty of a “Limited Liability Company” (LLC) is that it allows you—as promised—to limit your liability in the event that something bad happens to your business. As an owner of an LLC (deemed a “member” by the LLC laws¹), you contribute a certain amount of money or resources to the business that you’re willing to put at risk. Then, by doing business in the name of the company and complying with the formalities required by law, the LLC structure shields your personal assets from liability if something goes horribly wrong.

One of the great advantages of LLCs is that they are cheap and easy to create. In fact, if you are currently doing business without some sort of company entity, you should talk to an attorney and an accountant to see if an LLC is right for you. But don’t be lulled into a false sense of security by the ease of its initial setup. In order to get the full protection of the LLC structure, **it isn’t enough to just fill out some forms with the Secretary of State’s office and pay your \$180.** If that’s all you’ve done, you might as well have lit that \$180 on fire.

Money is money to a plaintiff’s attorney.

Let’s face it, nobody’s perfect, and at some point you or one of your business partners are going to mess up. Maybe you’ll take on too much debt, maybe someone will be physically or financially harmed by your business, or maybe one of your partners will try to take advantage of you. Now put yourself in the shoes of a creditor or a plaintiff suing your business because of your error (or better yet, put yourself in the wingtips of the plaintiff’s lawyer). All anyone wants is to get paid, and they will be more than happy to go after whatever pot of money they can find.

That means if your business is broke but your personal accounts are full of cash, the plaintiff’s lawyer is going to try every trick in the book to get a court to disregard² your LLC and recover damages from your personal assets. And in a many situations, this isn’t very hard to do. A judge wants to see that you are serious about treating the LLC as a truly separate entity from yourself. Filling out the LLC paperwork and paying the fee is a start, but if that’s all you’ve got to show a judge then the plaintiff’s lawyer is going to be licking his chops.

Five simple steps for better protection.

While there is no foolproof way to shield your personal assets in every situation, there are some easy steps you can take to reduce the risk that a judge will allow a creditor to crack your nest egg. The key is to be able to show the world—and especially the judge—that your business has a life of its own apart from your personal affairs.

This list is not exhaustive and some of the items on it are more complicated than others. If you have any questions or concerns about any of them, call an attorney.

1 Maintain separate finances and keep scrupulous records.

The first thing a plaintiff’s lawyer will look for is any blurring of the lines between your personal and business finances. The most obvious step for you is to maintain separate bank accounts and financial records for your business affairs, but that alone is not enough. Are you paying for your spouse’s cell phone or your morning latte from your business account? Any use of business resources for personal benefit could raise doubt in a judge’s mind about the separateness of your business. And the same goes for using your personal assets to prop up

¹ As opposed to a shareholder in a corporation, or a partner in a partnership.

² A “disregarded entity” is the legal term for an LLC (or corporation) that failed to meet its burden of proving that its owners treated it as separate and apart from their personal affairs. Therefore a judge “disregards” the entity and allows the plaintiff to go after the personal assets of the members to satisfy any legal judgment.

your business without making the necessary accounting designations. The key is to keep them separate: personal assets for personal uses and business assets for business uses. Some blurring is inevitable, but talk to your bookkeeper or CPA about how to keep it to a minimum and how to correct your records when you do occasionally slip up and use a business account for a personal purchase or vice versa.³

2 Get insurance.

Keeping your business adequately insured is an excellent way to show that you're serious about the separate nature of your LLC. Not only does it create one of those "pots of money" for creditors to go after, it also creates a buffer for both your personal and business assets. And that's exactly why judges want to see it. Case law is filled with instances where the validity of the LLC turned on the existence or lack of a suitable business insurance policy.

Don't make the mistake of assuming that your homeowner's policy will cover your business assets and activities. Insurance companies are typically careful to exclude business activities from your personal policies. And if you offer personal or professional services of any kind, you should look into an Errors and Omissions (or Professional Liability) policy on top of General Liability coverage for your business. Be sure to find an insurance agent who truly understands your business and can tailor a policy to meet your specific needs without charging you for unnecessary coverage.

3 Draft a solid operating agreement.

One of the perceived "advantages" of an LLC over other business forms is that LLC laws don't require you to keep lots of formal documents like bylaws and shareholder agreements. The reason is that the LLC statute contains a set of legislative defaults that govern your business where you have a missing or incomplete operating agreement. Think about that for a minute. If you don't write your own operating agreement you still technically have one that was created by the legislature around 1994 with no knowledge of you or your affairs.

That alone should convince you that creating a custom operating agreement is a good idea. If you are part of a multi-member LLC, an operating agreement is downright essential to outlining the rights, duties, and relative ownership of the members. Even if you're a single-member LLC, however, a well-crafted operating agreement is still important to governing your relationship with third parties such as vendors and customers. Still not convinced? Think again about that plaintiff's attorney breathing down your neck. He would love nothing more than to stand before a judge and say "how can this person be serious about maintaining a separate business structure when she didn't even bother to draft a simple agreement to govern her business operations?"

You may also want to detail how you will take on new members if the opportunity arises, how you will obtain financing when necessary, and how you will wrap up the business's affairs if things don't work out as planned. Finally, banks and other lenders will usually require you to show them a copy of your operating agreement as a condition of obtaining a loan or even just opening an account, so it is a good idea to have one on-hand rather than scramble to create something on the fly.

4 Give yourself a clear way out.

Some of the most complicated and expensive disputes involving LLCs actually don't involve third parties at all. You've probably heard that business partnerships are like a marriage, and disputes between members of an LLC can get at least as nasty as the messiest divorce.

³ Keeping things separate is also required by state and federal tax laws.

Pick your cliché: The time to prepare for stormy seas is when the sky is blue; an ounce of prevention is worth a pound of cure; penny-wise, pound foolish. The bottom line is that the best way to ward off nasty disputes is to agree on the rules for resolving them when everyone is getting along. Once the dispute arises, emotions can flare and you'll often wind up paying lots of money to a lawyer to try to untangle yourself from a tough situation.

Member disputes are an area where the statutory defaults are particularly poor. They often require the unanimous consent of the members to make major decisions like the entry or exit of a member or sale of the business, and that unanimous consent is awfully tough to come by when personal relationships have deteriorated. Even when times are good, unexpected events like death, incapacitation, or bankruptcy can wreak havoc on a business that doesn't have clear language in its operating agreement to deal with them. The only alternative in many situations is the time and expense of hiring lawyers to go to court and persuade a judge to sort things out.

5 Sign your name properly.

John Doe, Member, Acme, LLC.

Every time you sign on behalf of your business, the printed text under your signature should look an awful lot like this. Why the formality? Even though your registered LLC is, in most respects, a separate legal entity capable of taking on a life of its own, it still needs its human components to actually carry out an action. Each time one of its humans acts on behalf of the company, there is an opportunity for ambiguity: is John Doe acting personally or on behalf of Acme, LLC?

Some actions, like driving to a business meeting but picking up your dry cleaning along the way, aren't easily categorized.⁴ Fortunately, the act of signing a contract allows you to be abundantly clear: "I am signing this document on behalf of my business, not myself." You still need to sign your actual name again, your LLC can't take action without a human actor. And it should be obvious by now that you also need to include your company name or else you've left things ambiguous. But you also need to state your official title within the company (ideally, the title granted by the operating agreement). This serves to show not only that you are signing on behalf of the company, but that the company has granted you authority to do so.

As with many of the items discussed in this article, the time when this will make a difference is when you or the company has gotten into trouble. As always, a plaintiff's lawyer is looking for any crack in the company armor and he'd love to try to exploit any ambiguity he finds in his client's favor. In fact, some businesses you contract with might be sneaky and actually try to create ambiguity on your signature line for contracts they've drafted. Don't be fooled. You shouldn't blindly accept anything in a contract created by another party, especially the signing authority. Feel free to scratch out whatever they've printed and replace it with the proper language. If the other business complains, you might want to re-think your relationship with them.

Note that some entities, especially banks, lenders and landlords, will ask you to accept personal liability in addition to company liability if you default on a loan or break a lease. You can try to negotiate around this, but as a small business you'll often have no choice. When you are presented with this requirement, try to ensure the contract is clear that the LLC is primarily liable so that the other party can only seek redress from you personally if and when the company can't satisfy the contract.

⁴ Whether it was one or the other usually doesn't matter, but if you get in an accident along the way, the injured party will try to categorize it one way or another to increase his ability to find a pot of money.

Conclusion

Hopefully you've identified the theme from this article: **if you want others to treat your business as separate from your personal affairs, you need to make it obvious that you are treating it that way yourself.** Obviously this is only a partial list of ways to do so. As your business grows, the complexity of the legal issues increases.

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